GOVERNANCE IN LIQUIDITY PROVISION

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AL RAMZ THOUGHT LEADERSHIP.

In collaboration with **Hawkamah Institute for Governance.**

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A | INTRODUCTION

In 2023, the regional financial landscape witnessed a remarkable evolution as the popularity of liquidity provision services offered by market makers surged, signalling a shift in market dynamics. This resulted in an influx of service providers, equipped with hybrid models, which not only enhanced competitiveness, but also introduced a new level of complexity to the realm of financial transactions. As these service providers carve out their niches, they bring to the forefront pressing questions concerning the governance of such mandates, challenging traditional models, and calling for a nuanced understanding of their value proposition. This growing sector's impact on market liquidity and its implications for governance highlight a pivotal moment in the financial industry, urging stakeholders to navigate the intricacies of these changes with foresight and precision.

As listed companies, along with their boards, increasingly appoint market makers to provide liquidity services, it becomes imperative to ensure that governance structures are in place to safeguard the interests of stakeholders. This necessity stems from the complex nature of the services provided by market makers, which, if not properly overseen, could lead to conflicts of interest or even undermine the market's overall integrity. Recognizing the criticality of this issue, this paper, prepared in collaboration with the Hawkamah Institute for Governance, aims to outline the responsibilities of the boards of directors of companies engaging liquidity providers. Through a comprehensive framework, it seeks to provide guidance on establishing robust oversight mechanisms, ensuring transparency, and fostering an environment where the alignment of liquidity provision activities with shareholder interests is paramount. This initiative reflects a proactive approach to governance, underscoring the importance of adaptability and strategic foresight in an ever-evolving financial landscape.

Liquidity provision regulations are inherently business-friendly, formulated with the aim of cultivating growth and stability in markets. They prioritize a principled approach to governance over the rigidity of rule-based oversight, striving for a nuanced balance between adaptability and steadfastness. This flexibility, while aimed at propelling capital markets, has created a widening disparity between the operational ethos of market participants. This diversion underscores the crucial roles of board members and liquidity providers, respectively, where both parties bear the ultimate responsibility of honouring their duties to stakeholders, necessitating an ongoing commitment to self-regulate, the implementation of governance protocols, and an adherence to industry best practices.

Leveraging seven years of expertise in this sector and having witnessed various operating models employed by numerous market participants, we believe it would be advantageous to compile this paper. Its purpose is to furnish board members with an overview of the governance challenges observed over the years, and to devise a mechanism that assists listed companies in protecting their shareholders' interests.

B | KEY GOVERNANCE CONSIDERATIONS

01 | APPOINTMENT DECISION GOVERNANCE

In consideration of governance imperatives, it is essential for listed companies to affirm the suitability of the liquidity provision solution as a remediation prior to engaging a service provider. This not merely entails the fulfilment of contractual obligations - such as order book enhancement and the narrowing of the bid-ask spread - but also the realization of the intended consequence, namely, the facilitation of a liquid trading environment for shares. This aspect assumes heightened significance where the listed company demonstrates limited percentage or value of free float, casting doubt on the viability of targeted outcomes.

02 | SERVICE PROVIDER CONFLICTS

Listed companies should undertake a comprehensive evaluation of prospective service providers to ensure they meet sufficient ethical and professional benchmarks, encompassing effective conflict resolution mechanisms. Conflicts frequently originate from other licensed activities, including, but not limited to, research coverage (encompassing both buy-side and sell-side perspectives), proprietary investments, and corporate finance. Should such conflicts emerge, they warrant a structured evaluation, necessitating the liquidity provider to clearly define and execute effective measures to attenuate their influence.

Additionally, it is imperative that liquidity providers maintain stringent segregation of balances pertaining to distinct mandates, ensuring that funds are not intermingled nor repurposed for alternate uses, including cash reserves. Even when the funding originates from the liquidity providers themselves, it is crucial to earmark these resources distinctly to prevent the commingling of cash flows. Such a disciplined approach necessitates the maintenance of separate records for each mandate, thereby upholding the integrity of financial management and ensuring transparency. This segregation is fundamental to preserving the fiduciary trust and mitigating risks associated with financial mismanagement and enhancing overall governance.

