

The SCA approves Regulations concerning Securities Lending and Borrowing, Short Selling, Market Making and Liquidity Providers

The UAE Securities and Commodities Authority (the "SCA") has issued a number of Regulations to enhance the functioning of the UAE Markets. The Securities Lending and Borrowing, Short Selling, Market Maker and Liquidity Providers Regulations draw on international standards in an attempt to elevate the status of UAE Markets. The Regulations provide a regulatory framework; however, further rules need to be issued by the relevant UAE Markets before it becomes clear how activities will be undertaken in practice. In spite of this, the Regulations represent a positive step in attempts to have UAE Markets recognised as achieving "emerging market" status.

The Regulations are yet to be published in the Official Gazette and are therefore not yet in force. The Regulations will be effective the day after publication in the Official Gazette.

Market Maker Regulation

The Market Maker Regulation permits (i) SCA licensed brokers and local banks, branches of foreign banks (provided its head office is licensed to conduct such activity in its home jurisdiction), (ii) investment companies licensed by the UAE Central Bank, and (iii) corporate entities established under the UAE Commercial Companies Law having majority GCC ownership with corporate objects of undertaking market maker activities, to apply to the SCA to conduct market maker

activities. A licence is valid until December each year and requires renewal by submission of a renewal application.

In a departure from the proposals in the draft released last year, the Market Maker Regulation also makes provision for the registration of foreign market makers. To be registered as a foreign market maker, the applicant is required to be similarly regulated in its jurisdiction of incorporation and have more than five years experience in undertaking market maker activities. In order to trade on UAE Markets, the

foreign market maker is obliged to comply with the rules of the relevant UAE Market and is required to enter into an agreement with the relevant UAE Market to this effect. All orders of foreign market makers are required to be executed through a SCA registered broker. Interestingly, the SCA registered broker is responsible for ensuring the capital adequacy of the foreign market maker and ensuring that the foreign market maker is able to meet its obligations. It is unclear as to whether this is merely a due diligence requirement or

whether the SCA registered broker will have to provide some sort of financial guarantee.

Market makers are required to have in place adequate systems and controls segregating their market making activities from their other activities and have in place adequate risk management systems as well as internal procedures (including a professional code of conduct) relating to their market making activities. Employees involved in market maker activities will be required to meet certain fit and proper requirements as set out in the Market Maker Regulation and meet minimum knowledge and experience requirements.

Market makers are required to provide both the SCA and the relevant Market with reports and information, including monthly reports covering profits, losses and the size of the portfolios related to market maker activities, quarterly financial statements and audited annual financial statements (where the entity solely undertakes market maker activity), and bi-annual reports covering systems and controls arrangements. Market makers are also under an obligation to exert due diligence on transactions and disclose any unusual trading activity of which they become aware to the relevant UAE Market.

The Market Maker Regulation fits neatly with the other regulations issued by the SCA; market makers can engage in naked short selling and practice securities lending and borrowing to facilitate their market making activities. Market makers also benefit from reduced disclosure obligations regarding large shareholdings.

The Market Maker Regulation places obligations on the UAE Markets to put in place internal procedures and controls to facilitate market maker activities. As far as we are aware, neither the ADX or the DFM have made public any such procedures; however, pursuant to the Market Maker Regulation the procedures will cover technical requirements, trading and settlement of market maker orders, the type and amount of any guarantees required of the market maker, details regarding securities eligible for trading with support from one or more market makers, the obligations of market makers and the methods for disclosure by market makers. The relevant UAE Market is responsible for ensuring market makers comply with both the Market rules as well as the provisions of the Market Maker Regulation. Indeed, a Market is empowered to suspend market maker activities in instances when such activity is deemed by Market authorities to not serve the best interests of the Market.

The SCA retains the right to perform inspections and undertake investigations of market makers to ensure compliance with the Market Maker Regulation and Market rules and to impose penalties for failures to comply.

Liquidity Provider Regulation

Where a market maker additionally acts as a liquidity provider, it must enter into an agreement with the issuer setting out the terms, including fees payable by the issuer for the provision of liquidity services, under which it will provide liquidity services. This agreement must be reviewed by the relevant UAE Market. Following the execution of the liquidity provider agreement, the

issuer is obliged to disclose the name of the liquidity provider and the percentage of shares subject to the liquidity provider agreement to both the SCA and the relevant UAE Market. The relevant UAE Market is then obliged to disclose this information to the public. Further disclosures must be made as and when the liquidity provider agreement is terminated.

The Liquidity Provider Regulation limits the total number of securities that can be allocated to the liquidity provider to a maximum 5% of the total listed securities of the issuer (this appears to be 5% of the listed class of securities – not 5% of the free float, but the point could benefit from clarification by the SCA). A security may with the approval of the relevant UAE Market have more than one liquidity provider.

Where a market maker acts as a liquidity provider pursuant to a liquidity provider agreement, the liquidity provider is not able to take advantage of facilities available to market makers generally, including naked short selling, exemptions of market makers from disclosure obligations regarding large shareholdings and the ability to benefit from preferential trading fees.

Securities Lending and Borrowing

The Securities Lending and Borrowing ("**SLB**") Regulation permits securities lending and borrowing transactions to occur in one of two ways: (i) where the relevant clearing entity acts as central counterparty for securities lending and borrowing transactions and guarantees settlement, and (ii) through appropriately licensed "agents" of the lender and the borrower. The regulations and procedures for

undertaking securities lending and borrowing transactions are to be determined in accordance with the relevant Market's rules. To date, we are not aware of either the DFM or the ADX publishing such rules.

