Amafi
Association française des marchés financiers

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Short Cuts

Editorial

Regulatory activity is steadily intensifying. For this reason, much of AMAFI's attention in the months ahead will have a dual focus. At European level, naturally, further developments are in the pipeline. The introduction of a new supervisory architecture, the regulation of short selling and derivatives *[see feature article]*, and the review of the Market Abuse Directive and Markets in Financial Instruments Directive are all matters of key concern for the industry. In addition, AMAFI will contribute to the work of the G20, which France will preside starting in November. President Sarkozy is determined to put the functioning of derivatives and commodity markets on his agenda.

While these issues are crucial, they must be addressed in parallel with the AMAFI's other main platform: achieving recognition for the social and economic usefulness of financial markets. One major worry in this respect is the fast-diminishing level of savings invested in shares. Equity saving is not only essential for corporate financing, it is also a way for our fellow citizens to shield themselves from social risks, particularly in terms of their pensions. Going forward, therefore, AMAFI fully intends to contribute to the public debate on this question.

Philippe Tibi
Amafi Chairman

Feature

Short selling and the use of credit default swaps have come under fire for their alleged role in the financial crisis. The European Commission recently adopted a proposal for a Regulation on these issues, so *Amafi Financial Newsletter* decided to take a look at the new measures and set out the views of French market professionals.

Bane or boon?

Short selling occurs when an investor sells a security it does not own in order to benefit from an expected fall in price. Typically, the investor borrows shares from a broker and, if all goes according to plan, buys them later at the lower price, returns them to the original owner and pockets the difference. "Shorting" puts a twist on the stockmarket adage of buying low and selling high, because the selling comes first.

Of course, if things go wrong and the shares go up, the investor will have to pay the new, higher price in order to purchase and deliver them.

Investors short securities for many reasons: to hedge a long-term investment, to take advantage of price differences in the same stock on

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different markets – and of course, to speculate. It is this last motive that raises hackles. Short selling is often a convenient scapegoat, with CEOs of major corporations such as Citicorp's Vikram Pandit blaming it for their problems. Regulators, too, have taken a dim view of the practice. So just how harmful is it?

Emmanuel de Fournoux, Director, Market Infrastructures and Prudential Regulation at Amafi, sums up the association's view, widely shared by the industry as a whole: "Short selling is useful because it improves price discovery. Among other things, it stops prices from reflecting bullish sentiment only, makes markets more liquid and counteracts supply/demand mismatches". Short sellers — even those who use the strategy for speculative purposes — rarely act on a whim. They carefully analyse the fundamentals of the companies they short, and their research provides valuable information to the markets and helps ensure that investors' resources are efficiently allocated.

But even the most benign strategies can have unintended consequences or be misused. Excessive short selling can make prices more volatile and cause market swings. For example, it can lead to a "short squeeze", where the price of a security rises because demand outstrips supply, and short sellers rush to cover their positions. More significantly, some short sellers adopt predatory strategies, submitting aggressive orders and actively opening new positions in trading sessions with major price reversals. Regulators believe that this type of behaviour may have exacerbated the recent financial crisis.

Going naked

One version of short selling in particular has been lambasted. In "normal", or covered, shorting, the investor first borrows, or arranges to borrow, the securities it sells. In some cases, however, the investor does not hold the stock or make borrowing arrangements because it has no intention of fulfilling its obligations.

This is known as uncovered, or naked, short selling. If the seller does not acquire the securities within the standard delivery timeframe, generally three days after the trade, the result is a settlement fail, which disrupts the market and can sap liquidity. Naked short selling has been blamed for much of the recent volatility in share prices, especially those of financial institutions. It can be a mechanism for manipulation because the seller is unable – or, worse still, has no intention – to deliver. For this reason, it is outlawed or restricted in many jurisdictions.

The problem of CDS

Much of the recent debate on the pros and cons of shorting has centred on the sale of shares, especially financial stocks. But another, more contentious development is the naked use of credit default swaps (CDS), derivatives that act as an insurance policy on company or sovereign debt. With a naked CDS, the buyer is not exposed to the credit risk of the bond issuer but stands to gain from a rise in that risk, so it is actually speculating on the issuer's financial health.

This practice, which is equivalent to shorting the underlying bond, has been slammed by, among others, Greek PM George Papandreou, who warned against "unprincipled speculators", and Wolfgang Münchau of Eurointelligence, who said that the case for banning naked CDS was as compelling as that for banning bank robberies!

