Developments Affecting the World Capital Markets

It is my pleasure to address the ISEEE members on this very important subject. I will concentrate on the challenges and concerns affecting developing and emerging markets that will influence the developments of the capital markets in these jurisdictions.

During the last year, the Egyptian Stock Exchange had achieved success in the area of upgrading corporate governance and disclosure. Such achievement was reported on "Doing Business Report" regarding minority investors' protection after the Egyptian Financial Supervisory Authority ("EFSA") issued its new listing rules on February 1, 2014 that were updated in December 2014. However, the Egyptian Stock Exchange has still challenges and concerns to address, tackle and solve. These challenges and concerns may also be present in other developing or emerging markets.

The challenges facing developing markets in general are as follows:

1. Ongoing debates regarding the legal status of the Stock Exchange (in Egypt) whether it should be government owned, mutualized or private sector owned.

2. Regulatory/regulator capacity building is one of the major challenges facing developing markets.

3. Growing IT/Cyber risks associated with dependence on technology in trading, clearing and settlement.

4. Challenges associated with dual listing; internationally or regionally.

5. Money market funds and central banks looking at them as "shadow banking". Who should be really regulating how they operate?

6. Growing burdens; smaller markets are shouldering in dealing with complex anti money laundry measures with FATCA continuously developing international financial reporting standards.

These are few of the challenges facing developing markets.

I believe that the Egyptian Stock Exchange will have to tackle the above six concerns hopefully during the next two years. However, until that happens, we would need to discuss with you and receive from you your feedback and experience on how a developing and emerging market like Egypt would address the above issues. It should be noted that the Egyptian market, as any other emerging market, is predominantly an "equity" market with very little "debt" listed or traded instruments.

Let me take each one of these issues and solicit your views on how we could benefit from your experience.

1. Debates regarding the Legal Status of the Stock Exchange

With the help of my dear friends, Don Calvin and Richard Bernard, the Egyptian Stock Exchange embarked in 2003 on an exercise of reviewing its legal status with the aim of recommending a new legal status for the exchange. The result of the exercise proved that the current legal status was vague and at best was a quasi government owned entity. The recommendation at that time was to mutualize the Stock Exchange to be in line with European stock exchanges such as the Stockholm Stock Exchange. However, the project was not pursued and the legal status on Egyptian Stock Exchange remains unclear, thus unchanged. We hope that the matter be reopened and pursued, taking into account the recommendation reached in 2003.

The question is whether the conclusion adopted in 2003 still holds?

2. Capacity Building Challenges for the Regulator

Capacity building in a regulatory agency is the identification and implementation of institutional and management processes that make regulation effective and efficient. The regulator is therefore obliged to plan and manage the regulatory functions that fully monitor market behavior and make the necessary adjustments to achieve optimum market integrity.

In this context, it is important that the regulator adopts organizational and managerial practices that enable the regulatory processes to be delivered in a way that lead to the highest level of administrative performance and an efficient caliber of management.

These capacity building challenges can best be addressed as follows:

- At the chief executive level – the need for sound policy formulation and good institutional design.
- At the managerial and staff level – good strategic planning, practical work systems and clear performance assessments.

These components can further be enhanced by analyzing and evaluating results produced from the above organization and management framework against the degree of improvement in all areas of:

- regulatory outputs;
- key skills;
- performance; and
- achievements.

The question is what was the experience of the developed markets in this area in order for emerging markets to adopt?

3. IT/Cyber Risks associated with Trading, Clearing and Settlement

The Egyptian Exchange ("EGX"), like any prominent stock exchange in the world, relies on software and IT connections in running its operation. By default, any software and/or connection has its glitches no matter how advanced and well installed it is. Nasdaq, London Stock Exchange and the like have all been victims of such glitches whether caused inadvertently or through hacking.

