Amafi

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Getting tough on soft commodities

Editorial

Commodity derivatives markets are the focus of critical discussion and debate at the moment. And the issue of regulating them is firmly on the agenda of both the G-20 and the European Commission. Much of the criticism stems from the idea that the financial sector undermines stability in these markets. The attacks redoubled in the aftermath of this summer's farming crisis, which drove up the prices of commodities, especially wheat. In some cases, financiers have been portrayed simplistically as speculators driving the world to starvation.

One obvious response to the critics *(see Feature)* is that soft commodities are naturally exposed to weather-related contingencies. That said, there are certain aspects that warrant a closer look. Commodity derivatives markets are vitally important because they allow producers and agrifood companies to hedge their risks affordably and to expand their business. At the same time, the close links between these markets and the underlying physical markets raise specific problems that need to be addressed.

The market professionals represented by AMAFI want to be a voice for advocacy in the ongoing debate, because commodity derivatives markets allow them to serve their clients more effectively. The proposals that will be made in the coming months, both at the G-20 and at European level, will rely on professionals' knowledge of these markets and the needs of their users.

Pierre de Lauzun
Chief Executive, AMAFI

Feature

With investors and speculators being blamed for rising commodity prices, the role of financial markets is coming under increasing scrutiny. Moves are afoot to regulate commodities in general and "soft", or agricultural, commodities in particular. France intends to play a major role in bringing order to these markets. But the issues are global.

Regulating financial markets for commodities will be high on the agenda of the G-20 in 2011. France, which took over the presidency of the organisation in November 2010, intends to play a prominent role in bringing order to commodity prices through a three-stage process of consultation, coordination and decision-making. It has also urged the European Commission to address the question as part of the review of the Markets in Financial Instruments Directive (MiFID).

1/2/3_Feature
Getting tough on soft commodities
4/5_News
International, Europe, France
6_News
Taxation, new member

Feature

The aim is to ensure that Europe has a legitimate say in international discussions on these highly strategic matters, especially as regards agricultural commodities.

Naturally volatile

Investors and speculators are increasingly being blamed for wild swings in commodity prices. True, volatility in the market for agricultural commodity derivatives is around 30 per cent, but it can reach 50 or even 100 per cent for commodities such as oil. Nonetheless, volatility has increased sharply since 2006, affecting staples such as wheat, with sometimes tragic results. In Mozambique, for example, a dozen people died recently in food riots triggered by soaring bread prices. Governments and international bodies have woken up to the dangers of the situation, notably the ever closer links between finance and farming. In the aftermath of the subprime crisis, the financial industry can ill-afford to be accused of undermining these highly strategic markets. But in reality, agricultural commodities are naturally volatile because they are exposed to unpredictable weather conditions. The wheat crisis, for example, is nothing new. Similar upsets occurred several times in the previous century. After the 1936/1937 crisis (when peaks and troughs exceeded those of 2007/2008), prices remained highly volatile between 1940 and 1962.

A fresh crisis erupted in 1967, followed by a period of exceptional fluctuation in 1974, then a new crisis in 1992. Thus the pattern continues. This summer, prices soared by 70 per cent, but the spike was caused not by financial markets but by drought and wildfires in Russia that prompted an export ban.

> **Soft commodities are exposed to unpredictable weather conditions**

In fact, finance played a vital role by enabling the farming sector to hedge inherent price volatility. Despite fears to the contrary, the speculation that is starting to surface in the European commodities markets with new market participants such as hedge funds, index funds and institutional investors is not part of a dastardly plot to send food prices skywards. Interestingly, there is a marked difference in attitudes to speculation. According to a recent Financial Times/Harris poll, the French, Germans and Spanish believe that speculators have a much bigger impact on prices than do weather conditions or government policy measures such as export curbs, whereas most Britons and Americans believe exactly the opposite. According to Jean-Loic Bégué-Turon, Head of Risk Management at InVivo, "Speculation does amplify volatility and lead to slight price rises. But it is also a vital source of liquidity. So it's certainly not in the wheat industry's interest to turn its back on financial markets".

