

CP (2016-05)

Consultation Paper of the Cyprus Securities and Exchange Commission regarding a proposed circular on the selection, use and monitoring of liquidity providers/market makers

In the context of establishing effective arrangements and procedures for consultation with market participants regarding proposed changes in the regulatory framework, the Cyprus Securities and Exchange Commission ('the CySEC') is circulating this Paper for consultation in relation to the selection, use and monitoring of liquidity providers/market makers.

The proposed circular is attached as Appendix 1.

The CySEC invites you to submit your comments/suggestions, in Word format, by Monday, 18 July 2016, to the electronic address supervision@cysec.gov.cy only.

TO : Cyprus Investment Firms

FROM : Cyprus Securities and Exchange Commission

DATE :

CIRCULAR No :

SUBJECT : Selection, use and monitoring of liquidity providers/market makers

The Cyprus Securities and Exchange Commission wishes with this circular to inform the Cyprus Investment Firms ('the CIFs') about the following:

A. Selection and use of liquidity providers/market makers

1. A number of CIFs are using liquidity providers/market makers to execute clients' orders in a given class of financial instruments and/or to hedge their open trade positions and/or to reduce the exposure to certain trading positions, and in general, to facilitate in any manner the trading in financial instruments.
2. The Investment Services and Activities and Regulated Markets Law of 2007, as in force ('the Law') does not prohibit CIFs from selecting only one liquidity provider/market maker where they are able to demonstrate that such a choice enables them to consistently get the best results for their clients and that they will meet their regulatory obligations to deliver best execution at all times (as per the provisions of article 38 of Law).

It is noted that by using a single liquidity provider/market maker:

- i. it should not lead CIFs to be 'over-reliant' on the single provider/market maker,
 - ii. it does not diminish the CIF's responsibility to monitor the quality of execution, and
 - iii. it does not mean that merely executing client orders on that provider/market maker will allow the CIF to discharge its best execution obligations.
3. CIFs must exercise due skill, care and diligence in entering into a contractual agreement with a liquidity provider/market maker.
 4. CIFs may enter into a contractual agreement with a liquidity provider/market maker which it is established outside European Union provided that the CIF ensures that the following conditions are met:

- i. The liquidity provider/market maker is a regulated Investment Firm from a third country.
 - ii. The liquidity provider/market maker has a valid/activated Investment Firm authorisation from a third country.
 - iii. The liquidity provider/market maker has such financial soundness that can justify the trading risk it undertakes and it is in such a cash flow position that can undertake the settlement of all trades introduced or executed or hedged by its clients.
 - iv. 1st option - Either the liquidity provider/market maker is managing all its risks, directly or indirectly, with a liquidity provider that is regulated and supervised within EU, or the liquidity provider/market maker has sound financial records and can demonstrate a capital ratio of not less than 10%. It is provided that the ratio is calculated in accordance with the [European Directive 2013/36/EU](#) and [European Regulation 575/2013](#). In order to safeguard this provision, the CIF must make such contractual arrangements that will impose an obligation to the liquidity provider/market maker to disclose this ratio and maintain it up to standards.

2st option - Either the liquidity provider/market maker is managing all its risks, directly or indirectly, with a liquidity provider that is regulated and supervised within EU, or the CIF maintains, on an ongoing basis, in addition to Pillar 1 [article 67(1) of Law 144(I)/2007], own funds to cover the risk of failure/insolvency that it may undertake due to the fact that the liquidity provider/market maker is not situated in the European Union (article 68 of the Law). It is noted that the amount of additional own funds depends on the nature and the level of that risk, which may in no case be less than two million euro (€2.000.000). The final amount of the additional own funds to cover the specific failure/insolvency risk (conduct risk) will be assessed by CySEC in accordance with article 70 of the Law.
 - v. In case the liquidity provider/market maker belongs to the same group with the CIF, in addition to point (iv) above, the capital ratio and own funds are calculated on a consolidated basis (both CIF and liquidity provider/market maker), in accordance with the [European Directive 2013/36/EU](#) and [Regulation 575/2013](#).
5. When a CIF enters into a contractual agreement with a liquidity provider/market maker which it is established within European Union, it is provided that:
- i. The liquidity provider/market maker is licensed and regulated by a competent authority of a Member State.
 - ii. The provisions of [European Directive 2013/36/EU](#) and [Regulation 575/2013](#) are applied, on a solo basis and on a consolidated basis as well (in case the CIF belongs to the same group with the liquidity provider/market maker).

6. A CIF should be transparent about its trade flow and it should be clear to its clients what the CIF's hedging arrangements are and where the trades are executed.

B. Monitoring of liquidity providers/market makers

7. In order to comply with the requirement to act in the best interests of its clients [article 36(1) of the Law], CIFs need to regularly assess the market landscape to determine whether or not there are alternative liquidity providers/market makers that they could use.

To this effect, the CIF's Internal Auditor and Compliance Officer are requested to evaluate and assess the decision of the management of the CIF for the use of a liquidity provider/market maker and report to the Board of Directors of the CIF whether the CIF has exercised sufficient diligence to ensure that the best execution policy is safeguarded. It is directly implied that the Internal Auditor and the Compliance Officer will perform such checks and evaluation using risk related techniques on a sample basis.

8. When a CIF uses a single liquidity provider/market maker established outside European Union:
 - i. The CIF must effectively, through contractual arrangements, be able to regularly oversee and assess the financial performance and soundness, including capital ratio, of that liquidity provider/market maker regularly, but not less than on a quarterly basis.
 - ii. The CIF must ensure, through contractual agreement, that the liquidity provider/market maker is providing them, at least monthly, with a statement of all the transactions executed on behalf of the CIF's clients. The statement provided must clearly indicate any open trades the liquidity provider/market maker has with the CIF at the end of each calendar month or at the date of each month that the CIF requests its submission.

C. Actions to be taken by CIFs

9. CIFs are requested to:
 - i. Review their policies and procedures and ensure that they fully comply with the provisions of this Circular.
 - ii. Immediately take, without delays, corrective measures, where necessary.
 - iii. Provide to the CySEC confirmation signed by the members of the board as to their compliance with this circular and, where applicable, provide reference to any corrective measures adopted for their compliance.

The above confirmation must be sent to the electronic address supervision@cysec.gov.cy only as soon as possible and not later than xx (3 months).