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Client Alert Commentary

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Italian Securities Exchange Commission Announces Market Practice on Liquidity Contracts

The measure is intended to align market practice with the principles laid down under the European market abuse regulation.

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The Italian Securities and Exchange Commission (Commissione Nazionale per le Società e la Borsa, or Consob):

- Approved the new accepted market practice on liquidity contracts
- Ordered the termination of market practices on the purchase of own shares to set up a share warehouse position and for the buyback of bonds at predetermined conditions, as of June 30, 2019
- Announced the issuance of guidelines to regulate the set-up of share warehouse positions and bond buybacks, which will no longer benefit from market practice safe harbor provisions

This *Client Alert* outlines the main steps Consob has taken to reform market practices, focusing on the key features of the new accepted market practice on liquidity contracts (New Practice No. 1) as well as on the main differences vis-à-vis Practice No. 1 previously in force.

Introduction

The market abuse provisions introduced by Regulation (EU) No 596/2014 (MAR) and Directive 2014/57/EU (MAD2) provide for an exemption from sanctions in case a transaction breaches the general prohibition of market manipulation for transactions carried out for legitimate reasons and in line with accepted market practices (AMPs) established by national competent authorities (NCAs). NCAs are required to update the respective national AMPs adopted under formerly-in-force Directive 2003/6/EC (MAD1), in accordance with the newer European framework.

On April 8, 2019, Consob, in its capacity as Italian NCA, notified the European Securities and Markets Authority (ESMA) of New Practice No. 1 to enable ESMA to issue its assessment of the compatibility of the new Italian AMP with the MAR[1] provisions.

New Practice No 1 was notified following the conclusion of a public consultation procedure launched in September 2018 regarding the proposal to amend the formerly-in-force market practices (the Consultation), and in light of the comments some Italian market participants shared with Consob (including Latham & Watkins, by letter dated October 22, 2018) in response to the Consultation.

Under MAD1, Consob established three market practices:

- **Practice No. 1:** relating to liquidity contracts
- **Practice No. 2:** relating to the purchase of own shares to set up a share warehouse position
- **Practice No. 3:** relating to the buyback of bonds at predetermined conditions

Practice No. 1 and Practice No. 2 were adopted in 2009,[2] followed by Practice No. 3 in 2012[3] (together, the Practices).

Following the Consultation, Consob updated and replaced Practice No. 1 with New Practice No. 1, notified this new practice to ESMA, and ordered that both Practice No. 2 and Practice No. 3 be terminated as of June 30, 2019[4]. Therefore, starting from June 30, 2019, the purchase of own shares to set up a share warehouse position and the buyback of bonds at predetermined conditions will no longer benefit from the MAR safe harbor provisions applicable to transactions carried out in accordance with AMPs.

The Temporary Application of the Practices

On September 9, 2016, and November 4, 2016, Consob notified ESMA of its intention to temporarily retain in force[5] the Practices[6], pending the completion of its ongoing revision process aimed at aligning such Practices with the principles laid down under MAR. In light of the foregoing, ESMA suspended its review of the Practices notified by Consob for the purpose of issuing the compatibility opinion that the European Authority should have issued within two months from receiving the notification.

Therefore, the Practices were retained in force, pending amendments, for more than two and a half years, until completion of the Consob revision process (which occurred in April 2019).

The Consultation

In December 2016, ESMA published a document providing common criteria addressed to NCAs (Points for Convergence or Opinion)[7] to facilitate the convergence of the national AMPs on liquidity contracts — governed, in Italy, by Practice No. 1 — with the aim of promoting a uniform application of the principles laid down under MAR[8].

On September 21, 2018, Consob launched the Consultation regarding, among other things, the amendments required to align Practice No. 1 with the Points for Convergence and, more in general, with the principles laid down under MAR.

Consob also proposed to terminate Practice No. 2 and Practice No. 3, following the concerns raised by ESMA's Market Integrity Standing Committee regarding the integrity of the market as well as the compatibility of those practices with the new legal framework on market abuse. Consob additionally pointed out that, over the years, issuers had rarely used Practice No. 3.

