

# New SCA Securities Regulations

by Divya Abrol Gambhir - d.abrol@tamimi.com - Dubai International Financial Centre

November 2012

The Securities and Commodities Authority (“SCA”) issued new fund regulations (which came into effect on August 26, 2012) and pursuant to which the SCA has taken over the regulation of domestic and foreign funds.

In continuation of its objective of improving liquidity in the market and introducing international best business practices in the UAE, the SCA has recently issued four more regulations (“Regulations”). It is important to note that the Regulations have not been published in the Official Gazette. We would expect publication to take place within the next month. These Regulations, when implemented, would be landmark regulations. The four Regulations are:-

## 1. SCA Board Decision No. 48 of 2012 concerning the Regulations as to securities short selling (“Short Selling Regulation”):

Selling shares not owned by the seller at the time of sale is an activity that has always been prohibited by the SCA and the SCA has issued several notices to market members emphasizing this prohibition with warnings of severe penalties and cancellation of licenses to any person engaging in such activities. The SCA has now legalized short selling.

Currently, short selling has only been permitted to enable market makers to conduct their market making activity. Any other case for permitting short selling in the future would require approval by both the UAE exchange and the SCA. Additionally, securities in which short selling shall be permitted will require prior SCA approval. Securities may only be short-sold one month after their listing on any UAE exchange. There are provisions for suspension of short selling in securities.

Since a broker is obligated to ensure that it does not execute a short selling transaction except after ensuring its client’s ability to deliver the concerned securities on the settlement date, a precondition to a short selling transaction may be a stock borrowing transaction by the short seller. The broker would also need to ensure that the price at which securities are short sold is higher than the last executed price. These restrictions would not apply to market makers short selling securities since such market makers would have provided an independent guarantee to the exchange.

Notwithstanding that the Short Selling Regulations do not obligate a market maker to enter into a stock borrowing transaction as a precursor to a short selling transaction, it may be likely from a legal perspective that a market maker has possession of the securities at the time of placing the short selling orders, since there is a risk that the UAE courts may disregard such a sale based on Shariah principles.

Failure to settle short sold securities could result in fines imposed on brokers or market makers and in some cases liquidation of bank guarantees provided by them to the exchange.

Each of the exchanges is expected to issue their internal by-laws that will govern the procedures for short selling.

## 2. SCA Board Decision No. 47 of 2012 concerning the Regulations as to lending and borrowing of securities (“Securities Lending and Borrowing Regulations”):

The SCA is proposing to provide an internationally accepted market framework whereby investors

can borrow and lend securities. The scope of such transactions is essentially to assist market makers and for the purpose of covering a short position in a short sale transaction. Other cases would require SCA approval.

Such transactions may only be conducted through agents approved for such purpose by the SCA and counterparties to a transaction could either be the clearing house of the exchange or a borrowing/lending agent.

Approval granted to agents is valid for a year and requires the payment of fees to the SCA. Currently, custodians and brokerage houses licensed by the SCA and banks and investment companies licensed by the UAE Central Bank are eligible to apply and are required to comply with requirements placed by the SCA. SCA would respond to requests within 30 days.

Securities that are pledged or are under lien or purchased through margin trading or any other case determined by the exchange may not be the subject matter of a stock lending transaction.

The Securities Lending and Borrowing Regulations provide the minimum criteria to be set out in a stock lending agreement. The security to be provided by the borrower could be:-

- (i) a cash guarantee of at least 105% to be retained by the lender's agent;
- (ii) bank guarantee of at least 105%. If the lender is an individual resident, then such guarantee can only be provided by a local bank; or
- (iii) securities owned by the borrower having a market value of at least 110% to be retained at the clearing house. If the lender is an individual resident then the securities offered as security would need to be UAE listed securities.

The Securities Lending and Borrowing Regulations place obligations on the agents which shall be supplemented with internal by-laws issued by each exchange and contain oversight and penal provisions. Lenders are entitled to sell the lent securities before redemption. It is important to note that transfer of ownership of securities related to lending and borrowing transactions are permitted to be off-exchange.

3. SCA Board Decision 46 of 2012 concerning the regulations as to Market Makers ("Market Maker Regulations"):

The regulations appear to be similar to those adopted by some stock exchanges in Europe. EU legislation concerning market making sets out a similar mechanism concerning market making or enhancing liquidity in stock listed on several EU exchanges.

The Market Maker Regulations permits brokerage houses licensed by the SCA and banks and investment companies licensed by the UAE Central Bank or other non financial UAE entities to apply for a license to conduct the activity of providing continuous prices for the purchase and sale of securities to increase their liquidity. A foreign company being similarly regulated in its home country and having been established in this area of practice for not less than five (5) years may also apply and register with a UAE exchange. Licenses shall be for a year and requires the payment of fees to the SCA.

An important positive development is the introduction of a new security namely, the issuance of warrants. Currently there are no regulations that govern the issuance of such warrants, however, we understand that these regulations are being finalized and should be out for public consultation in a couple of months.

Internal procedures and controls issued to regulate the market making activity shall be developed

by the exchanges to provide for separate trading and settlement mechanisms, guarantees to be submitted to the exchange, obligations of market makers, standards for determination of eligibility of securities for market making, controls for execution of trades and trading commissions, reporting mechanisms. The Market Maker Regulations place continuous obligations on the market maker relating to due diligence, capital adequacy, reporting and record keeping requirements.

The market maker license is an important license since the SCA has granted exemptions to market makers from compliance with various requirements such as specific Articles of SCA's Disclosure Regulations. Market makers are permitted to engage in short selling of securities and in securities lending and borrowing transactions. They are permitted to issue warrants and if the issuer of warrants is a market maker then they are exempted from the requirement of having a minimum prescribed number of warrant holders. Securities subject to market making transactions may be permitted to be transferred off-exchange.

The Market Maker Regulations also contain oversight and penal provisions.

4. SCA Board Decision No. 49 of 2012 concerning the Regulations as to liquidity provision ("Liquidity Provision Regulations"):

The Liquidity Provision Regulations are supportive to the Market Making Regulations, whereby issuers of securities listed on UAE markets can directly engage market makers to enhance liquidity of the issuer's shares.

The requirement to have the Liquidity Provision Agreement approved by the Market seems overly burdensome and might result in over-regulation/over-intervention of the contractual freedom between liquidity providers and issuers. A notification that the criteria set out in the Liquidity Provision Regulations and as prescribed by the exchanges should have been sufficient compliance.

The liquidity provision ability of the liquidity provider is capped at 5% of the issuer's security. Additionally a liquidity provider is not permitted to be market maker for the same security. Exemptions available to market makers are also not granted to liquidity providers although they are required to comply with the same obligations placed on market makers.

It is not common practice in various markets that the agreement is publically disclosed. This proposed public disclosure of the amount of capital that would be allocated by the issuer to the liquidity provider under the Liquidity Provision Agreement is likely to affect the ability of the issuer to expeditiously inject additional capital for market making, should the publicly disclosed capital be utilized up.

The Liquidity Provision Regulations also contain oversight and penal provisions.