The regulatory response(s)

Given the controversy surrounding short selling, especially the uncovered version, and the use of naked CDS, regulators have taken measures to tackle the problems. The trouble is, the responses have been uncoordinated. In 2008, for example, the SEC outlawed the short selling of some 800 financial stocks for three weeks, France's Autorité des Marchés Financiers and Britain's Financial Services Authority both imposed similar restrictions, while the Australian Securities and Investments Commission went a step further and banned short selling altogether. In June 2009, in an effort to establish a consensus among regulators, the International Organization of Securities Commissions (IOSCO) published a paper setting out some key principles for regulating short selling: impose appropriate controls, introduce a reporting regime and compliance/enforcement system, and determine appropriate exemptions. But despite IOSCO's efforts, regulators continued to go their own way and extended or reversed their restrictions one-sidedly.

In Europe, the Committee of European Securities Regulators (CESR) issued proposals and technical details in early 2010 for a harmonised short selling regime, while the Commission published a Communication announcing its intention of proposing legislation on shorting and the use of CDS. A public consultation was organised to seek stakeholders' views. But the temptation to act unilaterally remained intact. The dangers of going it alone came into sharp focus in May 2010 when Germany announced it was banning naked short selling of certain shares as well as CDS swaps on eurozone government bonds. The main European indices plummeted immediately as markets feared the announcement might conceal bigger, unforeseen problems. The euro, too, fell sharply against the dollar. It would seem that the only positive outcome of the German decision was to underscore the need for consultation and concerted action.

Another example of unilateral action, this time in France, is a proposed amendment to the banking and financial regulation bill calling for the settlement cycle to be cut from T+3 to T+1. Since a one-day cycle is the cash market is nigh-on infeasible, this is another case of politicians taking a sledgehammer to crack the wrong nut. Moreover, in a unified European market, a purely domestic measure on settlement is likely to lead to an outflow of business and a high rate of attrition. Needless to say, Amafi is opposed to this measure.

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The Commission's proposals

On 15 September – the second anniversary of the Lehman Brothers collapse – the European Commission unveiled its proposal for a Regulation on short selling and CDS. The aims are to combat a lack of transparency, the danger of negative price spirals and the risks of settlement failure arising from naked shorting. The measures include a two-tier disclosure requirement, in line with CESR's recommendation, where net short positions must be reported to the regulator if they amount to 0.2 per cent of the issued share capital and to the market if they reach 0.5 per cent. Orders for short sales would also have to be marked or flagged. A specific regime would provide for notifying regulators of significant net short positions in EU sovereign bonds, as well as significant CDS positions on sovereign debt issuers. In exceptional situations, regulators would be empowered to impose temporary measures, such as demanding further transparency or restricting short selling and CDS transactions.

For naked short selling, the Commission proposes a "locate" rule: to make a short sale, an investor must first have borrowed the instruments concerned, agreed formally to borrow them, or made an arrangement with a third party who has located and reserved them so that they can be delivered by the settlement date. National regulators would have the power to restrict or ban short selling, including of CDS, in the event of "adverse developments" that "could seriously jeopardise the orderly functioning and integrity of financial markets". However, the Commission has stressed the need for consultation and coordination, particularly through the new European Securities and Markets Authority.

Q&A with…

Guillaume Heraud, Global Head of Clearing Services, Société Générale Securities Services

Do you support the European Regulation on short selling?
Absolutely. It's extremely positive, for two reasons: it addresses public concern about short selling while showing that not everything needs to be outlawed; and it brings some much-needed harmony to Europe, eliminating the anarchy and regulatory complexity that has reigned until now. That said, the devil is in the detail. We need to decide precisely what is considered bad and what's good. Short selling can be useful, so the rules must not be simply a knee-jerk reaction to recent upsets. They must be proportionate to the ultimate aim, which is to prevent abuse.

What impact will the new rules have on French markets?
Actually the French industry is already very disciplined in this area – our settlement rate is impressive – and our regulator, the AMF, is well aware of the issues at stake. So the European Regulation will serve to highlight the best practices already in place in Paris. But we need to see how it will work in practice. For example, stricter buy-in rules are a good thing in principle, but is T+4 the right timeframe, given that some settlement fails are due to technical problems?