In any case, agricultural products are unlike other financial underlyings. Which is why regulators have homed in on them. The US recently introduced a series of regulatory reforms, including mandatory position limits for trading in agricultural commodities.

Europe has a lot on its plate

Europe, too, is taking steps to regulate its markets. The Common Agricultural Policy kept prices stable for many years until recent amendments led to fluctuations, forcing producers to rely increasingly on financial markets to hedge their risks. Between 2000 and 2009 average daily trading volume in NYSE Liffe Commodities contracts increased by 161 per cent, from 18,000 to 47,000. The need to regulate these fledgling financial markets quickly became apparent. In July 2010 the French government issued a report urging Europe to adopt regulations to ensure transparency and prevent abuse in commodities markets. Easier said than done, however, because the new regulations must apply equally to derivatives markets and physical markets. And they will have to be tailored to the commodities being traded, because wheat does not raise the same market oversight issues as, say, copper. Another necessity is a supervisory and monitoring system that applies to all market participants. Jean-Philippe Folco, Head of Commodities at Newedge, explains: "To create confidence in the transparency system, you must be able to tell the difference between speculative trades and those made by the industry".

For example, the system will have to distinguish between commercial futures, used by producers to hedge price fluctuations, and financial futures, which are much more sophisticated. So it is important that producers should not be subject to the same regulatory constraints as investors. At present, MiFID imposes different regulatory regimes on commodity derivatives, depending on the type of trader. Some market participants are subject to the entire directive, some only partially so, while others are totally exempt. Going forward, the plan is to limit these exemptions solely to commercial traders dealing for own account.

One vitally important issue is to rejig the rules on market abuse, which were designed for conventional financial products. A special regime will be needed for agricultural commodities because they can be manipulated in specific ways, such as playing on a scarcity factor that is not present in equity markets.

Feature

AMAFI and commodities regulation

AMAFI set up a joint working group with the French Banking Federation in October to establish the industry's position on the regulation of commodities markets. The group has already held several meetings, including one with representatives of agricultural and oil producers and firms, the key players in these markets. Bearing in mind the work underway at European and international levels, the group intends to present a position paper to the French authorities, setting out the policies to pursue in order to meet the goals of the G-20, which France now presides. Other initiatives will follow.

AMAFI is also taking part in discussions launched recently by Paris Europlace on the same issues. The aim is to find ways of making Paris more competitive as markets in agricultural commodities, gas and electricity and carbon become increasingly globalised.

The members of the group, like the French financial community as a whole, are fully aware that genuine progress on commodities regulation hinges on adopting a global approach (see article).

Another proposal is to follow America's lead and introduce position limits to rein in speculation. But Dominique Depras, Director of Market Infrastructures at AMAFI, warns: "Position limits have to be carefully thought out: they must not hinder the main users of commodities markets or be so rigid that other participants are deterred from trading. AMAFI has set up a working group (see box) to provide input for the authorities working on these issues".

Global oversight

Regulating European markets alone is not enough. In a recent interview with *Revue Banque*, AMAFI Chief Executive Pierre de Lauzun said: "Markets are global, so the issues cannot be dealt with only at domestic or even at European level. We need a common, fundamental worldwide vision". Europe is a good place to start, however. "Transparency rules should be the same for everyone, so we must start by tackling regulations here in Europe. Then it will be up to international forums such as the G-20 to ensure that other countries fall into step with Europe and the US," notes Jean-Philippe Folco.

Above all, Europe must make its voice heard at the international level. In particular, it should regulate its physical markets more effectively, not only to prevent or cope with agricultural imbalances but also to deliver the transparency that financial commodity markets require to function properly. "We need a global commodity price monitoring unit, set up in collaboration with the finance industry. We also need to better educate market participants about the implications of inside information," says AMAFI's Depras. Imposing genuine transparency in both financial and physical markets at the global level will certainly be a daunting task. But it is one that the international community seems to be taking to heart.

