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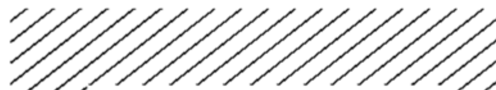
SUMMARY OF SPOT INSPECTIONS ON LIQUIDITY CONTRACTS



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INTRODUCTION

As announced in the AMF's supervision priorities for 2020, a series of short thematic "SPOT"[1] inspections targeting liquidity contracts was carried out. The inspections were conducted under the provisions of AMF Decision 2018-01 of 2 July 2018[2] on establishing liquidity contracts on equity securities as accepted market practice.

A liquidity contract provides a framework for the conditions under which an issuer entrusts an investment services provider ("ISP") with carrying out transactions on its behalf to stimulate the market and promote the liquidity of its shares.

AMF Decision 2018-01 sets out the conditions for implementing liquidity contracts within the framework of the accepted market practice established by the AMF. These conditions, when they are met, allow ISPs to benefit from the exemption framework provided for in Article 13 of Regulation (EU) 596/2014 of the European Parliament and of the Council of 16 June 2014 on market abuse (hereinafter the "MAR"). Accordingly, the prohibition of market manipulation as referred to in Article 15 of the MAR does not apply when an order or transaction has been carried out for legitimate reasons and complies with an accepted market practice as defined in Article 13 of the same Regulation.

The SPOT inspections were carried out on a sample of five ISPs: two credit institutions and three investment firms. The inspections took place over four months, between May and September 2020, and covered the implementation of liquidity contracts from 1 January 2019 to 30 June 2020. The main objective of this series of SPOT inspections was to ensure that the ISPs had implemented the provisions applicable to stimulating the market in an issuer's equity securities under a liquidity contract. Particular attention was paid to *(i) the organisational structure of ISPs; (ii) the management of volume and price limits and breaches of these limits; (iii) the compliance monitoring system for liquidity management activities; and (iv) information and transparency requirements.*

This summary aims to provide an insight into the operational implementation of the obligations for service providers to comply with the conditions established by accepted market practice and thereby benefit from the abovementioned exemption framework for liquidity contracts.

It should be stressed that the findings issued by the inspection task force relate to compliance with the conditions of AMF Decision 2018-01 with regard to the implementation of liquidity contracts by the ISPs in the sample. As stated in Recital 3 of this Decision, *"[o]perations carried out under the conditions set out in Article 1 of this decision to stimulate the market in an issuer's equity securities that do not comply with the conditions set out in this decision are not prohibited but do not benefit from the exemption provided for in Article 13 of the MAR."* It is important to remember that ISPs must at all times have robust market abuse prevention measures in place.

This document is neither a position nor a recommendation. The practices identified as either "good" or "poor" highlight approaches identified during the inspections that may facilitate, or complicate, compliance with the provisions applicable to managing liquidity contracts.

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1 *Supervision des Pratiques Opérationnelle et Thématique* – operational and thematic supervision of practices.
2 Applicable as of 1 January 2019.

1. OVERVIEW OF THE MAIN FINDINGS OF THE INSPECTIONS

In general, the investigations conducted by the inspection task force highlighted many good practices, together with some poor practices and shortcomings with regard to the conditions set out in AMF Decision 2018-01. In particular, the organisational structure (i.e. *(i) liquidity account management, (ii) independence of the operator responsible for liquidity contracts, (iii) the service provider's compensation, (iv) managing conflicts of interest, and (v) technical resources and facilities)* put in place by the ISPs in the sample broadly meets the requirements set out in the Decision. However, there is room for improvement in the internal control and monitoring systems implemented by these ISPs. Moreover, the price and volume trading limits set by the Decision are not always enforced by the ISPs in the sample, with the result that they lose the benefit of the exemption provided for in Article 13 of the MAR for the related transactions (remembering that failure to comply with trading limits does not constitute market manipulation in itself). However, it is important to stress that it was not the aim of the inspection task force to examine the trading carried out by liquidity contract managers in order to identify and analyse potential cases of market manipulation.

Firstly, the task force analysed the organisational structure of investment services providers in relation to the conditions set out in Articles 1, 4 and 6 of AMF Decision 2018-01. The task force's objective was to check the ISPs' compliance with the rules on independence, the integrity of directly or indirectly related markets, and the management of conflicts of interest.