The following persons can apply to the SCA for an annually renewable licence to act as agent in respect of securities lending and borrowing transactions:

- custodians licensed by the SCA;
- securities companies licensed by the SCA and demonstrating sufficient systems and controls to undertake the business; and
- local banks, branches of foreign banks and investment companies licensed by the UAE Central Bank.

Pursuant to the SLB Regulation, securities may be borrowed by market makers in the course of their market making activities, in instances where a person would otherwise fail to deliver sold securities by the settlement date and in other cases as approved by the SCA. The SLB Regulation therefore facilitates use of the Short Selling Regulation, providing a method whereby a short position can be adequately covered. The ability to borrow securities against a fee assists investors in avoiding the costs and penalties associated with settlement failure.

Prior to entering into securities lending and borrowing transactions, the parties are required to enter into a master agreement containing specific terms. Although the SLB Regulation provides for many terms present in internationally recognised agreements, the SLB Regulation has removed the requirement of the draft regulation that such agreements be based on internationally recognised agreements

such as the Overseas Securities Lending Agreement ("**OSLA**") or the Global Master Securities Lending Agreement ("**GMSLA**"). Although such references in the draft regulations raised questions as to the enforceability of such international agreements under UAE law, their inclusion in the draft regulations was perceived as a comfort in terms of creating a base line for standards of documentation. Instead of clarifying the position with regards to enforceability, the SCA have seemingly sought to avoid the question. Many will see this as a missed opportunity as the task will now shift to the private sector to create UAE law governed SBL documentation modelled on the OSLA or the GMSLA.

Other difficult questions arising out of the draft regulation, such as questions regarding foreign ownership, have been deferred or transferred with the SLB Regulation making it the responsibility of the relevant Market to ensure that the process of lending and borrowing will not breach foreign ownership restrictions.

Provisions relating to collateral have been strengthened. The draft regulation required transactions to be supported by collateral with a value at least equal to the mark-to-market value of the securities. Collateral requirements in the SLB Regulation provide for cash (or an unconditional bank guarantee seen as good as cash) collateral of at least 105% of the mark-to-market value of the borrowed securities or securities collateral of at least 110% of the mark-to-market value of the borrowed securities.

The disclosure requirements contained in the draft regulation

(which included weekly disclosures to the SCA and the Market relating to an agent's securities lending and borrowing activities) have been removed. Instead lending and borrowing agents are required to provide the SCA or the Market with any reports they request within two working days of the request. Furthermore, the SCA is empowered, without notice, to conduct inspections of all parties practicing securities lending and borrowing to ensure compliance with the SLA Regulations and relevant rules. Foreign market makers will presumably have to submit to SCA jurisdiction in this respect.

Short Selling

The Short Selling Regulation permits short selling of securities listed on UAE Markets by market makers doing so in the course of their market making activities and in other instances approved by the SCA. On the face of the Short Selling Regulation, it is unclear as to what such other instances may be - the Short Selling Regulation stops short of permitting SCA licensed brokers to enter short sales on behalf of their clients (which was the position in the draft regulation). Presumably then, there is scope for individual licensed brokers to apply to the SCA to conduct such activity.

Only time will tell whether the SCA will choose to permit short selling in circumstances outside market making. The Short Selling Regulation certainly provides a framework for such activity and safeguards have been built in to minimise the perceived negative effects that short selling activities can have on a market. Should the activity be permitted by the SCA, investors would only be permitted to conduct

short selling on a covered basis, with SCA authorised brokers being responsible for ensuring that investors are capable of delivering relevant securities by the settlement date. Furthermore, the Short Selling Regulation contains an 'up-tick' rule requiring every short sale transaction be entered at a higher price than that of the previous trade in an attempt to limit short sellers from adding to any downward momentum of share prices suffering from sharp declines. The SCA will also be able to temporarily or permanently prohibit short selling of certain or all securities in exceptional market situations and shorting of a security will not be permitted where the securities has experience a fall of more than 5% in one trading day or the intra-day price has decreased by 10% or more. These restrictions do not apply to short selling undertaken by market makers.

The procedures for short selling are to be determined by the relevant Market's rules, as approved by the SCA. To date, we are not aware of either the DFM or the ADX publishing such rules. The consequences for failing to settle a short sold security, for example, are left to the relevant Market's rules under the Short Selling Regulation. The same applies for details regarding fines and penalties to be levied in relation to violations of a UAE Market's rules.

The draft Short Selling Regulation imposed disclosure requirements on parties holding a disclosable short position; however, disclosure requirements are now restricted to the relevant Market. The relevant Market is required to make daily disclosure to the SCA of any single investor position short sold in excess of 0.25% of the total shares admitted to trading and provide weekly information in respect of the value and volume of

short selling trades and members executing short sales on the Market. The Market must disclose to the public on a daily basis the number of securities short sold during the trading session.

The SCA is empowered, on the request of a Market or upon its own initiative, to investigate breaches of the Short Selling Regulation and related decisions as well as behaviour that deviates from what is termed professional conduct. In the event the SCA determines that a violation has been committed, the SCA may issue warnings and require remedial action, impose a monetary fine or temporarily or permanently withdraw permission to conduct short selling activity.

If you would like to know more about the subjects covered in this publication or our services, please contact:



Tim Plews
Partner

T: +966 555 156 153
E: tim.plews@cliffordchance.com



Philip Jolowicz
Counsel

T: +971 4 362 0742
E: philip.jolowicz@cliffordchance.com



Max-Justus Rohrig
Senior Associate

T: +971 4 362 0665
E: max-justus.rohrig@cliffordchance.com



Jodi Griffiths
Associate

T: +971 4 362 0687
E: jodi.griffiths@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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