03 | INDEPENDENCE

Liquidity providers are frequently affiliated with sophisticated financial institutions that possess a broad array of licensed activities. It is therefore imperative to maintain the autonomy of decision-making and ensure the independence of the liquidity provision function from other licensed activities. Instituting information barriers, commonly referred to as "Chinese Walls" between separate licensed activities is an essential requirement in order to limit information flow and enhance independence. Current regulation mandates this separation for trading desks, as well as independent operations and compliance frameworks.

Moreover, it is a prevalent for service providers to combine market making and liquidity providing roles, given the significant similarity in operational features. However, traders allocated dual responsibilities in these functions often exhibit a predisposition towards market making, given its more immediate impact on their financial outcomes, potentially to the detriment of liquidity provisioning mandates. Consequently, it is essential to enforce clear segregation, prohibiting traders assigned to liquidity provision from participating in market-making activities, to uphold the integrity and objectives of each function. with an overview of the governance challenges observed over the years, and to devise a mechanism that assists listed companies in protecting their shareholders' interests.

B | KEY GOVERNANCE CONSIDERATIONS

04 | MANDATE SCOPE

Listed companies encountering difficulties in trading, such as fluctuations in prices or trading volumes, along with significant bid/ask spreads, are progressively turning to liquidity providers for assistance. In this context, scoping the mandate becomes crucial as it clearly defines responsibilities and boundaries. Distinguishing between obligations and targets is essential; obligations are mandatory commitments, while targets are aspirational benchmarks. Clarifying prohibitions is also vital, setting firm boundaries on unacceptable actions.

This precision ensures focused governance, aligns strategies with regulatory norms, and enhances accountability, enabling a structured and transparent approach to fulfilling objectives.

SCOPE	OUTLINE
Binding obligations	• Bid/ask spread • Presence in orderbook • Order refresh frequency
Non-binding targets	• Daily values traded • Inclusions, such as MSCI and FTSI
Prohibitions	• Daily values traded obligations • Share price targets

05 | MANDATE PRICING

In the context of mandate pricing governance, it is essential that the compensation structure for the liquidity provider is structured to be independent of share price variations and actual values/volumes traded. This approach is essential to avert the creation of incentives that might inadvertently motivate the liquidity provider to manipulate outcomes. Instead, compensation should be explicitly linked to the adherence to stipulated contractual responsibilities, as sit out in the service agreement. Such responsibilities commonly encompass asks such as populating the order book and minimizing the bid-ask spread, which in turn fosters enhanced market engagement.

At the heart of this remuneration framework are the fundamental operational expenses, which include labor, technology, and other indispensable resources, coupled with an equitable margin of profit. Moreover, in certain compensation structures, considerations for funding and market risk expenses might also be incorporated.

In instances where the liquidity provider benefits from lower or more accessible funding costs, or when the listed company is limited by existing credit facilities, it is common for the liquidity provider to fund the liquidity provision mandate. Consequently, these funding expenses should be explicitly integrated into the mandate pricing. Neglecting these costs might incentivize the liquidity provider to minimize share inventory, thus reducing the associated costs with the mandate and potentially undermining their capability to meet the commitments on the offer side of the order book. Overlooking such costs in mandate pricing impairs the liquidity provider's independence as it forgoes potential revenue on its funds.

It is commonplace for liquidity providers to accept share price risk as part of the mandate, especially when the trading price surpasses the book value or aligns closely with the fair value as determined by management. In such cases, additional renumeration should be explicitly incorporated as represented by the price hedging strategies. Disregarding this cost in mandate pricing compromises the liquidity provider's independence by embracing risk without corresponding return.