- ✓ Regarding the organisational arrangements designed to meet the objectives of physical separation of operators and of data and trading systems IT, the task force found that they were generally correctly implemented by the entire sample. In this respect, three good practices were observed: *(i) providing liquidity contract operators with a dedicated area for this activity, (ii) setting up restrictions on access to the information system aimed at separating the activities related to intermediation from those related to liquidity contract management,* and *(iii) deploying a separate order management system for each of these two activities.* Furthermore, three ISPs in the sample have implemented the good practice of prohibiting any direct or regular interaction between the operators responsible for maintaining the liquidity of the securities concerned and their issuer clients. In addition, for the other two ISPs, the task force highlights the existence of periodic controls and, in the case of one of these two ISPs, a temporary change of operator in the event that information is received by an issuer outside the framework of liquidity contracts, thereby mitigating the risks associated with this practice.
- ✓ Regarding the management of conflicts of interest, all the ISPs in the sample have correctly defined and identified the related risk within their procedural framework. However, one firm has not carried out any checks to identify potential conflicts of interest among its operators responsible for liquidity contracts.
- ✓ Regarding the compensation arrangements associated with liquidity contracts and any additional services, in accordance with the requirements of AMF Decision 2018-01, compensation is set exclusively on a flat-rate basis for almost all of the contracts reviewed. Only two out of a total of more than 300 contracts include variable compensation. Furthermore, only one of these two contracts includes a variable component that exceeds 15% of total compensation. This constitutes non-compliance with the provisions of Article 6 of AMF Decision 2018-01. Consequently, trading carried out under this contract does not benefit from the exemption provided for in Article 13 of the MAR.
- ✓ Regarding the analysis of additional services offered by ISPs to their issuer clients in addition to liquidity contracts, market surveillance is the service most commonly marketed, with two ISPs offering it systematically and the vast majority (75% of issuers that have entered into a liquidity contract) for another ISP. In the three cases mentioned above, two firms systematically include market surveillance in the liquidity contract at no additional charge, and one firm offers this as a supplementary service at a specific price. In this respect, two of the five firms in the sample do not have procedures for supervising and monitoring these services, which is a poor practice.
- ✓ Regarding liquidity account management and preventing debit balances (paragraph 6 of Article 4 of AMF Decision 2018-01 states that *"[c]ash and securities in the liquidity account shall show a credit balance at all times"*), it appears that the measures implemented by three ISPs in the sample are not sufficient to prevent a transaction from using or potentially using an amount of cash or securities that exceeds the

resources available in the liquidity account. Consequently, these measures are not sufficient to ensure that transactions do not lose the exemption benefit provided for in Article 13 of the MAR. However, two of the five ISPs in the sample have implemented a monitoring or blocking control mechanism that is integrated into the order management system, which is good practice.

Secondly, for the five ISPs in the sample, the task force then analysed the system for managing limits and breaches of these limits required under Article 4 of AMF Decision 2018-01. To benefit from the exemption framework provided for in Article 13 of the regulation on market abuse (MAR), these provisions specify quantitative limits and require justification to be provided when volume or price thresholds are exceeded.

The task force's analysis focused on limits exceeded at level 1 (limit requiring justification to benefit from the exemption framework) and at level 2 (absolute limit beyond which ISPs no longer benefit from the exemption framework) reported by the ISPs between 1 January 2019 and 30 June 2020. The ISPs reported 962 level 1 volume limit breaches and 52 level 2 volume limit breaches. Only one ISP set up measures to fully avoid exceeding the level 2 limit, having implemented a system that blocks orders that could exceed this limit. Furthermore, breaches of level 1 volume limits (i.e. requiring justification) were noted on a significant number of occasions for four out of the five ISPs. With regard to price restrictions, the ISPs reported 727 breaches of level 1 limits and 279 breaches of level 2 limits, with two ISPs reporting a significant number of occurrences. However, two ISPs reported no breaches of level 2 price limits.

In this area, the task force also analysed the systems implemented before and after orders are placed in order to assess the ISPs' practices for supervising and monitoring transactions within the limits mentioned above. Most ISPs were found to have shortcomings, particularly in terms of their procedures, which do not include a reminder of the conditions set out in the decision. Furthermore, all the ISPs in the sample were able to confirm an order that might result in the limit being exceeded without providing any justification in advance. However, three of the five ISPs in the sample have implemented operational measures to restrict certain limit breaches (warning systems and/or blocking limits built into the order management system), which is good practice.

