Trading in the Middle East:
The Road to Mecca

Rebecca Healey | V09:009 | April 2011 | www.tabbgroup.com

Vision

In the midst of political turmoil and civil unrest, the race is on in the Persian Gulf (the "Gulf") to overhaul market structures and increase foreign investment. Amongst the six GCC[1] countries which form part of this region, Qatar, and perhaps the United Arab Emirates[2] (UAE) are in line to have their MSCI Index classification changed in June 2011 from frontier to emerging market status.

Three other GCC markets – Oman, Bahrain and Kuwait – are also struggling to transform themselves. The Gulf needs to shift from petrochemical economies to commerce and finance to ensure long-term growth. Currently dependent on oil reserves, each nation requires varying degrees of investment to support sliding economies, but they are hampered by political infighting and entrenched culture. These sovereign states have competing markets but recognize that they must also cooperate to make the region more attractive.

The GCC states are aware that their market structures can work against them as it is hard to trade in size in these markets. If they are to grow, they must meet the expectations of foreign investors, such as modern technology, transparency, ease of access and the ability to get in and out of the markets efficiently. Yet for the Gulf States, these are not simple changes: politics, culture and faith all stand steadfastly in the way.

Much has been achieved in a short time. Most of the exchanges were only formed post-millennium and have yet to reach a decade of trading. But this is a race against time. Next door lies the sleeping giant, Saudi Arabia, the sixth GCC state currently closed to the rest of the world (see Exhibit 1). If Saudi Arabia decides to open its doors to foreigners and modernise its market structure, it will overwhelm the rest of the region with the sheer size of the investment opportunities available.

Exhibit 1
Map Showing the Six GCC and Surrounding Middle Eastern States

All the measures being taken by the exchanges will help to improve the maturity of the GCC markets and eliminate as much risk as feasible

[1] The Gulf Cooperation Council is a political and economic union of the United Arab Emirates (UAE), Bahrain, Saudi Arabia, Oman, Qatar and Kuwait.

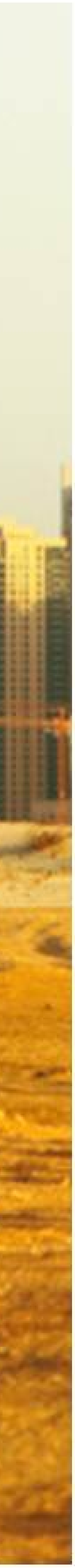
[2] The United Arab Emirates comprises three markets: Abu Dhabi, Dubai Financial Market (DFM) and Nasdaq Dubai.

through the introduction of delivery-versus-payment (DVP) and central counterparties (CCPs). In addition, the introduction of the Financial Information Exchange (FIX) Protocol throughout the region demonstrates a willingness to comply with international standards and procedures not previously seen.

However, whether the initiatives under way will be enough to attract the required flow is another question. The exchanges know that in order to regain the confidence of international investors, they have to move faster. They are aggressively tackling a diminishing market share in a shrinking world economy and losing out to other emerging markets.

With inward investment flows remaining a frustrating mirage for those states who want to transform the region’s capital markets, it is not clear whether o*ne* financial hub will emerge from the desert sand or whether a pan-regional exchange would offer a greater chance of survival in these testing times. Yet there is a heavy opportunity cost for waiting to act in unison.

With the Kingdom of Saudi Arabia toying with the increasing clamor to open its gates to foreign investors, the other GCC states know that they have a limited window of opportunity. The danger being that if they wait for Saudi Arabia to decide on their course of action, they may be waiting a long time. The Kingdom could yet still dominate events.



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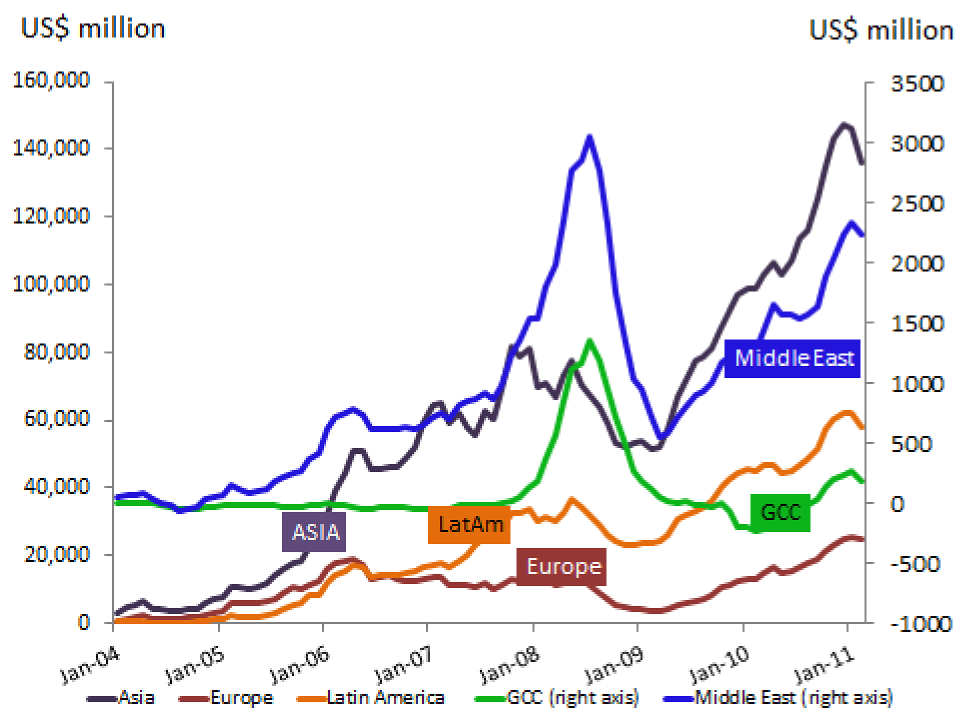
Introduction