Termination of the shares warehouse position and bond buyback market practices (Practice No. 2 and Practice No. 3)

In the course of the Consultation, market participants (including Latham & Watkins) pointed out to Consob the opportunity to retain in force Practice No. 2 in light of the fact that the practice is widely used by listed companies; indeed, Practice No. 2 represents a useful tool to achieve purposes not otherwise covered by the safe harbor provision provided by Article 5 of MAR, but which are justified by the need to ensure market integrity, such as in the case of purchase of own shares in the context of certain M&A

transactions. This specific aspect was highlighted by Consob in its explanatory report on the results of the Consultation issued on April 8, 2019 (the Explanatory Report).

In light of the criticisms expressed by ESMA on the retention of Practice No. 2 and also due to the fact that none of the other NCAs have established similar practices, Consob ordered its termination, together with Practice No. 3, as of June 30, 2019. In particular, the Italian Authority did not accepted the requests received during the course of the Consultation to extend such term (June 30, 2019) for the benefit of listed companies whose ordinary shareholders' meetings have already been called to approve the authorization to purchase own shares in accordance with Article 2357 of the Italian civil code and pursuant to Practice No. 2 for a period subsequent to the termination of Practice No. 2 or to listed companies that have already passed any such resolution.

In its Explanatory Report, Consob clarified that companies will still be able to operate substantially in line with the operating procedures and purposes provided by the terminated market practices (even if they can no longer benefit from the market practices' safe harbor provisions following termination of Practice No. 2 and Practice No. 3), by complying with the obligations set out in the Italian domestic regulations (*i.e.*, the obligation to disclose the purchase of own shares in line with the provisions set forth in Schedule 3F of Regulation No 11971/1999).

Consob announced the release of guidelines to regulate the set-up of share warehouse positions and bond buybacks at predetermined conditions in order to provide companies and investment firms with an operative tool to help them continue to operate while reducing the risk of market manipulation.

Liquidity support activities according to New Practice No. 1

In line with Practice No. 1, New Practice No. 1 provides that issuers interested in supporting the liquidity of their own shares may appoint an intermediary, on the basis of a contract, to independently carry out liquidity support activities to facilitate trading activities and with the purpose to avoid misalignments between price movements and market trends.

In performing the liquidity support activities, the intermediary shall:

- Act independently
- Have no access to issuers' inside information
- Ensure that such activity is not affected by other interests, including those relating to the performance of investment services

The remuneration of the appointed intermediary shall be structured so that it does not incentivize the intermediary to influence prices or trading of the financial instruments.

The appointed intermediary shall close the open positions as soon as practicable, thus avoiding the extension over time of the market liquidity conditions and of the comparison between current market prices and the book value of the trading positions[9].

Key features of New Practice No. 1

Distinction between "liquid" and "Illiquid" financial instruments

As recommended by the Points for Convergence, the New Practice No. 1 introduces different limits in terms of resources that may be allocated to the performance of liquidity contracts and the number of shares that may be purchased and sold by the intermediary, depending on whether the liquidity contract refers to issuers of liquid or illiquid financial instruments.[10]

In particular, instead of the 2% limit on the value of the issued financial instruments set out in Practice No. 1, New Practice No. 1 provides that the overall resources that may be allocated in terms of liquidity and/or financial instruments must not exceed:

- For liquid financial instruments, 200% of the average trading volume associated to a resources cap of maximum €20 million
- For illiquid financial instruments, 500% of the average trading volume, or 1%[11] of the outstanding issued financial instruments calculated as of the opening of the start of the liquidity support activities associated to a resources cap of maximum €1 million

According to the Points for Convergence, NCAs shall on a voluntary basis be entitled to introduce in their AMPs on liquidity contracts the distinction between issuers of liquid, illiquid, and "highly liquid" shares, corresponding — in Italy — to the issuers listed on the FTSE MIB index. However, it is worth noting that Practice No. 1 has been rarely applied by Italian issuers included in such group.

