ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

FINANCIAL MARKET PROFESSIONALS

AMAFI / 20-09
5 February 2020

PROVIDING LIQUIDITY ON A SME GROWTH MARKET

ASSESSMENT CRITERIA AND PROPOSED SKELETON LIQUIDITY CONTRACT

Regulation (EU) 2019/2115 of the European Parliament and of the Council of 27 November 2019 (SMEGR) has amended Directive 2014/65/EU and Regulations (EU) n° 596/2014 (MAR) and (EU) 2017/1129 (PR) as regards the promotion of the use of SME growth markets.

From 1 January 2021, MAR will provide: "*Without prejudice to accepted market practices as established in accordance with paragraphs 1 to 11 of this Article, an issuer of financial instruments admitted to trading on an SME growth market may enter into a liquidity contract for its shares where* [different] *conditions are met*" (*MAR, Art. 13-12*). Those conditions are set out in Paragraph 2 of Article 13 of MAR and in Commission Delegated Regulation (EU) 2016/908 (AMPR).

Aside from restating some of the main characteristics attached to the provision of liquidity on instruments traded on an SME growth market, the objective of this document is to specify the principles around which a high-level approach should be implemented. Considering that SME growth markets remain very local at this stage, it is indeed important that the framework be flexible enough to accommodate the specificities of each ecosystem.

Main characteristics of the provision of liquidity on instruments traded on an SME growth market

The purpose of a liquidity agreement is to provide market liquidity, for a given security. Through a liquidity agreement signed between an issuer and a liquidity provider (LP), the LP is entrusted by the issuer with shares and cash, and is responsible for using them for one single purpose: provide, by taking a long or short position on the market depending on what the needs are, market liquidity and thereby reduce, or even avoid, price mismatches that may result from the imbalance created by the non-simultaneous presence of buyers and sellers, without countering any market trend.

In furtherance of this overarching objective, the LP must always consider the long-term implications of its actions and ensure that the resources (shares and/or cash) it has been entrusted with are used in a reasoned way.

To achieve these objectives, the LP uses its knowledge of the market and determines, based on the resources allocated, the times at which its intervention will generate the additional liquidity needed by the market, and at what times an underlying upward or downward trend exists that must not be countered: the aim is not to oppose price changes due to a market trend.

As the buying and selling interests simultaneously present on the market are not always representative of the fundamental balance in existence, liquidity provided by the LP is obviously important for the issuer. Delays on either side of the transaction may trigger volatility, which is necessarily disruptive for investors who are then unsure as to whether they are buying or selling at the "right" price based on the current market conditions. For SMEs, this issue is particularly important considering the limited number of buyers and sellers significantly increasing the risk of mismatches, those then potentially carrying over several trading sessions without however ever constituting a fundamental trend. In the event of one-off market stress events, the countercyclical action of the LP is therefore crucially important.

The LP's aim, to that effect, is to reduce volatility and therefore those price movements that do not follow a fundamental trend but are instead uncorrelated to the market or the stock.

For SMEs, the LP's role is also to generate activity in the order book and thus stimulate supply and demand from investors who would not otherwise have considered the stock. It does not display prices constantly, but only when it considers it necessary in light of its mission.

But SMEs face another issue stemming from the investors' limited ability to easily invest or divest. As far as institutional investors are concerned, this ability is all the more important that, without a minimum level of liquidity, they are unable to invest in a quantity that is sufficient to justify their interest without suffering a delay in execution, making the market risk consequently unacceptable: in the end, they are potentially unable to execute the entire position at the initially agreed price[1]. The direct and inevitable effect of lack of institutional investors is a further reduction of the liquidity available to all investors.

Finally, it is also in the interest of issuers to ensure that the secondary market for their stocks functions properly. The liquidity premium required by investors when an issuer raises funds on the primary market in order to finance its development directly depends on the smooth functioning of the secondary market and its ability to reach a price that reflects, as accurately as possible, the stock's valuation fundamentals. The issuer's cost of capital is also, therefore, at stake.

The LP's intervention is not a matter of hindering the freedom of the price formation process; quite the contrary, it is a matter of, where possible, improving the quality of the process for the benefit of investors and issuers.

The risk in terms of market abuse lies mainly in the LP's ability to manipulate the market for the benefit of the issuer. But there are at least two limits:

- The first one is the level of resources allocated to the LP: they are too limited to counter a fundamental market trend over a sufficiently long period;
- The second one is the LP's independence from the issuer. It is sole responsible party, in its capacity as a market professional, for assessing when and at what level its effectiveness will be maximised: as stated in the AMAFI Standard Agreement, the sole objective of its interventions is to "*enhance the liquidity of the Shares, improve the regularity of trading and avoid price swings that are not justified by the current market trends*".