Furthermore, the analysis of the system for managing limits and limit breaches after the transactions have been executed revealed shortcomings in the content of the justifications provided for exceeding level 1 limits. In particular, two of the five ISPs in the sample[3] use only the classification defined by the French Association of Financial Markets (AMAFI),[4] providing standardised explanations that do not provide detailed information about the reasons for trading. In this context, the explanations provided are insufficient to satisfy the conditions set out in Article 4 of AMF Decision 2018-01. Accordingly, a poor practice was noted regarding the lack of systematic ex post controls on the justifications provided. However, a good practice was noted regarding the possibility of adding to the justifications entered after the close of trading.

Thirdly, the analysis of the monitoring system put in place by the ISPs in the sample reveals a varying level of maturity and effectiveness of the controls. The analysis focused on compliance with the conditions set out in Article 4 of AMF Decision 2018-01 regarding the compliance monitoring system for liquidity management activities. Even though all firms have compliance monitoring procedures for liquidity management activities, the scope of this monitoring varies from one firm to another. Furthermore, the controls carried out by two ISPs are insufficiently detailed and formalised, and even inadequately designed, with regard to the desired objective. These shortcomings relate in particular to the monitoring of the justifications for exceeding the volume and price limits noted, making it impossible to verify their relevance with regard to the provisions of Article 4 of AMF Decision 2018-01. In addition, one of the firms in the sample group has a first- and second-level control system for liquidity management that is very inadequate or even deficient in its implementation. However, two good practices were observed concerning the implementation of *(i) a specific reporting system for monitoring limit breaches and potential limit breaches*, and *(ii) an exhaustive periodic control of the resources allocated by issuers*.

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[3] Of which only one for level 1 limit breaches.

[4] Classification included in the document entitled *"Conditions for implementing AMF Decision 2018-01 – Points of clarification"* published by the AMAFI on 15 January 2019.

Lastly, the inspection task force assessed compliance with disclosure and transparency requirements for ISPs responsible for managing liquidity contracts and for issuers that have entered into them. To this end, the task force reviewed a sample of communications sent by ISPs to issuers to comply with the requirements set out in Article 2 of AMF Decision 2018-01, and also examined the reporting information sent by ISPs to the AMF under the provisions of Article 241-4 of the AMF General Regulation and Article 3 of the Decision. In this regard, the practices noted by the task force were generally consistent and compliant (in terms of frequency and methods used to send information) for all five firms, without prejudging the completeness and reliability of the content of the reports.

In view of the elements identified during these inspections, the AMF may investigate further in order to broaden the scope of the abovementioned analysis and ensure compliance with the accepted market practice.

2. CONTEXT AND SCOPE

2.1. PRESENTATION OF THE SAMPLE OF ISPs INSPECTED

These SPOT inspections were carried out simultaneously at five investment services providers (two credit institutions and three investment firms). The criteria used by the task force to select these five providers were:

- firms that actually provide liquidity management services;
- firms that are a significant liquidity management player in France.

The five firms selected manage just over 300 liquidity contracts[5] between them (out of a total of 430 contracts listed by the AMF, i.e. around 70% of the total). As regards markets on which the securities are listed, 250 contracts relate to securities listed on Euronext Paris and 50 contracts relate to securities listed on Euronext Growth Paris. Furthermore, 22 of the 300 contracts (around 8%) are for "highly liquid"[6] securities on the CAC 40 index.

2.2. TOPICS ADDRESSED AND METHODOLOGY USED

The following topics were addressed during these inspections:

- The service provider's organisational structure (liquidity account management, independence of the operator responsible for liquidity contracts, the service provider's compensation, managing conflicts of interest, and technical resources and facilities);
- The management of limits and breaches of these limits in terms of volume and price (management of volume and price limits and limit breaches, management of resources allocated to liquidity contracts, and study of limit breaches);
- The compliance monitoring system related to liquidity management activities (analysis of the procedures and the monitoring system, and testing on a sample of controls performed by the firm);
- Disclosure and transparency obligations.

For each of the five firms audited, the inspection task force analysed the following documents and information in particular:

- Current policies and procedures relating to liquidity contracts;
- The results of the compliance monitoring (first-, second- and, if necessary, third-level controls) performed during the financial years 2019 and 2020 relating to liquidity management;

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[5] As at the date of the inspection.

[6] Highly liquid equity securities: Securities that meet the liquidity requirements applicable to shares, as defined in Article 1 of Delegated Regulation (EU) 2017/567 of the Commission of 18 May 2016, and that are included in the main national stock market index determined by the AMF.

- The information provided by the operator responsible for the liquidity contract to the issuer and vice versa;
- The reporting on volume and price limit breaches from 1 January 2019 to 30 June 2020.