In the never-ending search for alpha, growing numbers of investors are increasingly looking to the emerging market economies whose higher GDP growth rates present some of the most attractive opportunities available in current market conditions. Their inefficient market structures ironically also create opportunity, as spreads are wide and there are fewer competitors, yet they also act as barriers for many long-term investors.

Regulatory uncertainty, coupled with sluggish GDP growth in developed markets, has fuelled investment in the emerging market economies, yet fund flow trends lag dramatically in the GCC countries in comparison with other emerging markets (see Exhibit 2).

Exhibit 2
Global Fund Flows into Emerging Markets, 2004-2011



Source: EPFR, TABB Group

Appetite for investment into the region is strong primarily due to its abundant natural resources. With over 50% of the world's oil reserves, the combined gross domestic product (GDP) of the GCC countries is projected to reach a record $1.1 trillion in 2011, fuelling a huge growth phase with big investment opportunities. However it remains difficult to invest in the region. Investors are frustrated by legacy retail markets which are characterized by low liquidity, extensive and complex regulation, information leakage, and limitations on foreign ownership. Politics, culture and technology also act as substantial barriers to further investment by Western institutions.

As a result, the Middle East has yet to see much of the fund flows that have been going into other emerging markets. The Dubai debt crisis in 2009, which led to the financial crash of Dubai World, the Dubai government's investment management company, resulted in major losses for overseas investors; and the more recent political unrest has sent would-be investors fleeing back to the side-lines.

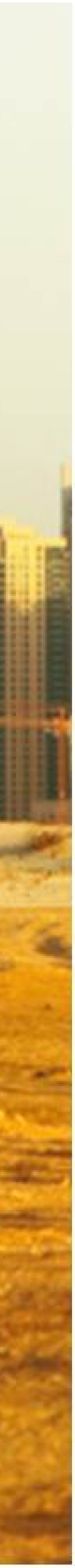
Arab markets saw just 27 IPOs in 2010, raising $2.7 billion, versus only 17 issues, raising $1.98 billion, the previous year; this is scant growth for such a rich region for investment. Recent political changes will make it even more key for the exchanges to attract international investment; in the space of five weeks, the market capitalization of sixteen Arab bourses plummeted 16% to $862 billion, and it is doubtful that local investment alone will lead to a market recovery.

Although only 10% of trading on the Saudi Arabian market is classified as institutional, and Dubai and Abu Dhabi are just modestly higher at about 21% and 23%, respectively, the definition of a "retail" investor in this region might qualify many such investors as institutions in their own right elsewhere, given the relatively large number of ultra-high net worth individuals. However a typical GCC "retail" order size is still lower than a western institutional order size and may be traded differently. In order to increase order flows, the GCC exchanges cannot rely on domestic retail flow alone.

The GCC exchanges now realize that they must act, but they have yet to figure out whether they will fare better by acting in unison or independently. It is also not certain whether they are able to work successfully in unison. The GCC comprises competing sovereign nations that agree, then disagree constantly; squabble politically; and have very different cultural views that stand in the way of strategic business alignment.

As foreign investors knock at the door to take advantage of current prices, and banks look to offer new services, the race is on in the Gulf's exchanges to change their market structures, as they compete both with each other and with other emerging markets.

In addition, Islamic Finance is another important vehicle to drive investment in the region. With the Islamic Global Equity Index now at $1 trillion in assets under management, and 60% of assets concentrated in the GCC, new product development is attracting significant investor interest, given the poor returns of late in traditional Sharia-compliant products. It has become ever more critical for Islamic banks to have a far greater range of Sharia-compliant products in which to invest.

