Markets Brief

Provision of Liquidity Operations or Services

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Introduction

In this edition of Markets Brief, we provide Issuers and market practitioners with information about the DFSA's approach to the provision of liquidity operations to Issuers whose securities (whether equity, debt, derivatives, ETFs or other structured products) (referred to in this Markets Brief as "Securities") are admitted to trading on an Authorised Market Institution (AMI), typically NASDAQ Dubai, or an alternative trading platform.

Liquidity operations would typically be used by an Issuer where its Securities do not trade with sufficient trading volume , where the depth of the market beyond the best bid and offer order is thin, or where the spread of the quote spread is excessively wide, thereby potentially creating a disorderly and inefficient market in the Securities.

Guidance

Please note that the contents of this communication are not intended to be Guidance as contemplated by the Regulatory Law 2004 and the contents should neither be interpreted, nor relied upon, as Guidance. You should refer to the DFSA Rulebook for Guidance or contact the DFSA if you require individual guidance.

Technical explanations given in this brief are for illustrative purposes and should not be considered or relied upon as legal advice. We recommend that independent legal advice is obtained if you are unsure about any aspect of the DFSA Markets regime which may apply to you.

Definitions

Defined terms are identified in this Brief by the capitalisation of the initial letter of a word or each word in a phrase and are defined in GLO.

On this point of definitions, we note that in this Markets Brief we use a number of terms which not all readers may be entirely familiar with. This section explains some of these terms.

"Market maker"

A market maker is a person who has entered into an agreement with an AMI, to provide two-way (buy and sell) markets in listed Securities on a continuous basis.

"Liquidity provider"

A liquidity provider is a person who provides liquidity operations to an Issuer under a liquidity agreement between Issuer and the

liquidity provider. A liquidity provider would usually be a licensed broker and exchange member. Typically a liquidity provider would also be a market maker. Liquidity provision is similar to but not the same as market making. The focus of this Brief is on the activity of liquidity provision.

"Liquidity operations"

Liquidity operations or liquidity services are those operations or services, which generally involve the execution of transactions or trade orders in Securities in order to promote liquidity of Securities. Liquidity operations involve maintaining a reasonable spread (as outlined in the obligations), or responding to the request for a quote with the aim to induce or enhance trading activity resulting in increased liquidity and an orderly market.

"Liquidity agreement"

A liquidity agreement is defined as an agreement between an Issuer and a liquidity provider whereby the liquidity provider will adhere to agreed obligations to bid and offer the stock narrowing the spread and creating depth for the purpose of promoting liquidity and supporting the normal trade in the Securities. Liquidity agreements are used to enhance liquidity for Securities where there is insufficient trading to achieve efficient price discovery.

Should I appoint a liquidity provider?

An Issuer whose Securities are illiquid may consider that it is appropriate to appoint a liquidity provider in order to prevent a disorderly and/or inefficient market in the Securities.

Examples of a disorderly and/or inefficient market for Securities caused by a lack of liquidity include:

a) a large bid/offer spread;

b) low volume of trading causing large swings in the market price of a Security, even at small trade sizes; and

c) difficulties for shareholders transacting in Securities e.g. no willing buyers, bid/offer prices significantly away from mid-price, valuation issues.

Poor liquidity is frustrating for shareholders for the reasons set out above. It also increases transaction costs. For Issuers, poor liquidity can raise the cost of capital by increasing the expected return on equity.

Other possible reasons to appoint a liquidity provider are:

a) it improves market quality - a decrease in quoted spreads and volatility of a stock return as well as an increase in the quoted depth and trading activity;

b) a positive impact on the overall quality of the market due to reduced bid-ask spreads and deeper markets. Lower spreads promote liquidity by allowing larger transactions increased trading activity, thereby reducing friction (transaction costs);

c) a possible increase in size of transactions; and

d) a liquid stock results in a more institutionalised shareholder base which is valuable to the company.Listing and admission to trading on an exchange

Appointment

An Issuer who intends to appoint a liquidity provider should enter into a liquidity agreement with the liquidity provider. Prior to the appointment of the liquidity provider, the Issuer should take reasonable steps to ensure that the liquidity provider has the required skills, resources and experience to conduct the functions of a liquidity provider. See Annex 1 for guidance on the appointment of a liquidity provider and Annex 2 for guidance on the standard contents of a liquidity agreement.