To supplement its analysis, the task force also:

- sent a questionnaire on liquidity management activities to each firm, which each firm completed and returned to the inspection task force;
- carried out testing on a sample of 10 volume and/or price limit breaches that occurred between 1 January 2019 and 30 June 2020 to analyse the corresponding explanations and justifications.

2.3. APPLICABLE REGULATIONS

The inspection task force based its work on the following legislation:

- Regulation (EU) 596/2014 of the European Parliament and of the Council of 16 June 2014 on Market Abuse (MAR);
- AMF Decision 2018-01 of 2 July 2018 on “Establishing Liquidity Contracts on Equity Securities as Accepted Market Practice”;
- AMF General Regulation.

Main legal sources:

1. **Service providers’ organisational structure**
   - ✓ Articles 1, 4 and 6 of AMF Decision 2018-01.
2. **Management of volume and price limits and limit breaches**
   - ✓ Article 13 of Regulation (EU) 596/2014.
   - ✓ Articles 4 of AMF Decision 2018-01.
3. **Monitoring system**
   - ✓ Articles 4 of AMF Decision 2018-01.
4. **Disclosure and transparency obligations**
   - ✓ Article 241-4 of the AMF General Regulation.
   - ✓ Articles 2 and 3 of AMF Decision 2018-01.

3. OBSERVATIONS AND ANALYSES

3.1. SERVICE PROVIDERS' ORGANISATIONAL STRUCTURE

The task force analysed the organisational structure of investment services providers in relation to the requirements set out in Articles 1, 4 and 6 of AMF Decision 2018-01. The objective was to check the ISPs' compliance with the rules on independence, the integrity of directly or indirectly related markets, and the management of conflicts of interest.

3.1.1. Independence of liquidity contract operators

The inspection task force focused on analysing the organisational structure of the liquidity contract management teams, both in terms of their internal operation and their relationships with the other functions of the inspected firms, in particular their interaction with operators responsible for other activities. The aim was to verify that the organisational rules defined by the ISPs in the sample met the independence objectives set out in the abovementioned Decision.

- The ISPs in the sample have set up relatively small teams of dedicated staff ranging from three operators for three ISPs in the sample, to five and eight operators for the other two ISPs in the sample. The number of contracts per operator dedicated to this activity corresponds to an average of fifteen contracts per operator, with a slight difference between four of the five ISPs in the sample, whose ratio varies between nine and thirteen contracts per operator. However, for the fifth ISP in the sample, the number of contracts per operator is much higher, at nearly 31.

	Inspected investment services providers				
	ISP "A"	ISP "B"	ISP "C"	ISP "D"	ISP "E"
Average number of contracts per operator	11.8	12.5	9.7	9.3	30.7

This situation can be explained by the difference in the liquidity segments of the securities involved ("illiquid" segment for 96% of the contracts managed by ISP "E", which has the highest ratio).

Liquidity Segments	Inspected investment services providers				
(as a % of issuers covered)	ISP "A"	ISP "B"	ISP "C"	ISP "D"	ISP "E"
Illiquid equity security[7]	66.1 %	68.0 %	24.1 %	10.7 %	95.7 %
Liquid equity security[8]	22.0 %	29.0 %	62.1 %	57.1 %	4.3 %
Highly liquid equity security[9]	11.9 %	3.0 %	13.8 %	32.2 %	0.0 %

- For four of the five ISPs in the sample group, the reporting structure of their liquidity contract management teams is similar, with a reporting line to the units responsible for corporate broking

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[7] Illiquid equity securities: Securities that do not meet the liquidity requirements applicable to shares, as defined in Article 1 of Delegated Regulation (EU) 2017/567 of the Commission of 18 May 2016 (for shares and similar instruments, free float > EUR 100 million if traded on a regulated market or > EUR 200 million if traded on a multilateral trading facility (MTF), average daily number of transactions > 250 and average daily trading volume > EUR 1 million).

[8] Liquid equity securities: Securities that meet the liquidity requirements applicable to shares, as defined in Article 1 of Delegated Regulation (EU) 2017/567 of the Commission of 18 May 2016, and that are not included in the main national stock market index determined by the AMF.

[9] Highly liquid equity securities: Securities that meet the liquidity requirements applicable to shares, as defined in Article 1 of Delegated Regulation (EU) 2017/567 of the Commission of 18 May 2016, and that are included in the main national stock market index determined by the AMF.