Anthony Bulger and Olivia Dufour

News

International

Anti-money laundering and counter terrorist financing

The International Council of Securities Associations (ICSA) has written to the Financial Action Task Force with proposals on client identification (ICSA's letter is available at www.amafi.fr). ICSA, of which AMAFI is a founder member, wants to apply a risk-based approach to the beneficial owner due diligence process. It is also urging the FATF to ask countries to provide data about the beneficial owners of legal entities registered on their territory.

The proposals are connected to the review of FATF's standards ahead of a fourth round of mutual evaluations. On 22-23 November FATF held a meeting with the private sector to outline an initial set of proposals. AMAFI attended the meeting under the auspices of ICSA, which questioned whether the onus of identifying beneficial owners should be placed on firms rather than countries. Many private-sector representatives supported ICSA's view.

In France, the Autorité de Contrôle Prudentiel (ACP) continues to consult with the industry on drafting AMF/CFT guidelines for firms. The ACP plans to devote a forthcoming publication to third-party reliance on customer due diligence. This will be followed by guidelines on exchanging information within and outside financial institutions.

Stéphanie Hubert

Europe

Short selling

After closely examining the draft Regulation on short selling issued by the European Commission on 15 September, AMAFI has welcomed the initiative, which will harmonise Europe's current patchwork of rules. One of the proposal's chief merits is that it would ban naked short selling and require short sellers to ensure that they can make delivery at the normal settlement date. This Europe-wide mechanism is similar to the one introduced in France by the Banking and Financial Regulation Act (LRBF). AMAFI also welcomes the proposal to harmonise central counterparties' buy-in procedures and settlement systems' penalties for delivery fails, an issue on which it has made a number of practical proposals. By contrast, AMAFI calls for further discussion on aspects such as the marking of short sale orders.

In France, following the adoption of the LRBF, the AMF amended its General Regulation in early November to require that net short positions be reported to the regulator and to the market when they cross certain thresholds. The new measures will come into effect on 1 February 2011. At the same time, the ban on the shorting of financial stocks announced by the AMF on 19 September 2008 will be lifted.

Emmanuel de Fournoux

OTC derivatives markets - EMIR

AMAFI examined the proposed European Market Infrastructure Regulation (EMIR), published in September by the European Commission, in a joint working group with the French Banking Federation (FBF). Although EMIR meets the demands of the French financial community and raises no particular issues, some aspects of the proposal ought to be amended in light of the lessons learned from the crisis.

AMAFI and FBF insist that central counterparties, which play a key role in preventing systemic risk, should have access to central bank money so that they can handle crises more effectively. This view runs counter to the current proposal. In addition, one crucial consideration when implementing EMIR will be to ensure consistency between the mechanisms in place on either side of the Atlantic.

Emmanuel de Fournoux, Véronique Donnadieu

EFSA meets in Copenhagen

The Danish Securities Dealers Association (DSDA) hosted a meeting of the European Forum of Securities Associations (EFSA) on 28 and 29 October in Copenhagen to examine a broad range of topical issues and ongoing European initiatives.

Among the main topics on the agenda were new European regulations on financial sector remuneration, proposals for the regulation of short selling and derivatives, and the creation of the European Securities and Markets Authority.

Véronique Donnadieu

News

France

Sale of complex financial instruments

On 15 October the AMF and the ACP jointly issued a position and a recommendation, respectively, on the marketing of complex financial instruments (structured funds and complex debt instruments) either directly or as underlyings for life insurance policies.

Through its Structured Products Group, AMAFI engaged with this initiative as soon as it was launched back in June 2010, drawing attention to a number of problems in the initial proposal *(AMAFI / 10-39, 10-55 and 10-56)*. As a result, some of these issues were either resolved or mitigated, particularly as regards exemptions for private banking, the definition of complexity criteria and the clarity of the AMF position. AMAFI continues to work with the AMF on a method to count the number of mechanisms involved in a structured product, a vital prerequisite for implementing the position effectively. It is also seeking a solution to the problem that the AMF and the ACP differ in their assessment of capital protection. As a result, the range of products actually eligible for life insurance policies is limited.