In essence, ensuring the liquidity provider's independence from the influence of share price movements, both in reality and perception, is vital for the effective execution of the mandate and for achieving a trading equilibrium while upholding the contractual obligations.

06 | TRADING STRATEGIES

Liquidity providers ought to establish a formally sanctioned liquidity provision playbook, encompassing a compilation of approved trading strategies, either as standalone methodologies or integrated within a broader policy and procedural framework. These approved trading strategies, though proprietary, function to validate the foundation of transactions executed by the liquidity provider. The legitimacy and efficacy of these strategies are further evidenced through rigorous back-testing, which demonstrates the effectiveness of the strategies employed in improving liquidity and contributing to a balanced price formation. Trading outside the remits of approved strategies undermines the independence of the liquidity provider from share price.

B | KEY GOVERNANCE CONSIDERATIONS

07 | TRADING RESTRICTIONS

Appropriate controls ought to be established to prohibit the liquidity provider, including its subsidiaries and associated entities, from buying or selling shares of companies under liquidity provision mandates.

These restrictions should also apply to the officers and directors of the liquidity provider for the duration of the mandate. The objective of these prohibitions is to preclude any conflicts of interest, whether actual or perceived. Furthermore, appropriate cooling off restrictions should be enforced by liquidity providers beyond mandate term.

08 | MANDATE INVENTORY

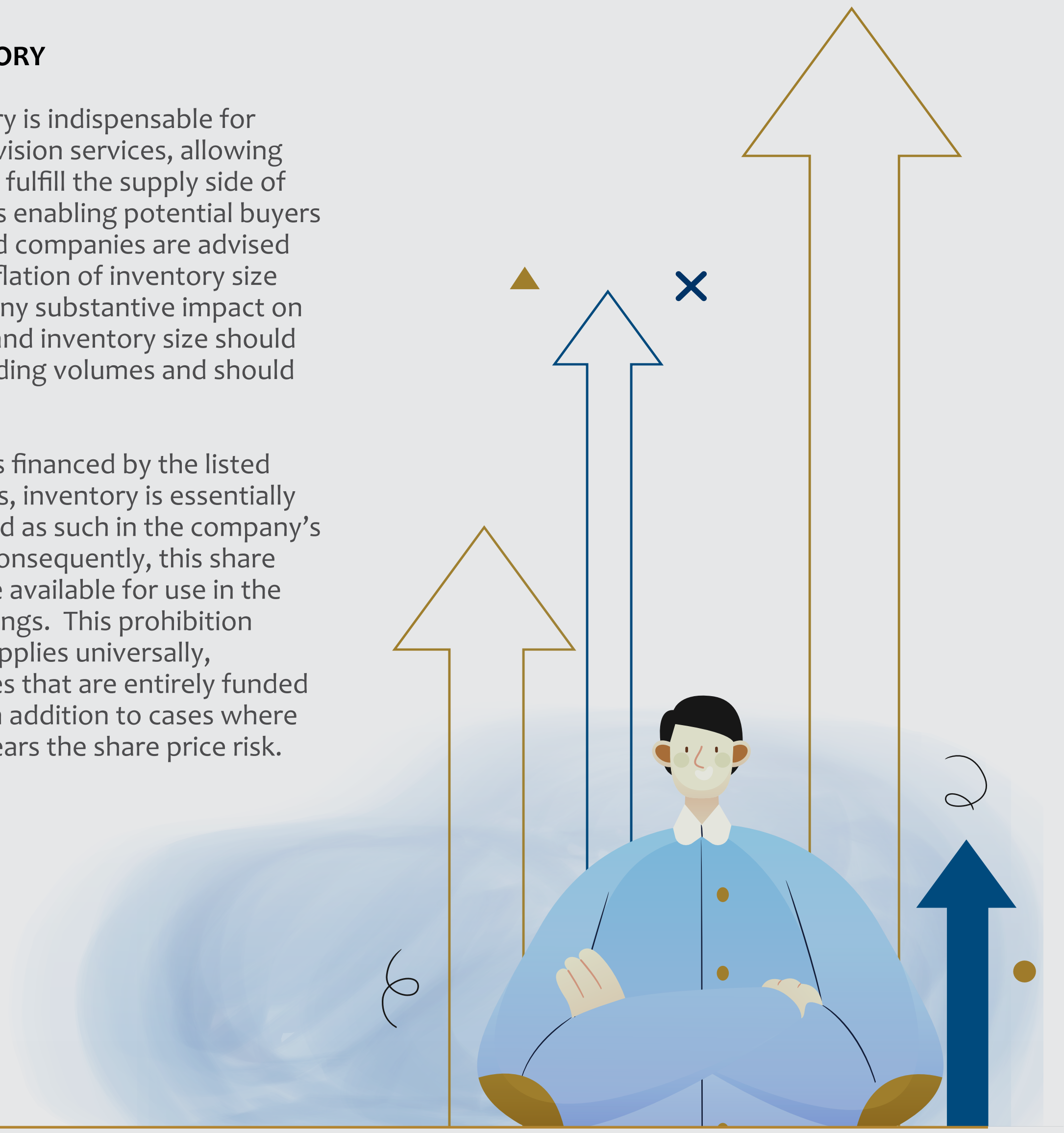
Maintaining an inventory is indispensable for facilitating liquidity provision services, allowing the liquidity provider to fulfill the supply side of the order book and thus enabling potential buyers to acquire shares. Listed companies are advised to prevent excessive inflation of inventory size and mandate to avoid any substantive impact on share prices. Mandate and inventory size should be linked to historic trading volumes and should be subject to a cap.