(hereinafter "intermediation"). For one of the ISPs, the management of liquidity contracts falls within the trading unit, which is separate from the intermediation activity. This organisational structure is underpinned by operating procedures designed to meet the objectives of physical and informational separation, ensuring a first level of independence within the teams:

- For example, the organisational structure at four firms creates a physical separation between liquidity contract operators and traders involved in intermediation:
  - ✓ Four firms provide liquidity contract operators with a room dedicated to their liquidity management activities, separate from the other traders;
  - ✓ In addition, at one of these four firms, the liquidity contract management team is not part of the intermediation team. Accordingly, in terms of hierarchical reporting, liquidity contract operators have a separate reporting line from other traders and therefore report directly to the firm's secretary general.

- Furthermore, the five firms in the sample group have implemented a logical or IT separation between liquidity management and intermediation activities:
  - ✓ Inflows and data related to liquidity contract management and intermediation activities are separated at the system level, and neither team has any access to the other's system;
  - ✓ The order management systems (OMS) in use are different between the two types of activity for four firms;
  - ✓ The entire IT environment is separate for one of the firms.

- In addition, the five firms in the sample have taken measures to supervise the relationship between liquidity contract operators and their issuer clients:
  - ✓ For two firms, there is no daily contact between contract operators and issuers;
  - ✓ For a third firm, a temporary change of operator is required in the event that the original operator has access to information about the issuer outside the framework of the liquidity contract. This situation reportedly occurred once within this firm in September 2019;
  - ✓ For a fourth firm, the analysis reports provided to issuers is sent by the intermediation activity's middle office and not by the liquidity contract operators;
  - ✓ Similarly, for a fifth firm, market analysis reports are sent to issuers by the relationship managers in the intermediation team and not by the liquidity contract operators.

➢ Two ISPs in the sample have implemented periodic controls to ensure that liquidity contract operators are assigned exclusively to liquidity contract management and do not execute any orders for the issuing company's securities outside the framework of these contracts.

3.1.2. Conflict of interest management

The provisions of AMF Decision 2018-01 require ISPs to identify potential conflicts of interest and implement appropriate measures to guard against them. These provisions are designed to deal with situations in which the organisational structure of the liquidity contract management teams does not allow the ISPs to comply strictly with the independence rules[10] set out in AMF Decision 2018-01. In these cases, the task force examined the procedural framework relating to this area. All the ISPs in the sample have defined and identified the risk of conflicts of interest associated with liquidity management activities through either overall or specific procedures.

[10] Extract from point 5 of Articles 4 of AMF Decision 2018-01: *"When the investment services provider, because of its size, is unable to ensure the independence of the staff responsible for executing contracts either by physically separating the contract management and trading teams or by having a reporting line separate from that of the trading team, it shall identify cases of potential conflicts of interest and put in place appropriate measures to manage them."*

However, one firm has not carried out any checks to identify potential conflicts of interest among its liquidity contract operators, which does not comply with point 5 of Article 4 of the Decision.

3.1.3. Compensation arrangements associated with liquidity contracts

The task force focused on verifying compliance with the condition relating to compensation arrangements as referred to in particular in Article 6 of Decision 2018-01, which limits the variable portion to 15% of total compensation. It also looked into the additional services that ISPs may offer the issuer in addition to the liquidity contract in order to ensure strict compliance with the principle of independence set out in Article 1 of the Decision.

- Four firms indicated that they had entered into liquidity agreements that include only a flat-rate compensation for the service provider, i.e. with no variable compensation. However, the task force identified on ISP for which two liquidity contracts include a variable portion, one of which has a variable portion of more than 15% of the total compensation (out of a total of 60 contracts managed by the ISP in question and more than 300 contracts across the entire inspection). However, according to the firm, no actual payment has ever been received for this variable portion. Pursuant to the provisions of Article 6 of the Decision, retaining the clause as is in this contract prevents the ISP from benefiting from the exemption framework provided for in Article 13 of the MAR even if the associated variable compensation is never actually paid by the issuer.

- Furthermore, the task force identified the widespread practice among the sample's five ISPs of providing services additional to the liquidity contract. Among these services, market surveillance is most commonly marketed as a service supplementary to liquidity contracts. Market surveillance is systematically provided to issuers for two firms (i.e. for all issuers that have signed a liquidity contract with the ISP), and to 75%, 5% and 0% respectively for the other three ISPs in the sample. The firms indicated the following additional services provided to issuers that have entered into a liquidity contract:

Additional Services	**Inspected investment services providers**				
(as a % of issuers covered)	**ISP "A"**	**ISP "B"**	**ISP "C"**	**ISP "D"**	**ISP "E"**
Market Surveillance	5.1%	100.0%	100.0%	75.0%	0.0%
Share Buyback	33.9%	Undisclosed	38.7%	17.9%	53.3%
Participating Interest Management	No	Undisclosed	6.5%	No	No
Trading Blocks of Securities	6.8%	Undisclosed	3.2%	No	No
Financial Communications	No	No	No	3.6%	0.0%
Stock Market Marketing	No	No	No	No	89.1%
Financial Research	20.3%	No	No	No	89.1%
Listing Sponsor	No	No	No	No	17.4%

- Two firms in the sample do not have procedures in place to oversee the additional services mentioned above. Moreover, both firms have de facto regular interactions between liquidity contract operators and issuers outside the framework of liquidity management, for example in connection with market surveillance.