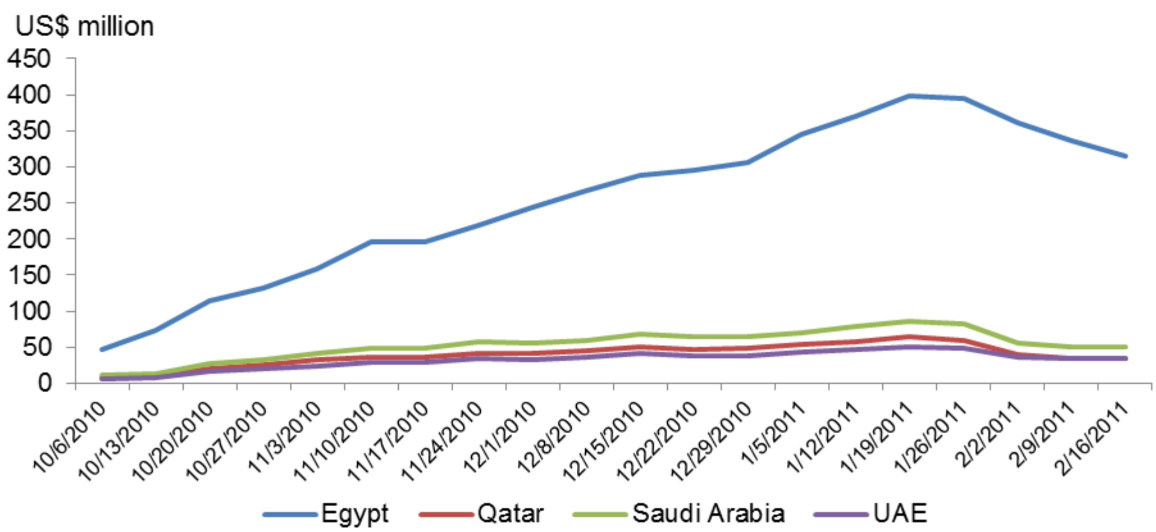


Game Changers in the Gulf

Two things will trigger major investment and trading shifts in the Gulf region: MSCI re-classification and Saudi Arabia. The MSCI Index re-weighting scheduled for June 2011 is expected to be a game-changer for the successful GCC states. If they are successful in being reclassified from “frontier” to “emerging market” status, Qatar and the UAE expect combined inflows of up to $5.4 billion out of the $380 billion invested in emerging markets funds. This will have a ripple effect throughout the region. In stark contrast, Saudi Arabia is the only G20 nation to hold unclassified status. MSCI announced in July 2010 that it would drop all indices with Saudi stocks after failed negotiations over the licensing of information, leaving investors to access the Saudi market via Participation Notes.

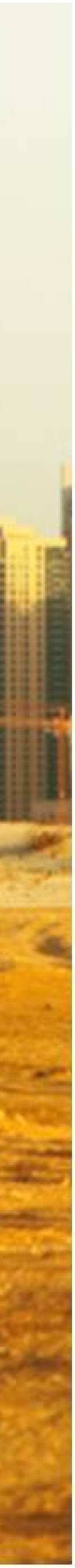
Egypt is currently the only MENA market to hold emerging market status, and has enjoyed significant investment throughout 2010 (see Exhibit 3). Although fund flows have recently left Egypt due to political unrest, and contagion may temporarily affect the region as a whole, countries such as Qatar and the UAE could benefit with their more stable economies and huge anticipated double-digit GDP growth. The recent political unrest has had a strong upward impact on the price of oil, which will further GDP growth, as seen previously in 2008.

Exhibit 3
Fund Flows into Egypt, Qatar, Saudi Arabia and UAE, 2010-11



Source: EPFR, TABB Group

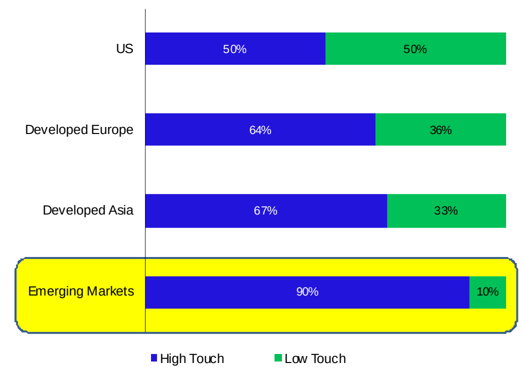
The GCC exchanges are changing their market structures out of both opportunity and necessity. With the MSCI re-weightings being so critical for foreign investment, a unique opportunity has emerged to tackle the current market access issues and fundamentally change the structure of the GCC markets. For the smaller states not in the running for MSCI re-weighting, the need to boost their liquidity both nationally and regionally is forcing change, or they run the risk of sliding into oblivion. Despite the recent political unrest having a strong upward impact on the price of oil which will increase GDP growth, volumes are



down 70% since the highs of 2007-2008, and there is fierce competition for the remaining volume.

Investment for Westerners is expensive and difficult. They lack the tools and access to trade themselves, as well as the visibility and knowledge to manoeuvre around the nuances of each market. Market access and restrictive regulation are a primary hindrance to the development of trading in the region. Individual market volumes are too small, the inability to sell short and borrow stock severely hampers liquidity, foreign ownership is limited and the red tape is a logistical nightmare. Even in emerging markets countries where low-touch trading is possible, high-touch trading still accounts for the vast majority of institutional flow (see Exhibit 4).