As mandate inventory is financed by the listed company's shareholders, inventory is essentially treasury shares reflected as such in the company's financial statements. Consequently, this share inventory should not be available for use in the general assembly meetings. This prohibition is comprehensive and applies universally, encompassing mandates that are entirely funded by liquidity providers, in addition to cases where the liquidity provider bears the share price risk.

09 | Mandate Disclosure and Enhanced Transparency in Liquidity Provision

Current regulation requires foundational levels of disclosure concerning mandates for liquidity provision. Augmenting the scope of disclosure significantly enhances transparency by encompassing critical elements such as:

- The scale and scope of the liquidity provision mandate, offering insights into the magnitude of funds committed.
- The origins and mechanisms of funding for the mandate.
- Price risk assignment and related circuit breakers as well as other risk containment measures.
- Regular updates to stakeholders regarding the mandate metrics and liquidity.



C | CLOSING REMARKS

In conclusion, the ascendance of liquidity provision services within the regional financial markets underscores a transformative phase, demanding meticulous governance to align with the evolving market dynamics and the intricate nature of these services. The insights presented herein advocate for a rigorous governance framework, emphasizing the criticality of establishing robust oversight mechanisms, transparency, and alignment with shareholder interests. Such a framework is essential for navigating the complexities introduced by the proliferation of liquidity providers and their increasingly divergent service models.

The governance of liquidity provision mandates encapsulates a spectrum of considerations—from the vetting of service providers and managing potential conflicts of interest, to ensuring the independence of liquidity functions and the judicious structuring of mandate pricing. The principles articulated in this document constitute a foundational framework for listed companies and their governing boards, directing them in maintaining the utmost standards of governance, promoting market integrity, and empowering them to solicit pertinent inquiries, acquire adequate information, and achieve assurance regarding the process's integrity.

Embracing these governance imperatives is not merely about adherence to regulatory expectations but about fostering a market environment that is resilient, transparent, and conducive to the long-term interests of all stakeholders. It requires a proactive, informed approach from boards and management teams, ensuring that liquidity provision strategies are implemented with foresight, precision, and a deep commitment to ethical standards.

This paper aims to catalyze a dialogue among stakeholders, encouraging a collective commitment to enhancing the governance framework surrounding liquidity provision services, thereby ensuring that these services continue to contribute positively to market liquidity and the broader financial ecosystem.

