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Editorial

Critics seeking to blame financial markets for the situation in the euro zone are quick to cast them in the role of dictators. Some dictators! In mid March they gave in and agreed to forgive more than 75 per cent of their debt claims on Greece.

So can it seriously be argued that in Greece and Italy it is the financial markets that make and break governments and politicians solely for their own ends and with no regard for people or their basic rights? The real story is quite different. Given the parlous situation in both countries, the responsibility for which lies entirely with earlier policy decisions, both Lucas Papademos and Mario Monti came to power through due political process and with the full approval of their parliaments. Questioning the legitimacy of that process simply because the two prime ministers want to reform their countries and avoid total bankruptcy makes no sense at all.

The markets aside, it is actually investors who agreed to fund those yawning government deficits. Most of these investors represent other people, generally small savers like many of us. Is it therefore unusual that they should worry about whether these countries are able to repay their debts? And how will they be convinced of that ability if the countries continue with the same old policies as before?

Harping on the notion of market dictatorship is simply a way of putting off decisions that ought to have been taken earlier. But heel-dragging does nothing to tackle the fundamental problem; it simply makes the situation worse. At least the markets serve as a warning system and force a reaction, whereas politics simply delays the much-needed reforms ad infinitum.

Pierre de Lauzun
Chief Executive, AMAFI

Defending the Liquidity Contract: A Worthy Cause

Feature

Widely used in France, liquidity contracts could be under threat from Brussels. Meanwhile, advocates of market making claim that their technique is superior. Does this spell the end for an accepted market practice that has definitely proved its worth?

When trading is thin, liquidity is key. One way for a company to maintain a liquid market in its stock is to sign a liquidity contract with an investment firm, a common practice in France. Another is to rely on a market maker, the norm in UK markets. The two models both have their advantages and drawbacks. But the future of liquidity contracts could be in jeopardy. The European Commission is in the process of tightening legislation to fight “market abuse” – price manipulation, insider dealing and misleading information. At the same time, to round off the construction of the single market in financial services, it wants to weed out local practices that differ from one market to another and tend to weigh down the European statute book. One step towards this so-called maximum harmonisation was the publication in late 2011 of the draft Market Abuse Directive 2 and Regulation, which plans to phase out accepted market practices (AMPs),

1/2/3_Feature
Defending the liquidity contract: a worthy cause
4/5/6/7_News
International, Europe, France
Taxation
8_News
Taxation

Feature

loosely defined as 'practices that are reasonably expected in one or more financial markets and are accepted by the competent authority'. In France, one such practice is the use of liquidity contracts (sometimes called liquidity enhancement agreements). While the idea of outlawing gold-plating is laudable, this may be a case of throwing out the baby with the bathwater.

A Tale of Two Cities?

A liquidity contract is an agreement between a listed issuer and a liquidity provider – typically an investment firm – under which the firm buys or sells the issuer's shares to provide liquidity at times when buyers and sellers are not in the market at the same time. The objective is identical to the one pursued by market making, and both techniques reduce volatility and the abnormal price swings that deter investors. But the means of means of achieving that aim are very different: liquidity providers use funds supplied by the issuer whereas market makers use their own capital.

Frowned upon when it was launched in France some 20 years ago, the liquidity contract is now recognised by the national securities regulator, AMF, as an AMP and is widely – but not universally – agreed to be an effective way of promoting normal trading in an issuer's stock, regardless of the size of the company. Jean-Paul Pechery, Director of Corporate Market Services at Rothschild & Cie explains: "For small and mid caps, liquidity contracts guarantee a minimum level of liquidity so that shareholders can trade at market prices. For big caps, they iron out excessive volatility and price swings". And because liquidity providers use the issuer's funds they can concentrate more closely on the demands of the market rather than constantly having to manage their own risk. However, critics argue that the contracts could actually encourage market manipulation and lead to a cosy arrangement between the issuer and its liquidity provider, whereby the latter generally acts in the former's interest and at its behest. The best solution, they say, is market making, where an investment firm undertakes to quote two-way prices for buyers and sellers of a particular stock. Supposedly, the chief advantages of market making are immediacy of trading and an arm's length relationship between the firm and the issuer. As is often the case, the two opposing points of view are typical of the differences between London and Paris.