Exhibit 4
Estimated Trading via High- and Low-Touch Channels for US Investors



Source: TABB Group

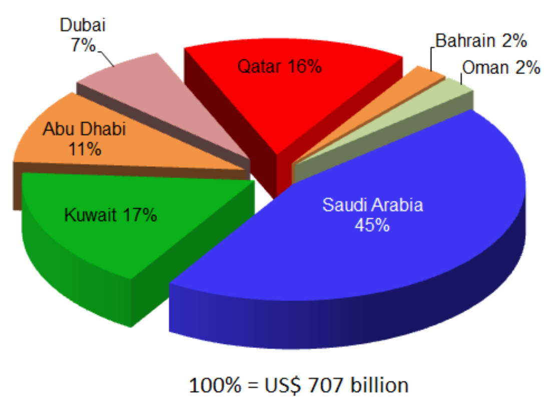
For investors and traders who expect transparency, electronic access, delivery against payment and a market structure that supports investment rather than acts as a hurdle, trading in the region needs to improve.

Irrespective of the MSCI outcome in the summer, certain basic regulatory issues need to be addressed now in order to attract institutional liquidity to the region once more. It remains the classic chicken-and-egg scenario: without the liquidity, investors are reluctant to become involved; without the mainstream investor flow, liquidity remains limited.

The Arabian Shuffle

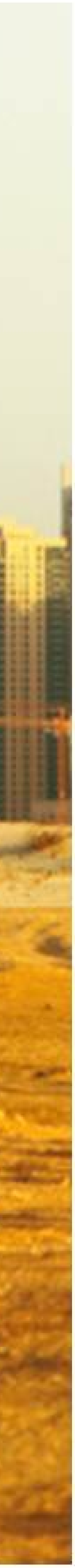
As the GCC states try to move forward, they are keenly aware of the one partner everyone in the West wants to dance with: If Saudi Arabia chooses to open up to foreigners wanting to invest in its massive infrastructure, it will dwarf the main players in the GCC world (see Exhibit 5).

Exhibit 5
Market Capitalization of GCC Markets



Source: Industry sources, TABB Group

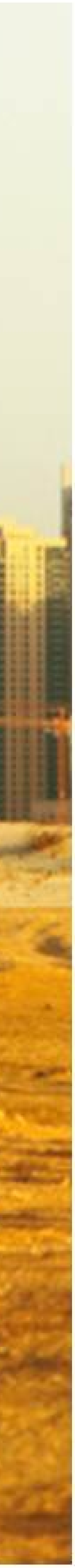
Rumours abound that the Kingdom of Saudi Arabia will open its doors by the year's end. Public expenditure in the GCC will surpass $300 billion this year due to higher oil revenues. Most of this is expected to be in Saudi Arabia, the



world's top oil exporter and largest Arab economy. With a much higher market capitalization than all of the other markets in the region combined, international interest is firmly focused on Saudi Arabia.

There have been active discussions over the last six months regarding the implementation of a custody and settlement system that would accommodate Western investors, but anticipated announcements have not been forthcoming. Much will depend on the trade off between the need for investment due to hitting the point of "peak oil" production and the culture clash between Saudi Arabian and Western capital markets structures.

However, Saudi Arabia will dictate the rules, potentially overriding much of the innovation and progress made by other countries. Given the internal squabbling over the Regional Headquarters of the GCC Monetary Union, one thing is certain: if Saudi is at the table, all bets regarding any kind of pan-GCC exchange will be off again until a suitable face-saving compromise can be found.



MSCI Re-Weighting: Gateway to Growth

For Qatar and the UAE there is no benefit in waiting for Saudi Arabia to decide on its course of action. Now is the time to act. With the MSCI Index re-weighting to Emerging Market status offering a potential prize of $5.4 billion, the areas of immediate concern are Foreign Ownership Limits (FOL) and the lack of formal segregation between custody and trading accounts.

Foreign Ownership: Solid Ground or Shifting Sands?

Easing restrictions on foreign ownership is a difficult issue being tackled throughout the region; a resolution of these issues is critical to enable growth. There are differing views as to what extent FOL will have to be adjusted, given that there are apparently no hard and fast rules. However, both the Qatar and UAE Exchanges are having extensive discussions to address the issue and balance the considerations of both investor and the invested (see Exhibit 6).

Exhibit 6
FOL Considerations

East	West
FOL differs per country and is usually decided by each company	The level will affect the investment decision due to the ease of investing and de-investing
"Strategic sectors" are off limits to foreign investors	Investors tracking indices will have a true representation of the market
Loss of corporate control over the stated valuations	Foreign investors demand transparency and disclosure
Local companies fear 'hot money' damaging balance sheets	Greater participation will increase liquidity

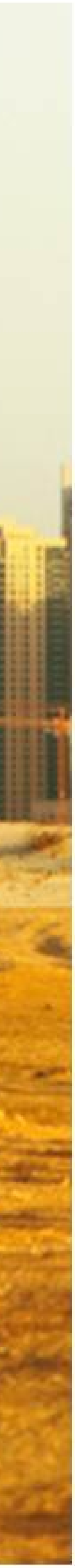
Source: TABB Group

Maintaining FOL may act as a barrier for Western institutions, which struggle to fill orders when the threshold is approached. Not only does the limit create a segmented market, but it also radically affects the portfolio manager's willingness to invest in individual stocks, since ease of investment and de-investment is part of the decision.