3.1.4. Issuer liquidity account management

The obligations imposed on ISPs are designed to prevent any risk of undermining the integrity of directly or indirectly related markets, as referred to in Article 6 of AMF Decision 2018-01.[11] In addition, the provisions of point 6 of Articles 4 of the Decision require the liquidity account to *"have a credit balance at all times"*. Accordingly, the inspection task force focused on verifying that *(i) a liquidity account existed for each issuer, (ii) the account is used exclusively for the liquidity contract,* and *(iii) monitoring procedures are in place to ensure the balance remains in credit.*

- Among the five ISPs in the sample group, two firms provide custody account management directly for accounts associated with liquidity contracts. The other three ISPs opened liquidity accounts with another firm (one with a company in the same group as the ISP and one with a company with which it has financial ties but which is not part of the same group).

  - The five ISPs in the sample have monitoring procedures in place to ensure that liquidity accounts are used exclusively by the dedicated operator for the associated liquidity contract.

  - Four firms have not, or not sufficiently, implemented a control system to ensure that liquidity accounts are not in debit, either in securities or cash:
    - ✓ Three firms have not implemented a blocking control or warning system integrated into the order management system for orders likely to produce a debit balance on the liquidity account;
    - ✓ Furthermore, at two firms (including one to which all three points here apply), the compliance teams do not have direct access to the liquidity account to perform controls, but must request operational or IT access from traders or the middle office;
    - ✓ For two firms, an automatic blocking mechanism rejects orders likely to produce a debit balance, either directly when the firm is itself the custody account-keeper, or otherwise by means of a contractual agreement with a custody account-keeping services provider;
    - ✓ The five firms on the sample have not, according to their statements, recorded a debit balance since the introduction of AMF Decision 2018-01.

Good practices:
- Providing a dedicated area for liquidity contract operators.
- Using separate computer systems to segregate data flows related to liquidity contract management activities from those related to trading activities, with neither team having any access to the other's system.
- Deploying separate order management systems (OMS) for each of the two different types of activity.
- Implementing a monitoring or blocking system to ensure that liquidity accounts have a credit balance at all times.
- Prohibiting any direct or regular interaction between operators of liquidity contracts and issuers.

Poor practices:
- Not having a procedure for identifying and/or monitoring the additional services provided to issuers delegating the liquidity management of their securities to the ISP.

[11] Extract from Article 6 of AMF Decision 2018-01: *"To prevent any risk to the integrity of any directly or indirectly related market on which the relevant equity security trades, the Issuer shall ensure that:*
- the investment services provider records transactions in a financial instruments account for this purpose ('Liquidity Account') opened in its books or in those of an investment services provider providing the service of account keeping and custody of financial instruments."

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3.2. MANAGEMENT OF VOLUME AND PRICE LIMITS AND LIMIT BREACHES

The conditions set out in AMF Decision 2018-01, in particular in Article 4, aim to ensure the free interplay of market forces and proper interaction between supply and demand by introducing restrictions on price and volume and during the price determination phases of an auction (fixing).

These restrictions, which apply to transactions under liquidity contracts, are divided into two levels for volumes and prices. The first limit level (in this document and conventionally referred to as the "level 1 limit") is the threshold above which the ISP must provide documentation for each trading day that *"leads to the view that exceeding the limit was necessary for the implementation of the liquidity contract and did not affect the orderly functioning of the market"*. The second limit level (in this document and conventionally referred to as the "level 2 limit") is an absolute ceiling above which the exemption framework provided for in Article 13 of the MAR no longer applies.

The Decision also specified that, with regard to volume limits, level 1 limits only apply to transactions in *"illiquid"* or *"liquid"* equity securities, while transactions in *"highly liquid"* equity securities are much more tightly regulated (absolute limit of 5% compared to 25% and 50% respectively for the *"liquid"* and *"illiquid"* segments).