The LP uses the issuer's own resources (shares and/or cash). Accordingly, it does not bear any financial risk, thereby not giving rise to any additional costs charged directly or indirectly to investors.

The LP tightens the bid-offer spread. Given that it is neither expected to generate a return on its capital nor to take risks, it has no interest in wide spreads. Quite the contrary, narrow spreads are likely to attract investors.

Drawing up a contractual template to be used for the purposes of entering into a liquidity contract

As per Article 1(2) of the SGMR, "*ESMA shall develop draft regulatory technical standards to draw up a contractual template to be used for the purposes of entering into a liquidity contract in accordance with paragraph 12[2], in order to ensure compliance with the criteria set out in paragraph 2[3], including as regards transparency to the market and performance of the liquidity provision.*"

[1] The financial instrument lacking liquidity, the order has to be executed several times and the price of each execution tends to increase, adversely affecting institutional investors.
[2] of MAR, Art. 13
[3] of MAR, Art. 13

This provision does not impose on ESMA an obligation to produce a detailed contract which parties would merely rubber-stamp. Quite the opposite: Recital 7 of the SGMR provides that "*It is therefore necessary to create a Union **framework***" and expressly recognises the existence of "***local specificities***". AMAFI strongly supports this approach and is of the view that anything excessively restrictive would further undermine SMEs' position in terms of their level of liquidity.

The template to be drawn up by ESMA should therefore aim at establishing high level principles in order to adequately guide SMEs in their compliance with the criteria set out in Paragraph 2 of MAR, Article 13, and in AMPR (*MAR, Art. 12(a) and Art. 13 - New*), in the form of a framework agreement, leaving national finance industry associations and regulators to finetune its terms.

With this objective in mind, AMAFI would like to submit, having considered the ESMA's "*Points for convergence in relation to MAR accepted market practices on liquidity contracts*" (*Opinion ESMA70-145-76*), the following proposal of a skeleton agreement:

CONTRACTUAL PROVISION	OBSERVATIONS
Identification of parties	
Source of law (i.e. MAR, SGMR, AMPR, RTS to be published)	
Purpose of the agreement	
Confirmation that the liquidity provider is duly authorised by in accordance with MiFID and is registered as a market member with the market operator or the investment firm operating the SME growth market on which the liquidity contract is to be executed	
Designation of the financial instruments covered by the Agreement and the EU SME growth markets they are traded on	
Requirements applicable to the account on which the resources allocated to the liquidity contract and any and all transactions executed thereunder are recorded	
Reasonable limits, taking into account the liquidity of the financial instruments, applicable to the resources allocated to the liquidity provider, such as a percentage of the average daily volume on the market in the previous [x] trading sessions or a percentage of the issuer's capitalisation	It is crucial that the length of the period of reference be inversely proportional to the capitalisation of the issuer, in order to reduce the necessarily excessive impact caused by the inherent volatility (meaningless spikes or dips) of the volume of SMEs shares' trading.
Reasonable volume and price limits, having considered the market conditions on the SME Growth Market on which the liquidity contract is to be performed, including monetary thresholds	The intrinsic low liquidity of SMEs' instruments justifies that a higher percentage and a longer period of reference than the ones currently set out in the ESMA Points of convergence be applied for the aforementioned reasons. Moreover, in relation to monetary thresholds, the rationale laid out in Point 29 of the ESMA Points of convergence, is particularly pertinent as far as

	SMES are concerned given their inherent low liquidity.
Specific requirements applicable to the performance of the liquidity contract during auction phases	The degree of intervention allowed during auction phases should be proportional to the liquidity of the shares. As ESMA pointed out in its Points of convergence, the key, during any auction phase, is not to "*impact the final price of the auction*". As far as more liquid instruments are concerned, there will be a number of participants at the point of "fixing". Considering the limited resources available to the liquidity provider, compared to the number of participants, its intervention has no chance of impacting the final price.
Specific requirements applicable to block trades	Blocks trades should be allowed in order for the liquidity provider to rebuild the resources allocated to the liquidity contract where necessary, exercise which may prove difficult in the case of SMEs.
Clear statement confirming the liquidity provider's independence vis-à-vis the issuer	
Reporting and transparency requirements	
Fees	
Duration & termination	
Confidentiality	
Choice of law and jurisdiction of the place of listing	The SME liquidity contract being an EU mechanism, it is important that law and jurisdiction remain within the Union.