The AMF position is predicated on the assumption that market participants sometimes fail to meet their professional obligations when selling complex structured products, triggering a change in the way that firms market them.

Stéphanie Hubert

Market soundings

Several European regulators, including France's AMF, have recently taken a close interest in market soundings, which have been used for some time in equity markets but only recently in fixed-income markets. In France there is no precise definition of market soundings, even though they are covered by specific provisions in the AMF General Regulation. Moreover, some aspects of sounding raise practical questions, such as the length of time that a contacted institution is an insider and the need for coordination between the members of a syndicate.

AMAFI has decided to set up a Market Soundings Group as part of its Compliance Committee in order to review current practices and how they are organised. Particular attention will be paid to the question of whether or not the information disclosed during a sounding related to an equity or fixed-income market is considered as inside information. Based on the group's findings, discussions will be held with the AMF to decide on further action.

Stéphanie Hubert, Marie Thévenot

Remuneration - Transposition of CRD III – AMAFI standard

Work is underway in France to transpose the remuneration-related provisions of the third Capital Requirements Directive. The new measures are due to be completed by year's end and come into effect on 1 January 2011.

The result of intense lobbying by MEPs, the CRD III provisions make it necessary to tighten up the system introduced in France last year.

- The system now applies not only to market professionals but to all risk-takers, supervisory functions and persons whose aggregate income is in the same remuneration bracket if their activities are likely to have a material impact on their firm's risk profile.
- At least 50 per cent of variable remuneration is to be paid in shares or equivalent instruments.
- The ratio of fixed-to-variable remuneration must be "appropriate".
- A mandatory minimum holding period has been introduced.

However, the proportionality principle, based on the firm's size and internal organisation as well as the scope and complexity of its business, now applies not only to these rules but also to the annual disclosure requirement.

The Committee of European Banking Supervisors recently completed a consultation on draft guidelines for remuneration policies and practices. In its response *(AMAFI / 10-66)*, AMAFI stressed that several of CEBS' interpretations of CRD III were overly strict, a view echoed by the European Forum of Securities Associations. In addition to mentioning the problems caused by the short implementation deadlines for the new rules, AMAFI stressed the need for a level playing field, both inside and outside the European Union. Failing this, serious competitive distortions may arise between foreign entities of European firms and their competitors, thereby hindering their ability to develop in fast-expanding economic areas.

With the final version of the CEBS guidelines due out in mid-December, AMAFI is now weighing up the amendments it will have to make to the professional standard on remuneration issued a year ago *(AMAFI / 09-60a and 09/60b)*. It is also seeking ways to help members implement the new arrangements.

Stéphanie Hubert

News

Taxation

2011 Finance Bill

The 2011 Finance Bill currently before Parliament includes measures with negative implications for the financial sector in general and equity-based savings in particular.

In addition to a 10% across-the-board reduction in tax shelters, individuals will be subject to several measures that purportedly contribute to the financing of pension reforms but that directly increase the tax bite on equity-based savings. If the bill is adopted:

- the flat-rate withholding tax on investment income (dividends and interest) will go up from 18% to 19% in 2011;
- the 50% tax credit on dividends liable to income tax, capped at €115 for a single person and €230 for a couple, will be eliminated as from 2010;
- from 2011, capital gains tax on property and investments will be raised to a uniform rate of 19%;
- capital gains on the sale of securities will be taxed in their entirety (the annual trigger threshold will be scrapped);
- the welfare levy on capital income will be raised from 2% to 2.2%.

The bill creates also introduces a “systemic risk” tax on financial institutions that is likely to add to the cost burden of the finance industry a whole. This comes on top of the increases engendered last year by the reform of local tax rates and a levy on 2009 bonuses.

Eric Vacher

New Member

Axeltis, an investment firm offering the services of investment advice and placing without a firm commitment basis for units and shares in collective investment schemes. Axeltis’ officers are Philippe Zaouti (Chairman of the Board) and Marie-Laure Faller (CEO).

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at
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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