What other measures are needed to make markets more secure?
The big problem with abusive short selling is to identify who the culprit is. It's easy enough to detect malpractice at local level, but what about traders who aren't based in Europe? The important thing is not to put the burden on intermediaries as a whole, which could make them less competitive, but to deter the dishonest ones. So Europe and its regulators need to decide on harmonised measures and, just as importantly, determine who will enforce them – for instance, ESMA.

Amafi's position

Naturally, Amafi endorses the view that harmonised regulation is needed to restore investor confidence, provided the new rules enshrine the positive role played by short selling in the price discovery process. In addition, the requirement to report net short positions to regulators should make it possible not just to assess market trends and determine whether further restrictions are needed, but also to punish market abuse more effectively. However, Amafi has serious misgivings about the proposed requirement to disclose short positions to the market.

One measure it insists upon, and which has been written into recent US legislation, is a crack-down on abusive short selling, notably where the seller has no intention of making delivery and therefore makes no prior arrangements. This practice has been tolerated for too long and, in view of the dangers it poses, should be outlawed. As Amafi's de Fournoux puts it, "We need to punish the bad guys, not weaken the functioning of the market" *(see Q&A)*. Offenders should be subject not only to exemplary sanctions, but also to a much stricter penalty regime that is not imposed solely by clearinghouses.

Despite being painted as a bogey man, short selling – including the naked kind – can be beneficial when practised properly. Even naked CDS have not been totally banned by the European Commission. What is really needed is a level-headed look at the key issues, with input from industry professionals, and a coordinated international response.

Anthony Bulger

News

International

IOSCO conference in Montreal – Meetings in Washington – 2-10 June 2010

As every year, AMAFI, represented by Pierre de Lauzun and Véronique Donnadieu, attended the annual conference of the International Organization of Securities Commissions (IOSCO), of which it is an associate member as part of the Self Regulatory Organisations Consultative Committee (SROCC). Meetings were also held in Washington DC, while the United States was finalising a sweeping programme of financial reforms.

IOSCO international conference, Montreal, 7-10 June 2010

The SROCC discussed reorienting its strategy to make a greater contribution to the work of the regulators. A number of areas in which some of the committee's members, including AMAFI, could add real value were identified and will be submitted to IOSCO for approval. AMAFI also attended bilateral meetings between the industry and the chairs of IOSCO's standing committees. The meetings highlighted an intensive work programme, especially as regards derivatives markets, but revealed a lack of ambition in terms of goals and schedules. IOSCO also announced that, as part of its strategic review, it was broadening its remit to include the monitoring and management of systemic risk in financial markets.

Washington meetings, 2-4 June 2010

For the third year running, AMAFI met with representatives of Congress, the SEC, the CFTC, the Federal Reserve and the US Treasury, all of whom were closely involved in the ongoing reform programme. The timing was highly appropriate because the legislation implementing the reforms was in the process of finalisation. The meetings confirmed that the United States and Europe had different priorities on some issues, but they also revealed a keen interest in gleaning a European view of the developments underway on both sides of the Atlantic.

Véronique Donnadieu

Anti-money laundering and counter terrorism financing (AML/CFT)

With the Financial Action Task Force (FATF) now re-examining its recommendations, the International Council of Securities Associations (ICSA) has written to FATF's chairman asking for a review of Recommendation 5 on customer due diligence. ICSA wants FATF to provide guidelines on the beneficial owner identification requirements, which its members currently interpret and implement in different ways. FATF's attention is drawn to the lack of reliable data on beneficial owners. This information ought to be requested directly from companies and legal entities and made available to firms subject to AML/CFT requirements. ICSA also asked for Recommendation 5 to be amended to permit the use of a risk-based approach when identifying beneficial owners and to grant specific exemptions for, among others, listed companies.

Stéphanie Hubert, Marie Thévenot

News

Europe

Modernisation of the Transparency Directive

The European Commission launched a public consultation in early summer on proposals to modernise the Transparency Directive. This follows an earlier consultation organised by CESR in February on a proposal to extend major shareholding notifications to instruments that create a similar economic effect to holding shares.

