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After a long period of calls by experts for the issuance of two stock exchange mechanisms: ‘market maker’ and ‘short selling’, and due to a significant decline in performance of the market compared to the previous year, the government agreed to issue the two mechanisms early this year (2019).

Chairman of the Egyptian Stock Exchange (EGX) Mohamed Farid Saleh issued a decree on January 6 that regulates the activity of the market maker on restricted securities to enhance liquidity and trading. The regulations allow brokerage firms to act as market makers: both buying and selling securities from their own inventory at prices they have a measure of control over. Saleh stated that this comes within the framework of the EGX Board of Directors' keenness to continue efforts for market development and provide financial mechanisms and tools for boosting the efficiency of the Egyptian Capital Market.

On 26 February, Chairman of the Financial Regulatory Authority (FRA) Dr. Mohamed Omran issued a regulatory decision no. (268) of 2019 on short selling rules and activating the mechanism “in order to add new mechanisms and increase liquidity on the Egyptian Stock Exchange”. The decision stated that “the Egyptian Stock Exchange and Misr for Central Clearing, Depository and Registry (MCDR) – established according to the provisions of the Capital Market law No. 95 of 1992 – shall prepare and set up the automated systems and technical requirements related to short selling mechanism. Both parties shall inform the Authority before activating the mechanism.”

Dr. Omran explained that short selling rules stated that brokerage companies shall manage short selling system and shall provide both the borrower and the lender. Besides, brokerage companies shall check cash collateral. In addition, it shall reinvest selling proceeds, cash collateral and shall hand over full investment's return to the client after deducting the set commissions. Moreover, custodians shall enter into contracts with clients wishing to lend their securities. Omran said that the decision (No. 268 of 2019) regulates transaction's commission taken from the client by brokerage company and custodians in accordance with the contract concluded between them and the client without considering the return. FRA's Chairman confirmed the commitment of the brokerage company, the lender and the custodian to conclude lending securities' contract according to the model issued by the Authority in this regard. He added that the contract must include the client's acceptance to lend his securities through securities' lending system of MCDR, taking into account the rules and procedures related to securities lending system adopted by the Authority.

The brokerage company is also entrusted with the management and investment of cash collateral (selling proceeds + initial collateral). Selling proceeds and initial collateral (50%) are deposited at the brokerage company.

But it is interesting to note that so far, no company has applied to the FRA or the EGX for starting this activity although major brokerage companies had earlier announced their interest in engagement in these mechanisms.

This raises a question about the reasons behind reluctance of the capital market to activate these mechanisms in a manner that contributes to increasing the efficiency of the market and stimulating trading, despite their strong need for that.

Before attempting to answer this question, however, it is important to address some concepts related to the two mechanisms, through the following points:

First: The concepts of the new mechanisms

1- Concept of the market maker:

The mechanism of the market maker is defined as a licensed entity that aims to provide liquidity (supply and demand) but is not a mediator. A market maker or liquidity provider is a company or an individual that quotes both a buy and a sell price in a financial instrument or commodity held in inventory, hoping to make a profit on the bid-offer spread, or turn. The U.S. Securities and Exchange Commission defines a "market maker" as a firm that stands ready to buy and sell stock on a regular and continuous basis at a publicly quoted price:

- Therefore, the market maker is constantly working on a bid for a particular stock, or more, in order to achieve a demand and supply "liquidity" on that particular share or security.

- The market maker has the ability to trade a security, bearing the risk of retaining a certain number of shares as his stock, or selling the security on which he serves as a market maker from the stock available to him. The objective of the existence of the market maker is to provide a constant balance between supply and demand and reduce the gap between the two prices. In contrast to many common traders in the local markets, it is not the task of the market maker to influence the price of the stock up or down or push it in a certain direction; as its job is to meet the demand and supply and reduce the gap between them, and getting its profits through the difference between the prices of supply and demand that it provides.

- The activity of the market maker is primarily aimed at contributing to the revitalization of the trading movement and creating greater liquidity on the restricted securities, whose market is made by a company licensed by the Egyptian Financial Regulatory Authority.

- In the Arab region there is no market maker in this sense in the local markets, except for what has been introduced by the Abu Dhabi market recently, and the mechanism that was introduced by the Egyptian Stock Exchange early this year.

In general, many economists believe the Egyptian market is extremely far from the development, depth, disclosure and transparency required for application of such mechanisms and achieving their objectives.

