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Egypt National Investment Reform Agenda Workshop

Financial Markets Session: Improving Capital Market Mechanisms

Draft Background Paper

This document provides a background for discussion of the National Investment Reform Agenda Item 'Capital Market Reform'. This session will focus on the recent developments in Egyptian capital markets, and in particular on measures to improve capital market mechanisms, such as Primary Dealers System for Treasury Bonds, Margin Trading and Short Selling, and financial derivatives.

I. Development of the Capital Market

1. Established in 1903 and 1883 respectively, the Cairo and Alexandria exchanges showed no significant activity until the 1990s. In fact, the Egyptian capital market was underperforming until the passage of the Capital Markets Law that removed restrictions on foreign investment and introduced changes into primary and secondary markets, and the re-opening of the Cairo and Alexandria stock exchange in 1993. After the enactment of the law, the Cairo and Alexandria exchange started growing rapidly, encouraged by changes in the regulatory environment and privatisation.

2. Since the 1990s, the market has been experiencing a revival. In 2002, market capitalisation as a % of GDP reached 29%, up from 21% in 1996. Market capitalisation has been particularly on the rise in recent years and as of 2005 it rose to 85%. Investor confidence has increased substantially, in part due to the resumption of the privatisation program by the new Cabinet and the launching of several high-profile initial public offerings. Foreign investor participation in the market has also improved noticeably, from a daily average of 16% in 2001 to 35% in 2005.

3. In 2006, the market is witnessing a more active trading activity, even as compared with 2004 and 2005, with a total number of transactions for the period January-April reaching 2.2 million and average monthly value traded reaching EP 29,480 million. Market activity in the recent years has been fostered significantly by privatisations, IPOs and new listings that began with Raya Holding, and continued with Alexandria Mineral Oil, Sidi Krir Petrochemicals and Telecom Egypt. These IPOs attracted more than 200,000 new investors to the market, substantially enlarging the investment base.¹ While many listed companies originated from Egypt's privatisation program, the State continues to play an important ownership role in many listed companies to date.

4. International indices also show that the performance of the market increased by 278.6% on average during 2005. Local return on CASE 30 rose to over 110% for the period January-October 2005. Volume and value of trading have also been demonstrating tremendous growth. Value of trading reached EP 83.5 billion in comparison to EP 32.4 billion in the previous year (a growth rate of 158%). Additionally, foreign purchases reached EP 19.8 billion in comparison to sales of EP 12.3 billion, implying that foreigners are net buyers in the Egyptian stock exchange.

5. However, the activity of the capital market has been uneven in the recent months. After two years of relatively constant growth, the market witnessed a slowdown and even a gradual dip of nearly 20 percent in February, but most analysts attributed the decline to profit-taking and believed there was still room for growth. The Egyptian capital market has dropped by 16% on March 14 this year in a market correction which has caught investors surprised. The drop in March was so abrupt as to halt the trading session. The reasons for the sudden drop of the Egyptian stock market have been disputed.

6. Market participants in Egypt have long called for the introduction of new mechanisms and instruments to reactivate the market, and are keen to remove the current limits imposed on intraday trading. To pave the way for their introduction, the Minister of Investment, H.E. Mahmoud Mohieldin, issued ministerial decree No. 192 in June 2005, which adds a new section to the executive regulations of Capital Market Law no. 95 of 1992 to organize margin trading and short selling. Market players are positive about the perceived benefits of margin trading, same-day trading, and short selling.

II. The legal framework

¹ All three offers were heavily oversubscribed.

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A key legislation regulating the Egyptian capital market is the Capital Market Law 95 of 1992. This legislation also provides the framework for supervision of the stock exchange and market intermediaries. The Capital Market Authority can draft new secondary regulations, which are issued as decrees of the Minister of Foreign Trade. Executive rules and regulations have been issued to address disclosure, stock exchange listing, minority shareholder rights, and securitization. The Central Depository Law 93 of 2000 regulates shareholder record keeping, clearing and settlement. The following table outlines in detail the legal framework of capital market regulation²:

Law	Description	Future Plans
<p>The Law on Joint Stock Companies, Limited by Shares Companies and Limited Liability Companies (No. 159 of 1981) or the "Company Law."</p> <p>The Investment Guarantees and Incentives law (No. 8 of 1997).</p>	<p>Company Law 159 establishes the basic company forms.</p> <p>Law No. 8 was designed to boost investments in various economic sectors and specific industrial zones through income tax exemptions of 5, 10, 20 years or permanently in tax-free zones. In all other respects, companies established under this law use Law 159.</p>	<p>The government intends to develop a new company law to replace the current laws and dispersed provisions and to place all companies of different types in Egypt under a unified, modernized regulatory system.</p> <p>A draft law has been in preparation since 1998.</p>
<p>Capital Market Law (No. 95 of 1992) and its executive regulations.</p>	<p>The Capital Market Law regulates the capital market, provides the legal framework for the Cairo and Alexandria Stock Exchange, and regulates the incorporation and operations of market participants.</p>	<p>The Capital Market Law was redrafted for submission to the People's Assembly. The current position of the government is that most of the changes in the draft law could be introduced by executive regulation in the existing law and through the CASE listing rules. Therefore, the introduction of the draft capital markets law has been given lower priority.</p>
<p>The Central Depository and Registry Law (No. 93 for the year 2000) and its executive regulations.</p>	<p>The Central Depository and Registry Law establishes the MCSD and provides the rules for shareholder recordkeeping, custody, and clearance and settlement. The law went into effect after its executive regulations were issued by the Minister of Foreign Trade (No. 906) in November 2001.</p>	<p>No revisions planned.</p>
<p>Accounting Practice Law (Law 133 of 1951).</p>	<p>The Accounting Law governs professional accountants and auditors, particularly in the private sector. Governs registration / licensing of accountants and auditors, provides a broad framework for bookkeeping and financial reporting, and authorizes the Ministry of Finance to develop a standardized chart of accounts and detailed instructions on the accounting treatments and reporting formats.</p>	<p>Law considered to be outdated by most practitioners.</p>