In addition, there are stocks which are considered to fall under "strategic sectors" which remain off-limits to foreign investors, such as the telecoms giant Etisalat, one of the eight large-cap stocks on the Abu Dhabi exchange. Of the $1.5 billion investment an MSCI re-rating is anticipated to provide the UAE, 30% could be erased unless investors use alternative access products.

In Qatar, FOL stands at 25% of free float. There have been suggestions that this limit could move to 30% of shares outstanding, and the change could happen overnight if the Emir issues a decree to this effect. There are other corporations who are pushing to lift the limit to 49% so that they can attract much-needed capital and thus enhance liquidity.

In the UAE, a Federal Decree has already put FOL at a maximum of 49%; however, each individual company can issue its own limit from 0% up to the 49%. A Companies Law which would apparently increase the overall limit to 75% was originally scheduled for October 2009 but is still under discussion.



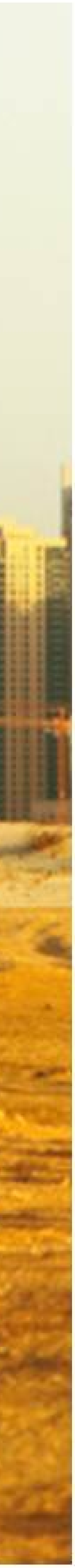
Despite the clear downside of highly restrictive FOL on publicly-listed corporations, stark cultural differences in the way business is transacted in the Gulf region mean that not every company wants or needs foreign investment. Indeed, no matter where corporations are listed, transparency and disclosure are not eagerly embraced. Increasing FOL limits will boost interest and liquidity, resulting in healthy trading conditions and a more-accurately valued share price. However there are companies who are accustomed to controlling the value of their assets and who oppose opening the books to prying investors. Some view Western institutions as flighty “hot money” investors who damage company balance sheets. Increased volatility in MENA names with higher foreign ownership limits have not helped allay suspicions.

DVP: Where There Is a Will, There’s a Way

One area that the exchanges have been able to address is DVP. The Qatar Exchange has recently announced the introduction of full DVP effective from April 14th 2011.The Emirates Securities and Commodities Authority (SCA) has announced that stock markets in the UAE will also start operating the DVP from April 28th 2011. This reflects the commitment of the GCC to developing the local securities market infrastructure and to adopting the best international practices in order to move further towards the MSCI re-weightings.

Custodians will now have the ability to confirm or reject trades for settlement, whereby cash and securities settlement obligations for rejected trades will remain with the broker for settlement. This ensures that custodians have full control of securities, thus making it optional to operate dual accounts. They also plan to implement a central counterparty as part of their strategy to enhance their post-trade infrastructure.

The apparent ease with which DVP has been introduced is a clear indication of just what the exchanges can achieve when they need to do so.



A New Dawn?

Whilst achieving the MSCI re-weightings will no doubt boost interest and fund flows to the region, it is not yet a guarantee of success. The reality remains that all GCC markets are legacy retail markets which do not fit well with the current Western institutional flow model. If they are to attract this flow and boost liquidity, further change is required. However, they are making a bold attempt at not only attracting international investment but also creating more opportunity for Islamic investments.

Each GCC state is implementing change to its market structure, but the extent and pace of progress are largely based on political and cultural appetites locally. Further options being considered or in progress include:

- Expanding electronic trading and upgrading platforms;
- Developing market-making models and shorting capabilities; and
- Harmonising regulatory rules to allow for further product launches, primarily derivatives and Sharia-compliant structures.

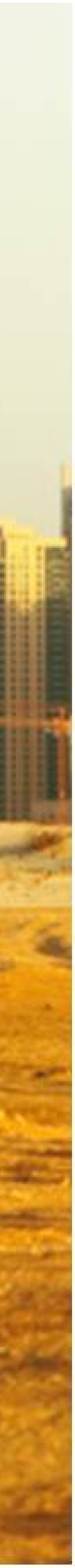
The Gulf in Electronic Trading

In line with more-developed markets, more than 80% of order flow now reaches exchanges via the FIX protocol. Technology is state of the art; exchanges are overhauling platforms, improving access, and attempting to improve the flows in anticipation of volume growth.

Local exchanges have teamed up with established global players with experience and best practices, implementing state-of-the-art systems that are able to handle high volumes of orders, and have greater liquidity and ease of trading (DFM, Nasdaq Dubai and Kuwait with OMX, Qatar with NYSE Euronext, etc.). Technology is now available across all asset classes; Bahrain Financial Exchange has introduced e-Tayseer, an electronic online product that streamlines previously complex Shariah-compliant liquidity management transactions from up to 10 legs into one seamless transaction through a fully automated process. Even high-frequency trading has now been translated into Arabic; the Dubai Gold & Commodities Exchange offers low latency of 120 milliseconds round-trip, and there are expectations of HFT in equities in the future.

Further encouragement comes from local brokerage houses and buy-sides increasingly “going electronic” in their trading rooms, eliminating paper and replacing the phone with electronic screens and order routing systems that give them a global reach.