Trading

Trading on EGX is done through a sophisticated well established system developed by leaders in the industry. Information and data are entered into the system and processed by the pertinent software to satisfy the supply and demand of the securities and other instruments traded during the EGX session. This process is connected to the system of the clearing and settlement house represented by Misr for Central Clearing, Settlement and Depository ("MCDR"). On several occasions, the link between EGX and MCDR has been disconnected, leaving the EGX outdated in respect of accurate numbers and names of securities and instruments offered. This disconnection has resulted in the nonconformity between purchases and sales concluded during the EGX session. This problem is resolved through the involvement of the Investor Protection Fund created saliently to resolve analogous issues.

Clearing and Settlement

Clearing and settlement of all trading transactions are conducted within the MCDR system using its own software which, by default, would not be 100% intact given the natural vulnerability of software as per the above.

The question is how do other exchanges overcome the risks associated with this problem in its trading?

4. Dual Listing

Dual listing (also known as cross listing) is the listing of a company's securities on two or more different stock exchanges. This generally occurs when the company begins to establish an international presence by operating in other foreign countries. In this case, it becomes more advantageous for the company to be listed on an international exchange as well as on the domestic exchange.

This dual listing approach accomplishes two things for the issuer. First, it tends to increase the liquidity of the security because:

- there are more places to buy and sell;
- there are more participants in the market; and
- there is sometimes more time to trade the stock (if the stock exchanges, where they are listed, are in different time-zones).

Second, it helps the issuer to raise more capital by having more investors available from other markets, and consequently, gives the issuer more exposure. This, in principle, lowers the cost of capital and promotes the idea of efficient markets.

Another aspect of dual listing is that it has several effects on the security's price and volume. The most outstanding of these is the disparity in trading prices from one exchange to the other; triggering "arbitrage practices".

However, variances in listing requirements among exchanges, different accounting rules, and different market regulations often cause problems for issuers. For example:

- there could be special corporate governance requirements to be met;
- there could be complex legal aspects that arise;
- the security may trade at a discount in one market; or
- the security may be less liquid in one market.

The question is how was these problems addressed?

5. Money Market Funds

Money Market Funds ("MMF") provide a big source of credit and liquidity and thus play a major role in capital markets. MMF are considered investment products subject to securities market regulations and not to banking regulations. However, because MMF are sources for short term funding for banks, they are considered a "shadow banking system". Shadow banking is defined as "the system of credit intermediation that involves entities and activities outside the regular banking system".

In Egypt, the regulator for MMF is EFSA and not the Central Bank of Egypt ("CBE"). While CBE is not the regulator of MMF, it has started to introduce ceilings and breaks on the issuing banks tying size of the fund to bank equity and size of deposits (5%).

In amendments to the Executive Regulations of the Capital Market Law, EFSA introduced, in February 2014, such amendments aimed to limit some risks inherent to MMF by requiring the MMF to:

- Diversify its portfolios in instruments by not exceeding 10% of the fund assets in each instrument;
- The maximum tenor of the investment should not exceed 396 days; and
- The maximum weighted average maturity of the portfolio holdings of the fund not to exceed 150 days.

The question arises who should regulate the legal framework of MMF, should it be the central banks or the regulator for the securities market?

6. Growing Burdens in dealing with Anti Money Laundry Measures

The US FATCA Law, which has an extra territorial application, requires foreign financial institutions to report to the IRS, on specific dates, all US citizens or green card holders owning financial assets outside the United States.

Foreign financial institutions are defined as security broker companies, asset management companies, investment funds, depositories, mutual funds and real estate finance companies.

The reporting obligations place an additional burden on the different financial institutions operating in the emerging markets, especially when such reports have to be submitted (i) periodically and (ii) after obtaining the consent of its clients to disclose his/her accounts to the IRS.

The reports have to answer the questions in the form and be written in English which may be difficult for some local financial institutions to comply with.

At the beginning of 2014, EFSA issued a circular outlining the procedures to be followed to comply with FATCA.

It is premature to judge the outcome of the application of FATCA in Egypt or other developing markets, but the definite result is that it creates an extra burden on such markets.

The question arises as to whether such obligations could be limited to one initial report and the pursue of the matter may be done by the IRS directly with its citizens or green card holders.

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The above issues are some of the developments affecting capital markets in general and especially emerging markets.

I hope to receive your feedback on these issues.

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March 5, 2015