In light of this and of the inputs that most participants (including Latham & Watkins) provided to Consob during the course of the Consultation , the Italian Authority introduced in New Practice No. 1 the only distinction between issuers of liquid and illiquid financial instruments, without providing for any additional special provision for issuers of "highly liquid" financial instruments.

Reference period for the calculation of the average trading volume

The reference period for the calculation of the average trading volume for the purpose of defining the resources that can be allocated for liquidity support activities is 30 days.[12]

According to the Italian Authority's intentions, such a timeframe — which is in line with the timeframe set forth for stabilization transactions pursuant to Article 5 of Commission Delegated Regulation (EU) No 1052/2016 — should foster the recourse to liquidity contracts by issuers who have been admitted to trading for only one month.

In response to the Consultation, on one side our firm recognized the adequacy of the 30-day timeframe introduced while at the same time expressing concern about the fact that a fixed time limit might discourage the recourse to that measure if not backed up by a residual (and exceptional) provision allowing for the application of different terms whenever market conditions do not permit to usefully apply a general 30-day term.

In its Explanatory Report, Consob expressly acknowledged our request for flexibility and, therefore, set out that, wherever the 30-day period does not apply,[13] the issuer may refer to any different period, provided that such term is prior to the launch of the liquidity support activities.

Remuneration of the intermediary appointed by way of the liquidity contract

New Practice No. 1[14] specifies that the fixed component of the remuneration of the intermediary must prevail over the variable component, if any, which in any event must not exceed 15% of the total remuneration.

Such a remuneration mechanism is aimed at ensuring the independence of the intermediary with respect to the issuer's interests and at discouraging any trading activities not strictly required.

Operational limits

New Practice No. 1 sets forth the following limits in term of volumes exchangeable by intermediaries on a daily basis:

- For liquid financial instruments, 15% of the daily average trading volumes in the preceding 20 trading days
- For illiquid financial instruments, 25% of the daily average trading volumes in the preceding 20 trading days

Such percentage values shall be calculated as the sum of all sale and purchase transactions carried out against the total number of trades, and not independently[15] as provided for by Practice No. 1. No derogations are allowed.

Performance of liquidity contracts during auction phases

New Practice No. 1 introduces restrictions with respect to transactions carried out during auction phases[16] with the aim of avoiding that the placed orders impact the final price of the auction itself and of granting to the other participants enough time to react. In particular:

- For purchase transactions, the price of the trade proposals must be lower than the theoretical auction price

- For sale transactions, the price of the trade proposals must be higher than the theoretical auction price

Block trades

In line with Practice No. 1, New Practice No. 1 does not cover block trades.

ESMA's Points for Convergence allow NCAs to introduce the possibility to carry out block trades in certain exceptional circumstances. During the course of the Consultation, Consob considered this option, but the Italian Authority thought it preferable to retain, as a conservative measure, the prohibition set forth under the previous regime, considering that block trades may allow the extension of long positions on financial instruments, thus enhancing market prices and potentially entailing the manipulation thereof.

Transparency

In addition to the information required under Practice No. 1, both issuers and intermediaries are required to provide the following:

- Prior to the start of the liquidity support activities, the issuer must disclose to the public, among others, whether the financial instruments fall within the category of liquid or illiquid instruments, the markets where the liquidity support activities will be performed, the duration of the liquidity contract, and the conditions that may determine the suspension or termination of the activity

- During the performance of the liquidity support activities, the intermediary must disclose, within the first 15 days of the month following the end of each quarter, among other things, details of the daily activities carried out during the relevant quarterly period by means of the form provided by Consob on its website.

The issuer must produce the relevant publication on a quarterly basis and send the communication to Consob by certified email (PEC).