Local equity trading is now widely conducted via DMA. With local understanding of the market nuances, DMA has become essential in certain names and certain stocks, which suits aggressive one-way markets. One local broker now sees



95% of regional institutions trading DMA. Although DMA trading is on the increase, international investors still predominantly send orders via FIX or Instant Messaging systems. In contrast, the retail investor in Saudi has been able to trade direct from his mobile phone using DMA for several years now.

However the perception in the West is that there is still no real electronic market to speak of. This has little to do with technology and everything to do with regulation and market structure.

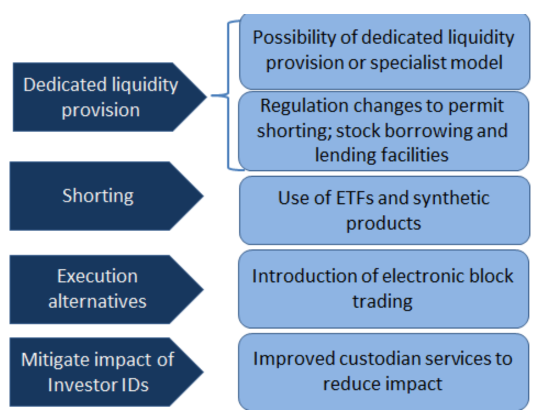
Due to the legacy retail market, it is nigh on impossible to trade volumes in the same way that Western institutional investors do currently in developed markets. A trader cannot enter multiple orders in an individual stock, as there can only ever be one order per price point per National Identification Number (NIN). As with most electronic order books, cancel-and-replace orders lose priority in the queue, but there are minimum ticket or cancellation charges as well. This makes working a number of larger orders over the day prohibitively expensive. There are no real visible trading patterns or predictive cycles; therefore algorithmic orders with traditional benchmark instructions are difficult to achieve in a region typified by low volumes and wide spreads.

Opening the floodgates to increased funds will not necessarily equate to a flood of Western institutional order flow. Liquidity needs to be increased and market structure adjusted before algorithmic trading can take off in its current form.

Liquidity Provision: Creating an Oasis

The exchanges are aware that more needs to be done to facilitate liquidity in the region and as such there are a number of initiatives that they are looking to implement (see Exhibit 7).

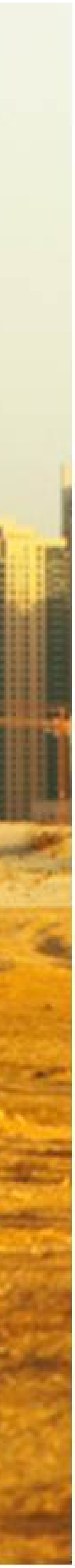
Exhibit 7
Initiatives to Improve Liquidity



Source: TABB Group

One critical aspect to building a more robust market is putting a market structure in place that can support stocks across a wide spectrum of liquidity levels. Market-making facilities are widely recognized as being critical to the success of exchanges in the developed markets. Volumes are currently so thin in the primarily retail markets of the Middle East that without dedicated liquidity providers, the exchanges may struggle to attract the extra liquidity they need in order to encourage further trading activity. Alternatively, or as well, a specialist system may be considered, particularly in less-liquid stocks to ensure consistency of liquidity.

However, the GCC states must first create true shorting capabilities. Shorting is not only necessary to enable market-making, but also to bring the efficiencies of short selling to what can be a dangerously one-sided market. Whilst there are



currently no rules regarding short selling per se, the fact that all trades have to be pre-validated means it is impossible to short the market physically. Abu Dhabi, Qatar and Nasdaq Dubai are all planning to introduce stock lending and borrowing facilities. New rules may pave the way for short selling to be offered regionally at the end of 2011, but the exchanges are in a hurry, and are looking at different ways of addressing the problem. ETFs, or Delta One products, including swaps, are being used to short stock, with brokers lending out their own inventory.

It is also critical that the exchanges support execution facilities that cater to institutional investors, particularly the ability to cross large block trades without necessarily needing to interact with the retail side of the market. Abu Dhabi is a leader on this front, with the recent introduction of “Big Block.” But this execution alternative has had limited traction because it is only available for trades over 1% of the capital of the company. The initiator of the trade must be only one individual; however, the counterparties can consist of a multiple of up to 10 other participants. This would appear to be a model better suited to Government placements rather than the block trading model used by mainstream traders in developed markets.

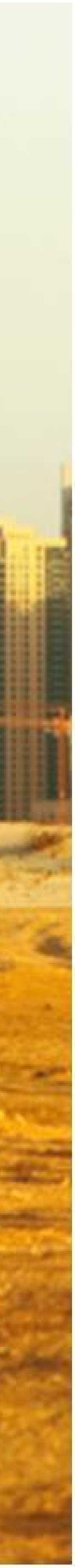
Last but not least, the exchanges need to reduce their pricing. Per-execution charges by the exchanges, coupled with high cancellation fees, make trading expensive and inefficient. Victims of the legacy retail market, locals tend to use brokerage services rather than pay separate custodian fees currently. As a result, execution fees can be two or three times higher in the Middle East than in other emerging markets such as Israel or Poland, although increased competition should drive costs down over time.