Disclosure to the DFSA

Where an Issuer at the time of listing appoints a liquidity provider, the Prospectus should include appropriate disclosure and a summary of the key terms and conditions of the liquidity agreement.

The full liquidity agreement would need to be disclosed to the DFSA prior to the DFSA granting approval for admission to the List. The DFSA does not require full public disclosure of the liquidity agreement but sufficient information should be provided in the Prospectus.

Suspension of liquidity operations

There are circumstances where a liquidity provider may consider that it is prudent to (or in the case of a DFSA direction is obliged to) suspend liquidity operations. Set out below is a list of such circumstances.

a) where the liquidity provider is in possession of inside information;

b) where the liquidity provider is also acting as a stabilisation manager in accordance with the Price Stabilisation Module of the DFSA Rulebook (PRS);

c) during a period where price stabilisation activities are taking place in accordance with PRS;

d) during a period where share repurchase activities are taking place in accordance with the Markets Rules Module of the DFSA Rulebook (MKT);

e) during a period where a takeover bid (which is in the public domain) is in process;

f) where the DFSA directs the liquidity provider to stop or suspend the liquidity operations;

g) the Security or underlying Security is suspended from trading for any reason;

h) when there are operational and technical problems beyond the control of the liquidity provider that hinder the liquidity provider's ability to provide liquidity; and

i) if there is a "fast market" (i.e. situations where the financial markets experience exceptional price movement and high volatility over relatively short periods of time leading to a sudden increase in risk and uncertainty) which materially affects hedging ability in the case of structured products, warrants, etc.

Independence and conflicts of interest

A liquidity provider must take reasonable steps to ensure that its activities and its employees are independent of the Issuer and must appropriately manage any conflicts of interest that may arise in carrying out the liquidity operations.

The principle of independence and identifying and managing conflicts of interest aims to ensure that conflicts of interest do not adversely affect either the ability of liquidity providers to perform their functions properly, manage the interests of customers with competing interests or maintain market confidence in their role. Liquidity providers are expected to identify and manage any conflicts on a case by case basis. Where a conflict cannot be effectively managed, a liquidity provider must not act.

A liquidity provider should introduce systems and controls which ensure through the terms and conditions of the liquidity agreement:

a) that it remains independent of the Issuer in executing transactions and cannot make decisions or influence the Issuer in the execution of trades under the liquidity agreement;

b) that its employees who are involved in the execution of the liquidity agreement remain independent of the Issuer;

c) an adequate separation of assets between the liquidity function of a firm and its other functions by ensuring that all Security and cash transactions are managed through a

specific account designated for the purpose of liquidity provision;

d) that the liquidity agreement clearly sets out the terms of remuneration between the Issuer and the liquidity provider and that such terms do not impair the liquidity provider's independence nor encourage it to artificially influence the Security price and/or trading volumes in the Securities;

e) that it does not use its own funds to execute trades under the liquidity agreement, nor may its remuneration be based on the number of transactions performed without prejudice to it being reimbursed for related expenses; and

f) that remuneration related is in no way related to the performance of the Securities or the valuation of the company.

Compensation with regards to general executed volume enhancement and overall activity in the market with due regard to the market abuse provision in the Markets Law 2012 would be acceptable to the DFSA.

Relevant Rules

The following DFSA Rules may be relevant to an AMI or Issuer in the context of whether the appointment of a liquidity provider is appropriate.

Proper Markets

Under Rule 6.2 of the Authorised Market Institutions Module of the DFSA Rulebook (AMI), an Exchange must have rules and procedures for a fair, orderly and efficient operation of trading in Investments on its facilities. For this purpose, an Exchange must ensure that only Investments in which there is a proper market are traded on its facilities.