Limit Breaches	Inspected investment services providers				
(total number of limit breaches recorded between 01/01/2019 and 30/06/2020)	**ISP "A"**	**ISP "B"**	**ISP "C"**	**ISP "D"**	**ISP "E"**
Number of volume limit breaches:	**139**	**182**	**237**	**46**	**410**
*- of which level 1 limit breaches**	*107*	*171*	*229*	*46*	*409*
*- of which level 2 limit breaches***	*32*	*11*	*8*	*0*	*1*
Number of price limit breaches:	**696**	**0**	**259**	**32**	**19**
*- of which level 1 limit breaches**	*446*	*0*	*231*	*32*	*18*
*- of which level 2 limit breaches***	*250*	*0*	*28*	*0*	*1*

***Threshold requiring justification to benefit from the exemption framework provided for in Article 13 of the MAR.**
****Limit above which the exemption framework provided for in Article 13 of the MAR no longer applies.**

Limit Breaches	Inspected investment services providers				
Percentage of limit breaches between 01/01/2019 and 30/06/2020 by liquidity segment	**ISP "A"**	**ISP "B"**	**ISP "C"**	**ISP "D"**	**ISP "E"**
Volume limit breaches:					
- "Highly liquid" equity securities	*10.1%*	*0.5%*	*0.0%*	*0.0%*	*0.0%*
- "Liquid" equity securities	*20.2%*	*32.0%*	*55.0%*	*65.2%*	*0.2%*
- "Illiquid" equity securities	*69.7%*	*67.5%*	*45.0%*	*34.8%*	*99.8%*
Price limit breaches:					
- "Highly liquid" equity securities	*31.3%*	*0.0%*	*7.6%*	*0.0%*	*0.0%*
- "Liquid" equity securities	*26.1%*	*0.0%*	*69.7%*	*0.0%*	*5.0%*
- "Illiquid" equity securities	*42.6%*	*0.0%*	*22.7%*	*100.0%*	*95.0%*

Source: Data reported by the firms to the inspection task force based on monthly reports sent to the Markets Directorate since the entry into force of AMF Decision 2018-01.

Management of limit breaches before trading:
Regarding the system for managing limit breaches before trading, the task force focused on analysing the systems put in place by the ISPs in the sample to prevent in advance any breaches of level 2 limits and to manage level 1 limit breaches. The analysis of the procedures implemented showed that the definitions and regulatory reminders relating to managing limit breaches were inadequate.

- The procedures of one of these four firms contain very few provisions relating to liquidity contracts, do not mention the obligation to justify level 1 limit breaches, and do not contain any restrictions or provisions aimed at regulating trading during fixing periods.

In practice, the arrangements implemented by three of the five firms are designed with operational restrictions that reduce limit breaches.

- Three firms have set up a warning system (level 1 limits) and/or blocking limits (level 2 limits) for both volumes and prices so that they do not issue or reject an order likely to have a significant impact on the price of the security. They therefore reduce the chance of exceeding these limits.
- In particular, one of these three firms has also implemented quantitative restrictions on trading during the fixing phases, even though AMF Decision 2018-01 does not require such restrictions.

For all five firms, however, it is possible to confirm an order that may result in a limit breach without first entering a justification. For one of these firms, volume and price limits can even be changed by operators in the order management system without any information from or checking by managers or the compliance department.

Management of limit breaches after trading:
Regarding the system for managing limit breaches after trading, the task force observed some common practices among the five ISPs in the sample. However, there were also some shortcomings, particularly with regard to the content of the justifications provided, which are sometimes very succinct, standard responses or not provided at all. For two firms, the justifications for limit breaches are standardised or automated,[12] for example by using only the classifications provided by the AMAFI[13] (e.g. “Volume justification V1”, “Price justification P2”, etc.). These justifications do not explain the specific reasons for limit breaches and do not therefore meet the conditions set out in Article 4 of AMF Decision 2018-01 to benefit from the exemption framework.

- To monitor compliance with price and volume restrictions on a daily basis, the five firms have set up reports to monitor for volume and price limit breaches. However, for one of these firms, the reports on price limit breaches are based solely on the operators’ statements, without any computerised verification of their completeness being possible.
- In the event of a limit breach, two firms provide detailed justifications both by using the standard AMAFI classification and by adding specific, detailed comments on a case-by-case basis and based on the market or trading conditions related to the observed limit breaches.
- Furthermore, two firms have introduced the option, after the markets have closed, of reviewing and adding to the justifications entered during the day.
- In addition, four firms have no systematic retrospective controls on the justifications provided.
- Lastly, the task force also noted that justifications may not be provided as soon as, or very soon after, a limit breach is identified but instead much later, or even at the express request of the inspection task force for the sample selected. In this particular case, at the end of the inspections, for 4 out of the 10 limit breaches[14] tested by the inspection task force, the justifications provided do not meet the above requirements.