Lifting the Veil on Trade Allocations

Investor IDs are required down to the individual fund level for all orders prior to trading. This enables the exchanges to control FOL. However, for Western institutional investors, this remains the most cumbersome pre-trade requirement and significantly adds to the difficulty of trading in the region.

Instead of being able to route one parent order, individual child orders have to be sent, which may or may not all be executed. It is impossible to receive an average price for an order allocated across multiple funds without after-hours back-to-back trades with a local custodian, which can easily decimate any alpha made on the trade.

Whilst it is highly improbable that the exchanges will move away from the unwieldy Investor IDs, as this falls under the auspices of individual regulators, they will offer multiple custodian services as a method of easing the process and reducing the red tape where possible. However, this Band-Aid solution will not sufficiently address the concerns of the international investor. It is likely to remain a stumbling block in the region’s quest for additional investment.



Derivatives and Sharia Compliance

Although foreign investors would willingly invest in existing companies already listed on the GCC exchanges, the introduction of derivatives to get around FOL and Sharia-compliant products are examples of product innovation that offer more ways of investing and manoeuvring around the current restrictions.

Nasdaq Dubai launched the region’s first exchange-traded equity derivatives platform in 2008. Other regional exchanges are now looking to follow suit with further derivatives products, including ETFs. Abu Dhabi listed the first ETF in the region and will be listing only UCITS-compliant ETFs in order to attract foreign and institutional investors, with a focus on ETFs whose underlying stock is restricted under FOL. Whilst the use of derivatives has yet to make much headway in the region, the MSCI re-weightings may provide renewed interest for those stocks which still remain out of reach.

While many other countries, such as Malaysia and Indonesia, also operate under Sharia law, the Gulf States have the most stringent interpretation. Every new product requires approval by the Imam, the local religious leader, and thus Sharia compliance is subject to an individual’s interpretation of Sharia law. To shorten the timeframe and introduce standards, mutual recognition agreements are now being put in place by bodies in Bahrain, and Dubai with Malaysia. These standards will enable new “Sharia-compliant” products to be created.

A Pan-Regional Exchange

While there are many changes in motion, each has an associated cost and no guarantee of success. The GCC exchanges therefore face the dilemma of survival of the fittest vs. safety in numbers. The rationale behind a collaborative effort is indisputable: strength as a block to rival potential global exchanges, lower cost of trading, common and improved settlement, and deeper liquidity pools with a single point of access. The exchanges across the Gulf are already collaborating to some degree as they recognize that there is already too little flow and activity to sustain sixteen exchanges across the entire region.

In conversations with institutional investors, hedge funds and brokers, there is a unanimous belief that a pan-regional exchange would open up the region to trading and boost liquidity. A unified platform, common liquidity pool, CCP, market hours, single set of rules and a single investor ID would be a very welcome improvement to the current messy trading environment.

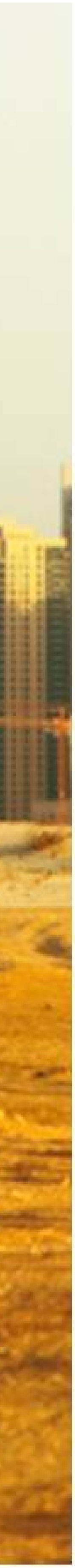
Investors are ambivalent about whether this pan-regional exchange would be virtual or real, and the result may be a little of both. Some mergers are more likely. Nasdaq Dubai recently merged its market model with that of the Dubai Financial Market (DFM), lowering the cost of entry and increasing the liquidity pools for both regional and international members. Both Nasdaq Dubai and DFM have been working closely with Abu Dhabi and their two regulators to grow the UAE capital markets as a whole by aligning their strategies. There is pressure from some quarters, including the regulator, to merge the exchanges to create a large single market with unified regulations and a wider range of stocks to trade.

By implementing NYSE Euronext's UTP platform, Qatar plans to leverage a strategic partnership by tapping into the global liquidity network, while adopting best international practices and standards. Maintaining access to one NYSE connection rather than to a number of local broker relationships or individual exchanges could be both cost-effective and efficient, and ease counterparty risk.

BFX: The Biggest Idea from the Smallest Country

Curiously little known outside the region, a pan-regional exchange was launched on February 7th 2011 by Bahrain, the smallest GCC country. The Bahrain Financial Exchange (BFX) is a multi-asset exchange offering trading in both conventional and Islamic products in equities, derivatives, commodities and currencies. Modelled on the upstart European multilateral trading facilities, the BFX challenges the status quo by offering greater flexibility and access across a broad range of products for the end user.

However, it launched straight into the headwinds of civil unrest, as violence forced the shutdown of the exchanges. Trading is currently scheduled to begin for the end of April 2011. The ambitions of this pan-regional exchange are impressive, having announced in June 2010 a licensing agreement with the FTSE



Group which would allow it to list, trade and market derivatives products based on a range of FTSE's regional and international indices. In launching a pan-regional exchange, however, Bahrain is once more staking a claim as a major financial hub in the GCC region.