III. Key Institutions

² Cited from IMF-World Bank Report on the Observance of Standards and Codes, March 2004.

The Capital Market Authority (CMA) is the securities market regulator, reporting to the Minister of Foreign Trade. The CMA has broad administrative sanction powers, including warnings, delistings, suspending/revoking licenses, and other punitive measures. The CMA is responsible for the enforcement of Capital Market Law, the supervision of capital market development, and the regulation and monitoring of market activities. The CMA has specific powers to protect minority shareholders through the Capital Markets Law. Shareholders who represent 5 or more of the capital have the right to raise a complaint to the board of directors of the CMA.

Cairo and Alexandria Stock Exchange (CASE) is a quasi governmental body operating under the supervision of the CMA responsible for monitoring compliance with listing rules, and may impose penalties on companies that do not meet disclosure requirements. CASE is responsible for supervising sanctions that include downgrading listing status, trade suspensions, delisting and monetary penalties. Until 2002, CASE had 3 listing tiers: the official schedule, the unofficial schedule, and the unofficial schedule 2. CASE listing rules were updated in August 2002, and were implemented in September 2003. CASE is the first Arab stock exchange to issue derivative products on its in-house index instead of listing on international indices such as S&P or FTSE.

Misr Clearing, Settlement and Central Depository Company (MCSD) is Egypt's central depository responsible for clearing and settlement of CASE-executed transactions. MCSD was established in accordance with the Capital Market Law 95, and now operates as a self-regulatory entity, subject to CMA supervision. Members of MCSD include banks and financial institutions that carry out brokerage or custodial activities.

The General Authority for Investment and Free Zones (GAFI) supervises companies incorporated under Investment Law 8. It approves and maintains on file a number of company documents such as company charters, the minutes of board meetings, etc.

The Ministry of Public Enterprises is charged with partially and fully state-owned companies incorporated under the Public Business Sector Law (No.203 of 1991). As soon as private ownership in a company reaches 51%, it becomes subject to the provisions of the Company Law (No.159).

IV. Recent Reforms

The following other reforms have been introduced recently and presented by H.E. Mahmoud Mohieldin during the Ministerial Meeting of the MENA-OECD Investment Programme on February 14, 2006.

- Issuing the Executive Regulation for the Securitization Law;
- Issuing a Prime Ministerial Decree allowing the establishment of the Investor Protection Fund (IPF), an insurance fund that would help investors hedging their positions against non-commercial risk;
- Amending the Corporate Law to allow the introduction of 'Employee Stock Option Plans' (ESP) to the financial market;
- Re-shaping the organizational structure of the Capital market Authority (CMA) and establishing a Corporate Governance department;
- Issuing Codes of Ethics and Conduct for brokerage and fund management activities;
- Issuing in May 2002 the Minister of Finance a No. 480 establishing the Primary Dealers System to allow financial institutions registered with the Ministry of Finance to underwrite

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primary issues of government securities Primary Dealers is allowed to trade government securities on the open market after notification to CASE of their purchase or sale of securities.

- Institutional changes have been introduced in 2002 including listing and delisting regulations and Over-the-Counter Trading;
- Introducing intra-day trading, in which the settlement for selected stocks would be T+0 on selected stocks instead of T+2/3 for other stocks. A set of requirements are set for applying this new mechanism on the stocks in terms of activity market capitalization;
- Establishing an electronic link between the Stock Exchange and the Clearing House. This link is designed to facilitate better market surveillance and permit margin trading, short selling and intra-day trading.

V. Measures currently being considered

The following measures are currently envisioned or in progress of being implemented:

- Transferring all regulatory entities related to the non-banking financial services to the Smart Village with view of establishing a 'One Stop Shop' which includes all financial services related authorities in Egypt. This centre is envisioned to include the Capital Market Authority (CMA), the Mortgage Finance Authority (MFA), the Egyptian Insurance Supervisory Authority (EISA), Cairo and Alexandria Stock Exchange (CASE), and Misr for Clearing, Settlement and Depository (MCSD). This centre would be the cornerstone for the establishment of the Egyptian Financial Services Authority (FSA) in the future, which would also be responsible for bank supervision.
- As described, a number of new financial instruments and mechanisms have been introduced to the Egyptian market, including the Primary Dealers System, margin trading and the short selling. Other new developments are in the pipeline such as the introduction of Exchange Traded Funds (ETFs) which are going to be issued by Cairo and Alexandria Stock Exchange and the introduction of financial derivatives. The Egyptian government hopes to accomplish these objectives by the end of 2006.