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[12] For one of these two firms, this only relates to level 1 limit breaches.
[13] Classification included in the document entitled “Conditions for implementing AMF Decision 2018-01 – Points of clarification” published by the AMAFI on 15 January 2019.
[14] Level 1 limits.

Good practices:

Before trading

- Implementing a warning system (level 1 limits) and/or blocking limits (level 2 limits) for volumes and prices to avoid issuing or rejecting an order likely to have a significant impact on the price of the security.

After trading

- Providing the option, after the markets have closed, of reviewing and adding to the justifications entered during the day.

Poor practices:

- Having no retrospective controls (carried out by managers and/or the compliance department) on limit breach justifications.

3.3. COMPLIANCE MONITORING SYSTEM

To assess the monitoring system put in place by the ISPs in the sample, with particular regard to the obligations set out in Article 4 of AMF Decision 2018-01, the inspection task force analysed the related procedural framework and the effectiveness of the controls defined for liquidity management activities (in particular with regard to the monitoring of limit breaches).

The task force's analysis reveals a varying level of maturity and effectiveness of the controls among the ISPs. Even though all firms have compliance monitoring procedures for liquidity management activities, the scope of this monitoring varies from one firm to another. Furthermore, the controls carried out by two ISPs are insufficiently detailed and formalised, and even inadequately designed, with regard to the desired objective. These shortcomings relate in particular to the monitoring of the justifications for exceeding the volume and price limits noted, making it impossible to verify their relevance with regard to the provisions of Article 4 of AMF Decision 2018-01.

From a methodological point of view, all the ISPs in the sample have implemented a monitoring system specifically for liquidity management.

- In particular, one firm has set up a systematic annual control (not by sampling) of the resources allocated to each contract, a second-level compliance control every six months, and has carried out two internal audits since the entry into force of accepted market practice. In addition, this same firm carries out a second calculation of limits and analyses market conditions to verify justifications as part of the second-level control.
- One firm has a detailed monitoring procedure and a specific operating procedure, and carries out second-level compliance controls on a real-time basis for each limit breach or potential limit breach using a specific alert management tool.

However, one of the firms in the sample group has a liquidity management monitoring system that is very inadequate or even deficient in its implementation. In particular, first-level controls were not carried out during the first half of 2020, and second-level controls were not carried out in 2018 and only covered the months of January and February for the financial year 2019. These shortcomings could constitute situations of non-compliance with the regulations.

Good practices:

- Having a specific reporting system for monitoring limit breaches and potential limit breaches.
- Putting in place an exhaustive periodic control of the resources allocated by issuers for implementing their liquidity contract.

3.4. DISCLOSURE AND TRANSPARENCY OBLIGATIONS

The inspection task force examined the ISPs' procedures for disclosing information to issuers and the AMF to verify compliance with their transparency obligations under Article 241-4 of the AMF General Regulation, which allows ISPs to benefit from the exemption framework under Articles 2 and 3 of AMF Decision 2018-01.

According to Article 2.1 of the Decision, the investment services provider responsible for implementing the liquidity contract shall provide the issuer with all information necessary for the issuer to comply with its transparency obligations to the public and the AMF before, during and at the end of the liquidity contract. Furthermore, the ISP is also required to inform the AMF of the services provided to the issuer under the liquidity contract and the various fees received in this respect.

To this end, the task force examined a sample of communications sent by the ISPs to issuers.

In this respect, the inspection task force found generally consistent and comparable practices among the five firms in the sample. However, it should be stressed that the task force's inspection did not focus on the completeness and reliability of the reports, but only on compliance with the required frequency of communications and on procedures for sending them.

In addition to complying with the half-yearly reporting to the issuer on the performance of liquidity contracts as referred to in Article 2.1 of AMF Decision 2018-01, the five firms in the sample provide issuers with additional information in the form of monthly, weekly and even daily reports. For example, the firms in the sample group send a report to issuers every day after the close of trading, which contains general market information and an analysis specific to the related equity securities. Four of the five ISPs also provide issuers with information on buy and sell transactions carried out under the liquidity contract during the trading session. For two firms, this reporting includes not only aggregate information but also a full list of all orders executed during the day. These two firms also provide issuers with daily details of the securities and cash balances recorded on the liquidity account at the end of the day.