This explains the reluctance of brokering companies from engagement in the new mechanisms, especially in light of agreement of the stock market experts that dealers in the Egyptian stock market believe the market makers have a lot of uncertainty because of the likeliness to control the prices and volume of trading, which had, in fact, happened so much in the Egyptian market previously.

This mechanism is called by the London Stock Exchange as (Book) is aimed only to reduce market volatility while all its movements are tightly controlled. However in Egypt, investors have suffered from the Market Makers a lot and are not ready to try this experience again.

2- Forward transactions:

In addition to the usual sale in which the buyer pays the price of the shares out of his own money and sells the shares that he owns, there are two other sale types in money markets: when the purchaser does not have the full price at the time of purchase, called 'margin buying'; and when the seller does not own the shares that he has sold at the time of sale, called 'short selling'.

Both concepts can be reviewed as follows:

a- Margin trading:

Buying on margin means that the investor pays part of the price of the shares he wants to buy from his own money and pay the rest from borrowed money, i.e. borrowing money from a broker to purchase stock. Margin trading allows you to buy more stock than you'd be able to normally. You can think of it as a loan from your brokerage.

- The buyer obtains the loan from a bank, a brokering company authorized to carry out the margin sale activity, or one of the other authorized financing companies.

- In accordance with the rules and regulations of the money markets and the circulation of cash and banking, this borrowing is carried out through a special agreement between the buyer and lender, to agree on the size of the loan according to part of the price of shares that he wants to buy.

- The lender obtains all the collateral from the mortgage of other shares owned by the buyer to secure such borrowed funds while allowing the lender to sell those shares at a certain limit of the share price in order to guarantee repayment of the loan and interest thereon.

- The amount of money paid by the investor from his own money is called ‘margin’, which includes two types:

- Initial margin, which is the minimum that is required to be paid by the buyer of his own money at the purchase will, set as a certain percentage of the price of the shares purchased.

- Margin Protection, which provides coverage against an unexpected decrease in operating margin. It is a coverage option that provides producers with coverage against an unexpected decrease in their operating margin.

- This system has been a disaster for investors because the loss is doubled in the case of falling prices. For example, in the case of the purchase of 100 shares at the price of LE 10 out of customer’s money, the loss in the case of the descent of the stock to LE 9 will be one pound and the loss of the portfolio will be LE 900.

- In the case of margin trading financed by the lender (bank or licensed company), the loan may reach 70%, which is the agreed rate. When 170 shares are purchased at LE 10 pounds (LE 10 out of the client's money and 70 from the lender); in case the stock falls to 9 pounds, the customer loses LE 1.7 and not only one pound, and the loss of the portfolio will be LE 1530 (LE 700 to the lender and LE 830 to the customer); i.e. the customer has lost LE 170 and not LE 100.

b- Short selling:

Short selling is a trading strategy that bets on a decline in a security's price. An investor or trader seller opens a position by borrowing shares of a stock or other asset, and then selling them. Before he has to deliver to his buyer, he expects the shares to drop and to be able to purchase them at a lower cost, thus keeping the difference as a profit. Short selling is defined as a sale of securities that a person does not own by borrowing from others (broker, other persons or financial institutions) in exchange for a commitment to repurchase and deliver them to the lender at a specified time.

- The main objective of the short selling is to speculate on the price differences in order to achieve short-term profit. Therefore, it is done only by those who expect stock prices to fall in the future allowing them to win the difference between the high price they immediately sold shares at and their expected low-price purchase in the future.

- Many investors are reluctant to engage in this type of trading for religious reasons, because you sell what you do not have.

Second: Main reasons for investors' lack of interest in the new mechanisms

**The non-activation of the short selling mechanism can be summarized as follows:*

- There are flaws in the formulation of the executive decision issued by the FRA (The most important items that need to be reformulated are those linked with the role of the MCDR, and the possibility of brokering companies to operate internally or through custodians).

- Lack of readiness of the internal systems of brokering companies and custodians.

- The absence of indicative contracts.

** The non-activation of the market maker's mechanism can be summarized as follows:*

- The main drawback is the lack of liquidity in the market. The weak trading volumes led to reluctance of brokering companies to engage in this activity. The weakness of trading volumes is in fact due to the lack of incentives for investing in the stock exchange.

- The high cost of trading due to the stamp duty. The speculative investor faces a problem because of the high tax, in addition to the lack of incentives for brokering companies.

The question that arises in light of the waves of profit taking in the Egyptian stock market in the past months: If all these mechanisms are applied, how much will the real loss borne by customers be?