

# Role of the Market Maker in the Ethiopian Capital Market

## 1. Introduction:

The establishment of a modern capital market in Ethiopia represents a pivotal development in the country's economic and financial architecture. For such a market to operate efficiently, the presence of issuers and investors must be complemented by licensed Capital Market Intermediaries tasked with facilitating transactions and supporting the evolution of a robust secondary market. Among these intermediaries, the Securities Market Maker plays a significant and distinctive function.

*"The strategic importance of Market Makers is creating liquidity, improving the price discovery system, and contributing to overall market reliability."*

This article provides a comprehensive analysis and detailed provisions on the role, the regulatory framework, and the operational obligations of Market Maker based on the Ethiopian Capital Market Proclamation No. 1248/2021 and the Capital Market Service Providers Licensing and Supervision Directive No. 980/2024. It discusses the strategic importance of Market Makers in creating liquidity, improving the price discovery

system, and contributing to overall market reliability, thereby serving as a foundation for a robust and dynamic capital market.

## 2. The Importance of Market Liquidity

A liquid market is a situation where securities can be bought and sold swiftly and with minimal price impact. Market liquidity is a blood vessel of a successful capital market. Where liquidity is insufficient, investors face elevated risks, including wide bid-ask spreads, greater price volatility, and reduced transactional efficiency. These dynamics discourage investment, increase the cost of capital for issuers, and hinder the overall maturity of the securities market.

Considering these issues from the outset, a specific licensing class for Market Makers has been established, and a comprehensive regulatory framework system was put in place. Accordingly, a system has been arranged by the Authority and the exchange to ensure liquidity and stability in the market. The Market Maker's function is not merely ancillary; it is a proactive and continuous commitment to market-making activities that underpin trading confidence.

### **3. Legal and Regulatory Framework**

The role of the market maker is based on the Capital Market Proclamation, no 1248/2021 Article 2(42), Market maker is defined as “a person who ensures the existence of supply and demand for one

or more securities in accordance with the regulatory framework issued by the Ethiopian Capital Market Authority." This definition expressly acknowledges the Market maker's obligation to maintain continuous Bid and Ask quotations.

Part Twelve (Articles 88–93) of Capital Market Service Providers Licensing and Supervision Directive No. 980/2016 provides detailed provisions governing Market Makers, including their qualifications, licensing criteria, permitted activities, and operational requirements. Additionally, the general obligations applicable to all service providers under part three and twenty apply concurrently for market makers.

This two-tier regulatory structure ensures that Market makers operate in a

transparent, well-regulated environment that balances their commercial interests with their quasi-public function of supporting market stability.

### **4. Eligibility and Licensing: A Tiered Entry Process**

The Market maker designation is reserved for financially sound and experienced entities. Article 88 of the directive stipulates eligibility requirements that ensure only credible institutions undertake this role.

#### **4.1 Licensing and Membership Prerequisites**

An applicant for a Market maker license must satisfy the following conditions:

**Licensed securities dealer:** An entity must already hold a valid securities dealer license issued by the Ethiopian

Capital Market Authority. A Securities Dealer is authorized to buy and sell securities for its own proprietary account, a foundational skill for market making.

**Trading Membership:** The entity must be admitted as a trading member of a securities exchange or an over-the-counter market. This membership provides direct access to trading systems, enabling the Market maker to fulfill its role of quoting bid and ask price.

**Appoint Trading Agent:** The applicant must employ at least one Trading Agent licensed by the Ethiopian Capital Market Authority who meets the qualification, experience, and competency standards set by the Directive.

These three main requirements show that Market maker is not a new entrant, rather

an experienced capital market participant. It can also be seen that the Market maker license is granted to entities that possess existing trading infrastructure, trading skills, and regulatory knowledge.

#### **4.2 Capital Requirements**

A Market maker must maintain 10,000,000 ETB, the minimum capital requirement applicable to securities dealers, and any additional capital requirements imposed by the relevant securities exchange (Art 88 of the Directive)

This requirement reflects the high-risk nature of market-making activities, which demand substantial capital to maintain securities inventories and to absorb potential losses arising from the

continuous quotation of bid and ask prices.

#### **4.3 Expedited Licensing Procedure**

The above mentioned directive indicated an efficient licensing process for market makers under Article 89 by recognizing the applicant is already a licensed and certified securities operator.

**Exemption from Standard Requirements:** Applicants are exempted from the standard application documentation and fees required under Articles 7, 8, and 9 of the Directive.

**Agreement with licensed securities exchange:** The key licensing requirement is a signed Market Making Agreement with a licensed securities exchange. The agreement must clearly set applicable rules and conditions that govern market-making activities,

including specifying the type of securities covered by the contract and other related obligations. The agreement indicates the special nature of the market maker license and operational regulation with a licensed securities exchange.

### **5. Activities permitted for Market maker**

Article 90 of the Directive expressly allows a market maker to perform the following functions

#### **Provide liquidity in the market:**

Market makers ensure a continuous supply and demand for one or more underlying securities. By always being ready to buy and sell, they bridge the temporary gap between buyers and sellers, which allows transactions to be completed quickly.

#### **Maintaining the Permissible Spread**

##### **Between the Bid and Ask Prices:**

Market makers have an obligation to quote prices for every buy and sell within the "permissible spread." A narrow spread not only reduces transaction costs for investors but also is a key indicator of prompt buying and selling conditions and a competitive market. In this regard, the exact size of the permissible spread should be specified in the Market maker agreement with the Exchange.

**Making short selling's:** Market makers are allowed to openly engage in short selling (selling securities that they do not currently own). This is a crucial tool for market makers to manage their inventory and create a quick buying and selling environment when there is excessive

demand in the market. This allows market makers to borrow and sell securities as demand for securities increases without having to first collect the securities, thereby reducing price volatility and stabilizing the market.

#### **Serve as a Source of market**

**information:** Due to their role in the trading of specific securities, market makers accumulate valuable information regarding the supply, demand, and trading patterns (pricing and volatility) of those securities. Although participating in insider trading and market manipulation activities is prohibited, market makers contribute to a transparent price discovery process for traders, given their overall experience and perspective in the market.

These authorized activities collectively transform the Market Maker from a passive trader into an active market participant with a public utility function.

## **6. Key Operational Obligations and Restrictions**

To ensure that Market Makers fulfill their role without abusing their position, the Directive imposes several critical operational obligations and restrictions.

### **6.1 Segregation of Functions**

The fundamental principle stipulated in Article 92 of the Directive is that the business of a market maker must be strictly segregated from the functions of a securities broker and/or a securities market dealer.

Any Market maker is prohibited from engaging in activities related to securities

brokerage or securities market dealership, except when necessary to fulfill its market-making obligations.

This is a critical component of the conflict of interest control system. Based on this, the following applies:

**Only Market maker functions:** Market maker is prohibited from executing transactions related to the firm's securities brokerage or execution business. Their role is limited to performing market-making functions.

**Distinct infrastructure:** The market maker must have distinct information technology infrastructures and controls in place to ensure the segregation of its business from the functions of a securities broker and a securities dealer.

This may involve separate reporting lines to the Ethiopian Capital Market

Authority and to the Security Exchange, distinct risk management systems, and physical or technological separation between the business units.

This means that when a market maker also holds a securities broker or Securities dealer license, its operational activities, risk management functions, and human resource administration must be conducted separately and supported by distinct technological infrastructure, except where integration is required to meet its market-making obligations.

Segregation prevents the misuse of client information, including practices such as front-running, and ensures that Market makers act independently.