28 February 2014

INTERPRETATION OF THE CONCEPT OF MARKET MAKING

Introduction

With a view to harmonising and clarifying market participants' interpretation of the concept of market making, the Danish FSA 21 February 2014 published the authority's interpretation of the concept as defined in the Danish Securities Trading Act.

The background for the authority's input is that a number of market participants have interpreted the concept differently, along with the fact that market makers to a greater extent than previously risk coming into conflict with the prohibition of share manipulation and insider trading, especially in cases where the issuer acts as market maker for its own shares.

Market making as Concept

In market making schemes, an issuer of shares concludes an agreement with a market maker (typically a bank or a securities broker), under which different prices are fixed for the issuer's shares in order to ensure that there always is a potential buyer or seller who will match the other market players' wish to sell or buy shares in the company. When the market maker's selling price is matched by a purchase offer in the market, the market maker will buy the shares. The market maker will adjust its purchase and selling price on an ongoing basis based on the development of its custody account.

The main purpose of the agreement is for the market maker, through the above-mentioned process, to create liquidity in the security and to establish a market for trade in the security in question between natural and legal persons. A market making scheme may be desirable for smaller listed companies in particular, as there is often not a sufficient amount of buyers or sellers to fix a clear and immediate market value.

The market maker acts as a sort of intermediary, who assumes the risk of holding a certain number of shares in order to facilitate the trade in such securities.

In addition to creating a market for the shares, the market maker contributes to the reduction of transaction costs and facilitates trading on the stock market in general.

The Statement of the Danish FSA

As a consequence of its activities, the market maker may accidentally affect or create a price for a share which may not necessarily match the actual market price. In so doing, the market maker may, as the case may be, unintentionally risk being subject to the prohibition of share manipulation in Section 38(1)(2) of the Danish Securities Trading Act, as the market maker's work may be regarded as misleading signals with regards to the offering of, demand for or the price of a share. Naturally, it is not allowed for this to be the purpose of the market maker's activities, even if the market maker acts as market maker for its own shares.

Among other things for this reason, the Danish FSA has observed a need to provide clarity with regards to the market marker concept.

The actual concept "market maker" has not been defined in the Danish Securities Trading Act. The FSA has reviewed a number of market maker agreements, and, against that background, views a number of elements as being characteristic of market making schemes:

- **Purpose**: The market maker will fix purchase/selling prices in the share with a view to creating liquidity
- **Number of shares**: The number of different shares for which the market maker will fix a price
- **Period**: The period for the market makers price fixing (for example 90% of the NASDAQ OMX opening hours)
- **Spread**: The market maker's maximum spread (price differential) between purchase and selling orders
- **Conduct**: The market maker will act as the passive party to the transaction, i.e. the role of the market maker is only to bid on/offer shares, but the market maker may not be proactive or align its purchase and selling price with the other players' with a view to closing the transactions
- **Risk**: The trade in the share will take place at the market maker's own account and risk
- **Independence**: The market maker's price fixing will take place without the involvement of the issuer
- **Compensation**: The issuer's payment for the market maker's efforts

It is emphasised that the Danish FSA has not considered what *should* be included in market making schemes.

In addition, the FSA has listed a number of elements which are not regarded as part of a legal market maker agreement (negative characteristics):

- Price stabilisation
- Speculative short or long equity positions
- Performance of larger share trading

Particular Cases

As mentioned, market makers are at risk of coming into conflict with the Danish Securities Trading Act's prohibition of share manipulation and/or insider trading. In order to avoid this, the Danish FSA has – among other things based on a number of police reports – identified a number of cases where market makers and issuers should show particular caution.

Dominant position
The market maker must be careful not to obtain a dominant position with regards to the offering of and/or demand for a security, as the market maker in such a case would risk contributing to the fixing of a share price not corresponding to the market price.

Market making own shares
Issuers should show particular caution if the issuer acts as market maker for its own shares, as this implies a risk that the issuer – in addition to the wish of creating liquidity in the share – may have an interest in the share price developing as positively as possible.

In order to avoid doubts as to the motives of the issuer and to ensure that the issuer does not unintentionally affect the market price, the Danish FSA recommends that the issuer prepare procedures for market making its own shares. Furthermore, the issuer should ensure that there is complete transparency with regards to the terms and extent of the market making.

Issuers, who act as market maker for its own shares, must be aware of the prohibition on insider trading. Section 35 (3)(2) of the Danish Securities Trading Act contains a special exception where a company may carry out conventional trade as long as the transaction takes place as a normal part of the securities trader's function as market maker for the security in question.

Other price-sensitive activity
In addition, the Danish FSA assesses that listed financial institutions in certain cases may indirectly affect the securities pricing in the market if they – concurrently with a market maker scheme – trade in the financial institution's own shares relative to its own portfolio with reference to the highest offers/ offerings in the market. If the financial institution experiences purchase or selling pressure relative to its own shares, and absorbs this in the holding of own shares instead of the market maker portfolio, the price will not accurately reflect the interest for the share.

In such cases, issuers may attempt to minimise such risk by carrying out the market maker and own portfolio transactions through the same portfolio.

If you have any questions or would like additional information on the recommendations of the Danish FSA, please contact partner Dan Moalem (dmo@mwblaw.dk), attorney Lennart Meyer Østenfjeld (lmo@mwblaw.dk) or junior associate Mattias Vilhelm Warnøe Nielsen (mvn@mwblaw.dk).

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