Under AMI Rule 6.2.1(2)(i) an Exchange must ensure that where it enters into a contract with a market maker it complies with AMI Rule 6.9 – *Liquidity Incentive Schemes.* AMI Rule 6.9 sets out certain minimum requirements for a market maker. A person can simultaneously enter into a market maker agreement with the AMI and a liquidity agreement with the Issuer.

If there is a disorderly market for Securities caused by a lack of liquidity, the appointment of a liquidity provider (by the AMI or the Issuer) may be appropriate.

Shares in public hands

Under MKT 9.3.10, a company must ensure that at least 25% of its Shares are distributed to the public. Under MKT 9.7.2, a company must ensure that it has 25% of its Shares in public hands on a continuing basis.

The purpose of these Rules is to ensure sufficient liquidity within the secondary market through a widely distributed independent shareholder base. However, a free float of 25% does not guarantee liquidity for an Issuer's shares.

The DFSA market abuse regime

As well as having an impact on DFSA Rules, an Issuer which proposes to use a liquidity provider to undertake liquidity operations must take into consideration the impact of the DFSA's market abuse regime in Part 6 of the Markets Law 2012.

The liquidity provider will also need to be careful that his activities in carrying out his obligations under a liquidity agreement do not constitute market abuse. The key risk is that the activities carried out by the liquidity provider may result in or contribute to a false or misleading impression as to the supply of demand for or price of the relevant Securities. This could amount to market manipulation under Article 54 of the Markets Law 2012.

There is no statutory defence to market manipulation that would apply for liquidity operations as there is for price stabilisation and Share buybacks (article 64(1) of the Markets Law 2012). However, the term 'market maker' in the context of article 64(2)(d) of the Markets Law

2012 should be read to include the services of a liquidity provider and would therefore benefit from similar protection. This reading of the term 'market maker' is designed to provide a safe harbour for, and promote, legitimate liquidity operations in the DIFC.

However, we impose certain conditions on the person seeking to rely on it. The conditions are:

a) the Issuer would need to disclose to the market sufficient information about the liquidity agreement and its effect before any trading under the liquidity agreement takes place;

b) any transactions undertaken under the relevant liquidity agreement would need to be disclosed to the market on a quarterly basis;

c) termination, suspension or a material change to the liquidity operations would need to be notified to the DFSA without undue delay;

d) any material amendments to the liquidity agreement would need to be disclosed to the market before any further trading under the amended liquidity agreement is permitted;

e) termination or suspension of the liquidity operations would need to be disclosed to the market without delay; and

ci) the Issuer and/or liquidity provider would need to comply immediately with any DFSA direction regarding the liquidity operations.

The relevant market disclosures above would need to be made through a Regulatory Announcement Service.

The DFSA's Code of Market Conduct (CMC) provides general guidance on what constitutes "inside information", "insider dealing" and "market manipulation" amongst other things. The CMC includes our view on the interpretation of certain provisions, examples of conduct that in our view may contravene the Law and other conduct that in our view does not contravene the Law in regards market abuse. The legitimate performance of market making will not usually constitute market abuse (CMC 10 Specific Market Practices). The CMC also sets out factors that we may take into account in determining whether or not conduct may be market abuse.

In particular, the DFSA would be concerned with inducement s that would encourage trading activity by the liquidity provider for non-economic reasons ('wash trades'), or inducements that would involve increasing rewards for progressively higher volumes ('cliff structured fees').

The DFSA Markets team can be reached on markets@dfsa.ae or 04 362 1585. The DFSA will not advise a particular course of action or provide (legal) advice, but it is prudent to keep the DFSA informed of ongoing developments in relation to the Reporting Entity.

Arabic edition

Every Markets Brief is produced in both English and Arabic and is available on the DFSA website.