The key issue for AMAFI is how holdings of cash-settled derivatives are to be reported: by treating them in the same way as shares and "similar" instruments or reporting them separately. AMAFI once again argued forcibly that a separate declaration was the only way to provide the market and issuers with relevant information. Specifically, AMAFI proposed that the percentage holding that generates a separate notification requirement should be unrelated to the percentage of voting rights and "similar" instruments and should also be substantial – at least 10% – unless, and until, the holding of voting rights and "similar" instruments itself reaches the legal thresholds for mandatory reporting (from 5% upwards). In this case, cash-settled derivatives would be reported, whatever percentage they represent. AMAFI also called for maximum harmonisation throughout the European Union on this issue in particular and, more generally, on any topic related to major shareholding notifications. This would probably require a European Regulation.

On the second aspect of the consultation, on whether and how to make regulated markets more attractive to smaller listed companies, AMAFI supported the idea in principle. However, it stressed the need to avoid creating an overly complex system and argued that the criterion for defining a smaller company should not be set too low (market cap should be at least EUR 1 billion).

Sylvie Dariosecq

Remuneration – CRD 3

The final text of the third Capital Requirement Directive (CRD 3) was adopted on 7 July 2010 after intense discussion. In addition to capital charges for trading book positions and re-securitisations, the directive contains stricter requirements on remuneration policies, notably regarding the structure, amount and timing of variable payments. On some issues, CRD 3 goes further than the principles laid down by the Financial Stability Board and endorsed by the G20. One of the most noteworthy points is the requirement for firms to set an appropriate ratio of variable-to-fixed remuneration. Due to be implemented from 1 January 2011, the measures will apply to variable remuneration paid in 2011 for 2010. In this context, particular attention will be paid to the recommendations that the Committee of European Banking Supervisors is expected to release this autumn.

Véronique Donnadieu, Stéphanie Hubert

Corporate governance in financial institutions and remuneration policies

The European Commission published in early June a Green Paper on corporate governance in financial institutions and remuneration policies, which was put out to consultation. Starting from the observation that shortcomings in the governance of some financial institutions were among the reasons for the financial crisis, the paper examines areas for improvement. The main thrust is to prevent systemic risk, in view of its harmful consequences for the economy and for society at large.

AMAFI favours European harmonisation in this area, since governance requirements, just like other rules, may distort competition. In particular it stressed that the European Commission should initially focus solely on major listed financial institutions, which raise specific governance issues. At a later stage, it can examine whether these measures should and could be extended to unlisted institutions, adjusting them to the size of the firm if need be.

Véronique Donnadieu

Review of the Market Abuse Directive

AMAFI has been actively involved in the review of the Market Abuse Directive (MAD), which began in April. This summer, it took part in the public hearing and responded to the consultation organised by the European Commission. It stressed that the review both of MAD and of the Markets in Financial Instruments Directive should include a thorough overhaul of the monitoring of European markets. It considers that the overhaul is especially necessary if, as proposed, the scope of MAD is extended. AMAFI supports the extension in principle, but also suggests that:

- Extending the directive to derivatives of instruments that are not themselves subject to it should be decided on a case by case basis, depending on the associated risks of manipulation and misconduct. This could be done through the European Securities and Markets Authority.
- Multilateral trading facilities that do not deal in instruments traded on a regulated market should be able to operate outside the market abuse framework, under certain conditions, in order to give small and midsize European companies access to financing without straitjacketing them.
- A special anti-abuse system must be designed for commodities derivatives. It must not simply replicate as-is a set of rules that was originally intended for equities and bonds, since one of the most critical issues is the level of information on the underlying physical markets, which differ significantly from markets in financial instruments.
- Protection for people who file suspicious transaction reports should be strengthened and harmonised across Europe.

A draft directive is due out this autumn and is likely to be adopted in the following months.

Stéphanie Hubert, Marie Thévenot

News

Europe

Standardisation and exchange trading of OTC derivatives

Responding to a CESR consultation on the standardisation and exchange trading of OTC derivatives, AMAFI expressed disappointment that CESR should choose to consult on such an important issue in the middle of summer and with a short feedback period. On the substantive issues, it stressed that standardising OTC products is certainly a desirable and widely shared objective, making it possible to mitigate financial and operational risks by enabling them to be incorporated into the clearing process. However, at this stage, there is no firm evidence that trading these products on an organised platform is more advantageous than trading them over the counter.