That a divergence exists is hardly surprising because the two countries have always relied on different market models: quote-driven in the UK, order-driven in France. But the difference between the liquidity contract and market making goes beyond models; the angle of approach is entirely different. A liquidity provider will quote prices only when necessary to fulfil the terms of its contract. It seeks to maximise the impact of its trades in terms of both the liquidity supplied to the market and the resources allocated to it by the issuer. By contrast, the market maker's aim is to earn a return on its trades and, since it is using its own capital, it needs to focus on managing its risk exposure. As a result, the liquidity it supplies is limited by the way it reads the market. Trading in an illiquid stock implies a cost for both the market maker and its client, so the firm is unlikely to respond to the investor's request at a reasonable price unless it is sure of having a counterparty for the other leg of the trade. Systematic immediacy is therefore not always guaranteed.

Strictly regulated, AMAFI-guided

Advocates of market making argue that there is a risk of collusion between the liquidity provider and the issuer – that the former will simply do the latter's bidding, taking advantage of its privileged position as a de facto insider to artificially support the share price. This overlooks the fact that the use of liquidity contracts is strictly regulated and closely monitored, and that the resources made available by the issuer are modest compared with its market capitalisation: "less than 0.5 per cent for

The 11 Principles of the AMAFI Code of Conduct for Liquidity Contracts

Specialisation
Contracts must be used only to encourage liquid trading

Independence
The investment services provider acts on its own initiative

Regulated market
Contracts can be used only on regulated markets (or MTFs)

Continuity of action
The liquidity provider ensures a continuous presence

Identification
Trades are segregated in a special identified account

Restricted use
The shares earmarked for the contract cannot be used in any other way

Proportionality
The amount of cash and shares on the liquidity account must be sufficient for purpose

Cash withdrawal
When a liquidity account is closed, any remaining shares are cashed out

Information exchange
The company does not disclose privileged information to the provider; the provider supplies the company with information about its duties under the contract

Market disclosure
The company informs the markets when it signs a contract

Communication
Contracts are reported to the securities regulator

Feature

large caps," says Mr Pechery. Hubert Brac de La Perrière, Corporate Broking Manager at Exane BNP Paribas, points out: "Our research, which we submit regularly to clients, confirms that we provide liquidity. If we tried to boost a share artificially, the funds that the issuer allots to us would quickly run out". In short, a liquidity provider does not have the financial firepower to trade against a deep-seated trend.
To ensure that liquidity contracts are used properly and that the provider remains independent of the issuer, AMAFI has drawn up a standard agreement. It has also drafted a code of conduct based on 11 principles (see sidebar, p 2), the first of which states clearly that the sole purpose of a liquidity contract "is to encourage the liquidity and regular trading of an issuer's shares and to avoid price swings unwarranted by market trends". Moreover, it is on the basis of the code that the AMF authorised the use of liquidity contracts as an AMP and now supervises them. Mr Brac de La Perrière stresses that "we do not know of any cases where the AMF has punished market abuse arising from one of these contracts". Moreover, liquidity providers are obliged to report regularly to the market on their activity, thus giving participants a clear idea of the resources given to them by the issuer. By contrast, no special transparency rules apply to market makers.

Q&A with…

Bertrand de Saint-Mars,
Deputy Chief Executive, AMAFI

Why are liquidity contracts worth defending?

This is a crucial issue because the contracts serve a valuable purpose. For mid caps, hampered by a structural lack of liquidity, they supply additional funds and let investors know they can find a buyer if need be. With big caps, the problem is not structural; it's a question of timing. Buyers and sellers are not always present in the market at the same time, which leads to volatility spikes. So the contracts deliver liquidity at critical moments. Lastly, they also help an issuer to understand trading patterns in its shares, amid the fragmentation triggered by the Markets in Financial Instruments Directive.

How do you respond to critics who liken the use of liquidity contracts to market manipulation? Is market making a better solution?

The criticisms are unfounded. First, the resources allocated to a liquidity contract are small compared with the trading volumes in the issuer's shares – and certainly not enough to reverse a major trend. Neither are the contracts intended to generate profits for the issuer. More importantly, the use of liquidity contracts is an accepted market practice that is closely supervised by the AMF, renowned in Europe for its efforts to prevent and punish market abuse. As for market making, it certainly has a legitimate place but the underlying logic is very different. A liquidity provider works on behalf of an issuer but in the market's interest; a market maker is working for its own ends..

Will Paris succeed in its efforts?

The entire financial community is pitching in – AMAFI and its members, obviously, but also listed companies, which have the support of the Treasury and the AMF. Other European countries also use liquidity contracts, so we have support from that quarter, too. Above all, given the growing importance of getting market financing for small and midsized businesses, we hope that Brussels will recognise the importance and value of this truly effective technique.

Goodbye to all that?