Contact us

Visit the DFSA website www.dfsa.ae for:

- other editions of the Markets Brief;
- access to DFSA-administered legislation and the DFSA Rulebook, including a full text of the Markets Law 2012 and Markets Rules; and
- the Code of Market Conduct (in the Sourcebook Modules part of the DFSA website).

For enquiries:

- Telephone +971 4 362 1500
- Email markets@dfsa.ae

Feedback

We appreciate your feedback and welcome any suggestions that you may have. Please email us at markets@dfsa.ae

Annex 1

Additional guidance on the appointment of a liquidity provider

a) Appointment

An Issuer who intends to appoint a liquidity provider should:

i. enter into a liquidity agreement with a liquidity provider on terms which include the matters set out in Annex 2;

ii. prior to the appointment of the liquidity provider, take reasonable steps to ensure that the liquidity provider has the required skills, resources and experience to conduct the functions of a liquidity provider.

b) General conditions for applicants to the Official List

The liquidity agreement would need to be disclosed to the DFSA for approval prior to the DFSA granting approval for admission to the List.

The Prospectus should contain:

i. a prominent statement which clearly states that the offer may be subject to liquidity operations/activities which promote and support liquidity in the Securities of the Issuer;

ii. the name of the liquidity provider;

iii. the likely expected costs associated with these activities; and

iv. a summary of the liquidity agreement.

The liquidity provider should not conduct liquidity operations in any case where:

i. it and/or the Issuer is in possession of inside information;

ii. it is also acting as a price stabilisation manager under the PRS Module;

iii. price stabilisation activities are taking place;

iv. share repurchase activities are taking place;

v. a takeover bid is in process;

vi. the Security or underlying Security is suspended from trading for any reason;

vii. there are operational and technical problems beyond the control of the liquidity provider that hinder the liquidity provider's ability to provide liquidity;

viii. if there is a "fast market" which materially affects hedging ability in the case of structured products, warrants, etc.; and

ix. any requirements of an AMI or any other exchange have not been complied with.

c) Public disclosure requirements

An Issuer should publish the following information as soon as possible after the date of appointment but prior to the commencement of the liquidity provision:

i. the terms of appointment;

ii. the duration of the contract;

iii. the date of the commencement of the appointment;

iv. the name and address of the liquidity provider;

v. the name and type of the security;

vi. the name of the market/trading platform; and

vii. the quantity of securities or the monetary amount.

An Issuer should publish the following information on a quarterly basis, or more frequently as determined by the liquidity agreement, and on termination of the liquidity agreement:

i. the number of purchase and sale transactions;

ii. the average size of the transactions;

iii. whether a transaction was undertaken otherwise than through the central order book of the relevant AMI;

iv. if the liquidity provider has an outstanding short position, the number of Securities in that short position;

v. the amount of compensation received, and the balance of the Securities and cash accounts at the end of the reporting period]

d) Independence

A liquidity provider should:

i. execute all transactions through an account specifically designated for that purpose;

ii. make decisions relating to the execution of the liquidity agreement independently from the Issuer;

iii. ensure that its employees involved in the execution of the liquidity agreement remain independent of the Issuer;

iv. ensure that terms of remuneration between the Issuer and the liquidity provider do not impair the liquidity provider's independence nor encourage it to artificially influence the Security price and/or trading volumes in the Securities; and

v. not use its own funds to execute trades under the liquidity agreement nor may its remuneration be based on the number of transactions performed without prejudice to it being reimbursed for related expenses.

Annex 2

Guidance on the contents of a liquidity agreement

A liquidity agreement should at least include the following information:

a) names and addresses of contracting parties;

b) agreement commencement and end dates;

c) name(s) of market/ trading platform;

d) name, ISIN and type of Security;

e) details of the parameters under which the liquidity operations will be conducted;

f) securities and cash accounts held by the Issuer for the execution of the agreement;

g) duties to be undertaken by both parties (for example, the publication of information);

h) expected date that liquidity operations will commence;

i) terms of remuneration; and

j) statement of independence and conflicts of interest.