Given the current political state of Bahrain and the lack of unity in the region, it will be a challenge to realize the ambitions of this pan-regional exchange, although the die has been cast in that direction and few doubt the benefits of such a venture.

Technology upgrades throughout the region prove that the once-impossibility of a pan-regional GCC exchange now could at least become a physical possibility, if only a faint political one. Yet with the continuation of merger mania globally, this may be the only route forward. It is likely that if one dominant player emerges, the other GCC countries will unite behind one regulator, forcing a possible single exchange to be developed. However, few are convinced of the GCC's ability to achieve the level of cooperation required. Given that Qatar already only has a single exchange and that the UAE needs to resolve internal differences over the current three exchanges, some exchanges would appear to have a natural head start over others.

Conclusion

This is a time for change for the Gulf States both politically and economically. The race for MSCI emerging market status, and the search for alpha and liquidity are forcing sweeping changes across the Gulf.

Exchanges clearly want to compete for the flow they would appear to be missing out on, and there are those who feel that achieving the MSCI Index re-weightings will help to them obtain this. With this in mind, the exchanges have either addressed or are in the process of addressing the conditions imposed, which include FOL and DVP.

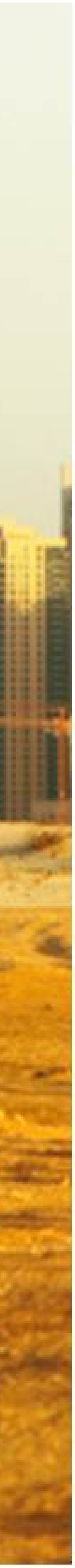
However, the required changes are also forcing questions that need to be answered. The thorny issue of foreign ownership limits presents major cultural issues, and some Gulf States do not want strategic companies being owned by foreigners at all. Some are interested in foreign investment but are not prepared to relinquish any control; others are keen to open the floodgates and offer limitless foreign ownership.

Even if MSCI Index re-weightings are achieved, this is no guarantee that all the flow will come. The gulf between how Western institutions choose to trade and the myriad of difficulties in trading this legacy retail market may just be too wide. So the exchanges are working to change the rules where they are able to do so. Together with the sell side adapting the rules where possible, the flow may yet increase.

The GCC states now have to move at different speeds, and a two-tier multi-structured region will make it much harder to achieve any kind of cooperation. If the exchanges cannot even agree on *whether* they should cooperate, they will struggle to agree on *how* they should cooperate, even though every exchange knows that this cooperation is required.

If one exchange pulls away from the pack, the others – particularly the smaller states – risk being left behind with fewer cards to play and even less ability to act in unison. There are those who can see the potential of safety in numbers and the reasons for integrating into a pan-regional exchange are compelling. But then there are the politics. Historically stricken with best endeavors, the potential of the Gulf seems to remain tantalizingly out of reach for the moment.

It remains to be seen whether the GCC states are a group of nations able to unite as a regional force, or whether it comes down to those who have enough oil to sustain their economies being able to ignore Western institutional flow. Dubai clearly wants to establish a stock exchange capable of achieving international standards of capital-raising. Bahrain, once considered one of the financial centres of the GCC but hardest hit by the political unrest, must now reinvent itself in the wake of two weeks of violence and tank damage. This is the bitterest

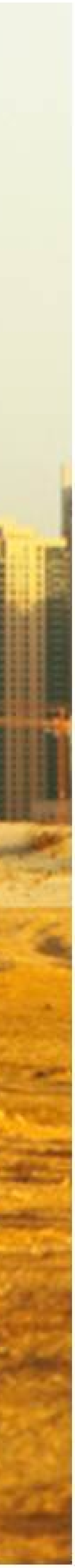


pill to swallow for a country with such high international ambitions. And then there is Saudi Arabia, who will dominate whatever it decides to do.

Even if the necessary political will and unison between the states is achieved, without the required regulatory changes the Western institutional fund flows will not necessarily increase. Tinkering around the edges of market structure will not solve the fundamental problems of market access and lack of liquidity, but the exchanges are aware of this.

There is hope. For all the complaints made regarding the difficulty of trading in the region, the Gulf states have shown just how much can be achieved in such a short time. In comparison to the developed markets trading over hundreds of years, the speed and depth of change in the GCC market structure has been extremely impressive.

There is still everything to play for.



About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of *first-person knowledge*, TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their business.

TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, go to www.tabbgroup.com.

The Author

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Rebecca joined TABB Group in March 2011, bringing more than 15 years' experience in E-Trading and Financial Services. Rebecca has held various positions in Sales and Trading positions with Bankers Trust, Goldman Sachs and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European Cash Equity Markets and covered Sales Trading into Asia and then Europe from 1997 to 2000. More recently, Rebecca was based in the Middle East from 2008 to 2010. There, she was employed by the British Embassy in Bahrain, where she successfully launched the UK Government's Financial Services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic Finance.

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