D | ANNUAL REPRESENTATION

To guarantee sustained compliance with established governance practices in liquidity provision, listed corporations that request such services should obligate the designated liquidity provider to fulfil the subsequent annual representation checklist.

	DESCRIPTION	YES / NO	IF NO, PROVIDE DETAILS
1	The liquidity provider believes that the size and the value of free float are adequate to achieve targets setout in the proposal and agreement.		
2	The liquidity provider did not provide any other service to the listed company during the term of the mandate.		
	The liquidity provider maintained separate records for the mandate and did not commingle mandate cash balances with other balances.		
3	The liquidity provider instituted Chinese walls separating liquidity providing from other licensed activities.		
	The liquidity provider prohibited market making activities for all traders engaged in liquidity provision.		
4	The remuneration of the liquidity provider is not correlated with the share price, nor are there any commitments made regarding pricing.		
	The remuneration of the liquidity provider is not linked to values/volumes traded, nor are there any commitment made regarding pricing.		
	Where mandate is funded, or partially funded, by the liquidity provider, funding compensation is expressly stated.		
	Where mandate share price risk is assumed, or partially assumed, by the liquidity provider, share price hedge cost compensation is expressly stated.		
5	The liquidity provider instituted trading strategies (playbook) which are strictly adhered to.		
	The liquidity provider conducts regular back testing of approved trading strategies (playbook).		
6	The liquidity provider and its related concerns did not buy/sell company shares during mandate term.		
	The liquidity provider directors and officers did not buy/sell company shares during mandate term.		
7	The liquidity provider did not present the shares held, or made them available, to general assembly.		

E | GLOSSARY

#	TERM	DEFENITIONS
1	Market making	The activity that mainly based on the provision of continuous prices for the purchase and sale of certain securities to increase the liquidity of such securities in accordance with relevant regulation.
2	Market maker	A corporate person licensed or having the approval of the market to practice the activity of the market making. Market makers are traditionally appointed by the respective exchanges to improve trading of a particular security.
3	Liquidity provision	The service under which a market maker undertakes to improve the liquidity of a listed security based on a liquidity provision agreement with the issuer of that paper.
4	Liquidity provider	A market maker engaged with an issuer of a listed security in order to provide liquidity on that security in accordance with the provisions of this regulation. Liquidity providers are traditionally appointed by a listed company to improve trading of own shares.
5	Trading strategies	Trading strategies are plans or methods that traders use to determine when to buy or sell assets in the financial markets. These strategies are based on various criteria such as technical analysis, fundamental analysis, and quantitative analysis. For liquidity provision, trading strategies should exclusively be linked to improving trading rather than achieving mandate profitability. This should be objectively linked by back testing.
6	Order book	An order book is a ledger containing all outstanding orders – instructions from traders to buy or sell a specific listed security – organized by price level.

ABOUT AL RAMZ

Founded in 1998, Al Ramz is a UAE domiciled public joint stock company listed on the Dubai Financial Market and regulated by the UAE Securities and Commodities Authority and the Dubai Financial Services Authority. Al Ramz provides a broad spectrum of services including asset management, corporate finance, brokerage, security margins, market making, liquidity providing, public offering management and financial research.

HAISAM ODEIMEH

GROUP CEO | FINANCIAL SERVICES

Haisam has over 25 years of experience in the financial services and previously served as Head of Financial Services at KPMG. He led key high-profile transactions, holds a master's degree in Banking and Finance from Paris Sorbonne University and is a US Certified Public Accountant.

ABOUT HAWKAMAH

Hawkamah, the Institute of Governance, owned by DIFC, Dubai, UAE. It was launched in 2006 with the aim of advancing and improving corporate governance practices in the MENA region. Hawkamah has a strong track record in delivering board evaluations, board training sessions, and advisory. Hawkamah assist companies to develop sound and globally recognized governance frameworks and helping in building qualified directors and top executives who are able to apply corporate governance in their organizations.