Market making and liquidity contracts both have their place in today's equity markets. But the French financial community is rallying round to defend its AMP (also used in Belgium, Italy, the Netherlands, Portugal and Spain), which has delivered on almost every promise. Liquidity providers generally trade against trend because they enter the market at the most opportune moment whereas market makers are pro-cyclical since they use their own capital and are generally unwilling to increase their risk exposure. This leads to wider bid/ask spreads and higher volatility. Above all, issuers do not derive a direct financial benefit from a liquidity contract: usually, contracts simply break even.

Under the shadow of the crisis, Europe is fretting about how to finance the real economy amid growing disenchantment with markets across the Union. Liquidity contracts could contribute to solving the problems of liquidity for small and mid caps, and volatility in big caps. They also reassure investors. As the debate on scrapping AMPs rumbles on in Brussels, it makes no sense for the European regulatory framework to favour marketing making over liquidity contracts.

Anthony Bulger

News

International

Volcker Rule

The International Council of Securities Associations (ICSA) has published its comments on implementation of the Volcker Rule (Section 619 of the Dodd-Frank Act), which the US financial authorities have put out for comment. The aim of the rule is to prohibit banks that benefit from the financial protection of the central bank from engaging in so-called speculative or risky activities such as proprietary trading, private equity and hedge funds.

But as ICSA points out, the proposals as they stand give the Volcker Rule a broad extraterritorial scope, which is at odds with what Congress apparently wanted. Under certain circumstances, it would cover business transacted outside the United States. As ICSA points out, this would have a truly unsettling impact on a number of activities. In particular it would restrict the capacity of a wide range of market participants – including non-US firms – to supply financial products and services to North American clients. One striking example is the sovereign debt market: US Treasuries would be exempted from the rule but non-US government securities would not.

Véronique Donnadieu

Anti-money laundering

The Financial Action Task Force (FATF) published its revised standards on 16 February. ICSA, which regularly shared its views and proposals with the FATF during the process of drawing up and reviewing the standards (see the December 2011 letter on www.icsa.bz) welcomed the advances, especially recognition of the risk-based approach. While urging the FATF to continue its policy of dialogue with the private sector, ICSA also called for further efforts to improve transparency of legal entities with respect to their beneficial owners (see ICSA press release).

Stéphanie Hubert

News

Europe

Review of the Market Abuse Directive

As part of its work on the proposed revision of the Market Abuse Directive published last October, AMAFI met with the Danish Presidency of the EU and with the European Commission. It held detailed discussions on several aspects of the proposal that raise particular concerns. These issues, which have also been examined closely with the French authorities, concern the definition of inside information (and in particular extending it to "relevant information"), broadening the scope of the directive to all financial markets and instruments, and creating a European framework for pre-sounding *(AMAFI / 12-07)*.

AMAFI is also actively seeking to maintain accepted market practices, notably liquidity contracts (see Feature). It continues its lobbying efforts at domestic and European levels, in collaboration with issuers' associations.

Stéphanie Hubert, Sylvie Dariosecq

Short selling and CDS

AMAFI responded to two consultations organised by the European Securities and Markets Authority (ESMA) on technical regulatory or implementing acts in connection with the European Regulation on short selling and certain aspects of Credit Default Swaps *(AMAFI / 12-10 and AMAFI / 12-13)*. The proposals were to be submitted before 31 March to the European Commission, which has sole power to adopt them formally under the existing legislative procedure.

Noting that both consultations were conducted in under three weeks, AMAFI stressed the risk of giving ESMA such a short timeframe for formulating its proposals. These tight deadlines make it hard for stakeholders in the consultation process to contribute constructive and helpful input based on an in-depth analysis of often complex issues that require a combination of competencies. AMAFI is concerned about this situation, which impinges on the quality of the implementing regulation and its ability to reach its Level 1 objectives, particularly in view of the extensive work that ESMA will have to do on various regulations and directives in the years ahead.

AMAFI made a number of comments on ESMA's proposals, noting that some seemed to go beyond the provisions of the European Regulation and the Level 2 mandate. This applies in particular to the obligation for sellers to "locate" securities before shorting them and to the granularity of short position reporting within the same firm.

Emmanuel de Fournoux

MiFID - Suitability and compliance

AMAFI responded to ESMA's draft guidelines on two requirements under the Markets in Financial Instruments Directive (MiFID): product suitability and organisation of a compliance function.

Suitability
(AMAFI / 12-11)

Generally speaking AMAFI is surprised that ESMA should choose this moment to issue guidelines on a topic which has raised no serious problems and will doubtless be amended in light of the MiFID review. For this reason, AMAFI stresses the need for stable regulations in an area that has major implications in terms of organisation. And in any case, firms will need enough to time to comply with guidelines that sharply tighten current standards. AMAFI has also pointed out that the wording is slanted towards issues specific to retail clients and does not give enough consideration to the wholesale.