Emmanuel de Fournoux

Derivatives and market infrastructure

AMAFI and FBF responded jointly to a European consultation on a draft regulation on derivatives and market infrastructure, the so-called EMIR project. They stressed the need for effective coordination between the EMIR initiative, which they support, and the prudential work underway at international and European levels. Furthermore, the issue of where market infrastructures are located and how they are supervised is key to the solidity of Europe's financial market. It is therefore vital that infrastructures contributing to market resilience, such as central counterparties (CCPs) and trade repositories, should be located in Europe and overseen by European regulators.

The European Commission published in mid-September a draft regulation based on three main principles:

- require the use of CCP clearing for all over-the-counter derivatives traded by investment services providers, on condition they meet pre-defined eligibility criteria; this requirement will apply only if trading volumes exceed a certain threshold;
- set standards for CCPs and trade repositories;
- require market participants to report OTC derivatives trades to regulators.

The proposal is currently being analysed and will be closely monitored throughout the pre-adoption process.

Emmanuel de Fournoux

France

Financial and banking regulation bill

AMAFI has been paying close attention to the passage of the financial and banking regulation bill, which was submitted to the lower house of parliament in September 2009 and given its first reading this June. Ahead of the vote in the Senate at the end of December, a large number of amendments have been filed with and approved by the finance commission of the upper house.

One of the amendments, strongly opposed by AMAFI and other members of the financial community, originally proposed cutting the settlement cycle to one day after the trade date in order to restrict short selling *(see feature article)*. Progress has been made on this issue, since the bill that will be submitted to the Senate now calls for a two-day cycle. In addition, the ban on short selling would apply only where the seller has not made the necessary arrangements with a third party "in order to have reasonable assurance that it can make delivery".

AMAFI is also satisfied with some other positive developments in the bill, notably the introduction of a rapporteur at the new regulatory body, Autorité de contrôle prudentiel, and a negotiated settlement procedure at the AMF. AMAFI supported both initiatives in principle when they were first mooted. It also welcomes the fact that some of its arguments have been taken into account in the new measures concerning the spot carbon market, which were written into the bill following a market-wide consultation in August *(see page 7)*.

By contrast, AMAFI is disappointed by an amendment aimed at bringing the trigger point for a mandatory tender offer into line with that used for major shareholding notifications. As mentioned on several occasions, this measure will not only cause numerous problems; it runs counter to the position adopted by the industry after a series of consultations in summer 2009.

Sylvie Dariosecq, Marie Thévenot, Emmanuel de Fournoux

News

France

Regulation of the carbon market in France

Further to the Prada report issued in April 2010, the Treasury department consulted the industry on draft legislation designed to strengthen the supervision and regulation of the carbon market in France. In light of the responses, a number of proposals were written into the bill ahead of its passage through the Senate. Give the pan-European importance of carbon markets, the main thrust of the proposal was to adapt the regulatory framework and give the French market regulated status, an initiative that AMAFI has always supported.

However, AMAFI voiced its opinion that the conclusions the Treasury intended to draw from this measure, notably the implementation of the market abuse and client protection mechanisms, could impact negatively on the competitiveness of the French markets. It therefore recommended that the measures be referred to the regulator with a view to organising a stakeholder consultation. AMAFI's opinion was clearly heeded to some extent since a number of the proposals made during the consultation were set aside.

Dominique Depras, Sylvie Dariosecq

Compensation of retail and professional investors

The AMF has set up a working group to examine the ideas on investor compensation outlined in the regulator's New Strategy Proposals. The decision followed on directly from the announcement made by AMF Chairman Jean-Pierre Jouyet in summer 2009. AMAFI and the FBF have been taking a close interest in the group's work, which is proceeding remarkably quickly in view of the issues that need to be addressed. The group is due to release a preliminary report in October and complete its work by the end of the year.

Stéphanie Hubert, Marie Thévenot

Market access for midcaps

A draft charter on financial research covering small, midsized and mid-tier companies has been drawn up on the basis of work done by the Treasury on facilitating market access for midcaps. AMAFI, which was involved in these developments, is anxious to ensure that they do not conceal the fact that market services available to midcaps in the Paris market are under heavy pressure due to the economic situation and the drive for European integration. As far as AMAFI is concerned, the key issue is the lack of savings being channelled into this type of investment, just when market financing for businesses, notably small, midsized and mid-tier companies, is becoming increasing critical.

Emmanuel de Fournoux

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www.amafi.fr
Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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