Conclusion

Consob's interpretation of the guidance provided by ESMA in its Opinion is substantially in line with the purpose of ensuring the uniform application of the principles laid down in Article 13 of the MAR with respect to the choices made by other Member States that already comply with the new regulatory framework. Moreover, Consob gave great importance to the specific features of the Italian domestic market to facilitate (compared with Practice No. 1) the recourse to liquidity contracts by issuers listed on the FITSE MIB index and by newly listed SMEs.

The indications arising from the use of New Practice No. 1 over the coming months will help demonstrate whether market participants recognize the full worth of the measures introduced by Consob or whether the level of detail, including with respect to the EU measures, will discourage the recourse to liquidity contracts for the benefit of other instruments fulfilling similar purposes that had greater success (*i.e.*, specialist contracts). Consob's efforts to provide clarification in outlining the operational limits for intermediaries are, however, remarkable.

Particularly useful are the guidelines the Authority provided in response to the market participants' concerns about termination of Practice No. 2, which has been broadly used over the years by Italian-listed companies to set up share warehouse positions, including for purposes not covered by MAR's safe harbors but equally deserving protection. At the same time, Consob showed remarkable commitment to provide the market participants with guidelines to continue to operate while reducing the risk of abuse in the absence of an accepted market practice.

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Endnotes

1 Pursuant to Article 13(3), (4) and (5) of the MAR, NCAs are required to notify their intention to establish a new AMP to ESMA at least three months before such AMP is intended to take effect. Such notification shall provide the details of the assessments made by the NCA on the possibility of establishing the new market practice. Within two months following the receipt of the notification, ESMA shall issue an opinion assessing the compatibility of the practice with the market abuse provisions. ESMA shall also assess whether the establishment of the AMP would not threaten the market confidence in the Union's financial market. Where a NCA establishes an AMP contrary to the opinion of ESMA, it shall publish on its website within 24 hours of establishing the AMP a notice setting out in full its reasons for doing so.

2 See Resolution No 16839 of March 19, 2009.

3 See Resolution No 18406 of December 13, 2012.

4 See Resolution No 20876 of April 3, 2019.

5 Pursuant to Article 13(11)(2) of the MAR.

6 Besides Consob, NCAs in France, Spain and Portugal notified ESMA of their intention to retain in force a number of AMPs on liquidity contracts established prior to the entry into force of MAR.

7 ESMA's Opinion sets out, among other things, that: (i) AMPs should provide for the liquidity contract to be entered into in a written form, (ii) the person performing the liquidity contract should be a supervised firm providing investment services and executing the contract as member of the relevant trading venue, (iii) AMPs should gradate between liquid and illiquid instruments (and, if relevant, highly liquid instruments), (iv) AMPs should set forth trading conditions for the performance of liquidity contracts in terms of price limits, volume limits, requirements to operate during tender phases without impacting the final price of the tender.

[8] Following the disclosure of ESMA's Opinion, the NCAs in France, Spain and Portugal aligned their respective market practices and notified such practices to ESMA. Upon obtaining the favorable opinion of the European Authority, those AMPs entered into force in the relevant Member States.

[9] The scope of this provision is to avoid that liquidity contracts will turn into instruments to enhance financial instruments' price (instead of their liquidity). Moreover, trading of predetermined volumes of financial instruments at predetermined prices with selected counterparties shall not be permitted.

[10] See Paragraph 7 of New Practice No 1.

[11] The 1% limit shall be calculated at the beginning of the day in which the activity is initiated and shall be updated upon each significant variation of the issued financial instruments.

[12] France adopted the same reference timeframe.

[13] For example, to suspend the financial instrument from trading or admitting it to trade on a different market segment characterized by a lower liquidity.

[14] See Paragraph 14.

[15] In order to clarity how such mechanism operates, Consob provided the following example in its consultation document dated September 21, 2018: "if, therefore, the intermediary carries out purchase transactions on illiquid instruments amounting to 20% of the average trades, such intermediary may not carry out sale transactions in excess of 5% of that same average value; whereas, in accordance with current practice (editor's note: i.e., Practice No 1), it may reach 25%".

[16] See Paragraphs 17-bis and 18-bis.