Compliance function
(AMAFI / 12-12)

AMAFI welcomes the draft guidelines on this issue, in which it has a keen interest, but considers that, among the various themes addressed by the document, the proposed positioning of the compliance function ought to be reviewed. AMAFI also stresses that the preamble to the guidelines should emphasise the part played by senior management in compliance and that the function's advisory role needs to be be given greater consideration relative to its supervisory role.

AMAFI also suggested amendments on other matters, such as outsourcing, centralisation of compliance resources, and the function's role in terms of staff training, complaint handling and approval of new businesses or products.

Stéphanie Hubert, Marie Thévenot

News

France

Major holding notifications

The recently adopted Warsmann Act (2012-387, 22 March 2012) on legal simplification and streamlined administrative formalities contains two measures of particular interest to AMAFI members: major holding notifications (Article 25) and share buybacks on Alternext (Article 15).

Notification of major holdings
Article 25 significantly amends the French regime for declaring major holdings, thus anticipating the measures currently under discussion for the new Transparency Directive. Cash settled instruments are now to be aggregated with shares, voting rights and other instruments already taken into account when calculating reporting thresholds. By contrast, they are formally excluded when calculating the trigger points for takeover bids. This is consistent with the position defended by AMAFI for several months *(see Info AMAFI No 102)*. A new notification has been introduced for cases where a threshold is crossed as a result of changes in the breakdown of different types of instruments that have already been declared as holdings. Also, the scope of the declaration of intent has been broadened to include declarations concerning the unwinding of derivatives positions held by the person filing the declaration. A number of key details are due to be spelled out in the AMF General Regulation, and AMAFI fully intends to contribute to the regulator's deliberations in the coming weeks. Article 25 is due to come into effect on 1 October.

Buybacks on Alternext
Article 15 broadens the possibility of share buybacks on Alternext by aligning the rules on those applicable to regulated markets. This is a long-awaited move, since buybacks on this market are currently permitted only in connection with a liquidity enhancement provision.

Sylvie Dariosecq

Taxation

Financial Transaction Tax (FTT)

A financial transaction tax (FTT) has been written into the 2012 Supplementary Budget Act. Although the new tax will not have the same impact as the now-defunct stamp duty, which tended to drive business away from French markets, AMAFI regrets nevertheless that this measure was taken unilaterally without a detailed analysis of its negative impact on French companies *(AMAFI / 12-14)*.

Due to come into effect on 1 August, the FTT actually consists of three taxes:

- A tax on equity trades, equivalent to 0.1% of the value of the shares of listed French companies capitalised at more than €1 billion. The equity tax is payable by the buyer regardless of its nationality or that of the intermediary making the trade and regardless of the trading venue;
- A tax on high-frequency trading (HFT), equivalent to 0.01% of the amount of cancelled or modified orders exceeding a threshold to be set by decree. This tax will be payable by French firms engaging in proprietary HFT;
- A tax on naked trades in Credit Default Swaps (CDS), equivalent to 0.01% of the notional value of CDS contracts of a European Union member state. The naked CDS tax is payable by French individuals or legal entities that acquire these contracts for reasons other than to hedge existing assets or commitments.

Based on the findings of a preliminary assessment *(AMAFI / 12-16)*, AMAFI organised two meetings in partnership with Ernst & Young-Société d'Avocats and STC Partners, one in late March in Paris, the other in early April in London, in collaboration with the Association for Financial Markets in Europe (AFME).

A number of implementing statutes will have to be adopted before the FTT comes into effect on 1 August. AMAFI has therefore been playing an active part in the work being done on several fronts to identify the technical constraints affecting the operating environment. On this basis, AMAFI is organising a conference on 24 May to present the FTT implementing measures, in association with CMS-Bureau Francis Lefebvre and Euroclear France. Representatives from France's Tax Legislation Directorate are also expected to attend.

Eric Vacher

News

Taxation

FATCA

Under the US Foreign Account Tax Compliance Act (FATCA), non-US financial institutions will be required to pass on information concerning their clients to the American authorities. For the purpose of implementing that requirement, the IRS and the Treasury Department issued on 8 February a set of proposed regulations giving details of the measures, especially the institutions and accounts that will be affected.

In parallel, the governments of the United States, France, Germany, Italy, Spain and the UK issued a joint statement stressing their intention to adopt an intergovernmental approach to FATCA implementation. The statement proposes a new system whereby foreign financial institutions would send information to the authorities in each country, which would pass it on to the United States in accordance with existing bilateral tax treaties for information exchange.

Eric Vacher

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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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