Amafi
Association française des marchés financiers

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Breaking the Pre-sounding Barrier

Editorial

It is more urgent than ever to tell savers about the benefits of channelling some of their funds into business financing. That is why the 2012 Supplementary Budget Act and the plans for 2013 are sending out extremely negative signals, with measures including higher dividend taxes, a rise in the employers' tax on profit sharing and employee savings, a financial transactions tax and capital taxation.

This heavier tax burden may seem inevitable in our stretched fiscal environment, although the onus ought to fall on spending cuts. But as the pressure mounts, so does the importance of having a tax structure that gives a relative advantage to savings invested in long-term corporate funding – bonds and, more importantly, equities. Growth and employment, two of the government's stated priorities, depend heavily on such a structure. If the current budget plans go ahead, however, there will be almost no natural buyers of shares left in France; the only access to equity financing will be through foreign investors. That situation is unprecedented in our history. And it would end in disaster.

Whatever the merits or failings of the other actions initiated or backed by the government, such as the Public Investment Bank and the small-business exchange (see page 6), they will not deliver an appropriate response to the challenges unless they are part of an overall approach that is aimed in the right direction. AMAFI put forward a set of proposals on these issues in mid-July *(AMAFI / 12-33)*. The forthcoming budgetary debate will provide an opportunity to get to grips with them.

Pierre de Lauzun
Chief Executive, AMAFI

Feature

When does information become inside information? Can someone become an insider unwittingly? If so, what are the consequences? These are just some of the questions raised by the practice of pre-sounding, an area where clear-cut rules are more necessary than ever.

Pre-sounding – a practice that consists in contacting investors to gauge interest in a possible capital raising or pricing structure – is an important technique for facilitating corporate financing. Until the financial crisis hit in 2007 it was used chiefly on equity markets. Since then, owing to a combination of strong volatility and shaky investor confidence, pre-sounding has become common in fixed income markets. Understandably so, since companies want to be sure that a bond issue will fly before committing time and resources to it.

The technique itself has evolved, becoming lengthier and more regimented. More importantly, the risks involved in discussing a possible transaction with potential investors have multiplied due to the increasingly strict regulation of market abuse. Sometimes, enough feedback on market appetite can be obtained by disclosing general information that does not qualify as inside or material non-public information. But in other cases, specific details have to be revealed and potential investors may find themselves being "wall-crossed" and receiving inside information. This is where a grey area

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opens up, since the line between engaging in a general discussion and being made privy to specific – and inside – information is often blurred. Investors have to take precautions to avoid falling foul of market abuse regulations, and the sell side needs to be sure whether or not an investor is being wall-crossed and what to do if he refuses to become an insider. This, in turn, requires systems and procedures that some firms are ill-equipped to put in place. Furthermore, a number of investors quite simply refuse to take part in pre-soundings, either because of the risks involved or because they do not want their trading activities to be hampered by insider status.

Greenlight, red flag

The question of what constitutes inside information – and, in particular, whether being aware of a forthcoming transaction amounts to being wall-crossed – is not always clear. A recent high-profile case in the UK points up the dangers arising from the lack of specific rules on market sounding. At the beginning of this year the Financial Services Authority fined a hedge fund, Greenlight Capital, and its president, David Einhorn, for insider dealing because Mr Einhorn had failed to identify information received from a corporate broker about a forthcoming equity issue as inside information. (The broker was subsequently fined for improper disclosure.) Mr Einhorn had refused to be wall-crossed but agreed to take part in an open telephone call. Crucially, the FSA acknowledged that no single piece of information given to him at the time constituted inside information. It also agreed that he had not acted deliberately or recklessly and had specifically refused to become an insider. Nonetheless, the UK regulator ruled that, as an experienced professional, Einhorn ought to have been able to recognise inside information when he received it and had therefore acted inappropriately. His failure was described as "a serious breach of the expected standards of market conduct". So even though a market participant specifically requests not to be wall-crossed, he can still infringe market abuse regulations by automatically assuming that he is not receiving inside information. Other questions also arise. For instance, could the very fact of being asked to cross the wall be enough to indicate a forthcoming transaction? And what happens when inside information turns "stale" because, in the end, a contemplated transaction has not gone ahead?

The situation in France

Some years ago the French securities regulator, AMF, became concerned about market participants' increasing reliance on pre-sounding. It feared inside information would be unduly disclosed to potential investors, disrupting fair and orderly markets. In 1998 it introduced a section into its General Regulation[1] and subsequently imposed sanctions on firms that infringed the rules when sounding out investors for equity issues. As the practice of pre-sounding spread to bond markets, the AMF publicly reminded the financial community in September 2010 of the prevailing regulatory requirements. In 2011 it imposed financial penalties on several banks and a bond fund manager for failing to ask formal permission to wall-cross potential buyers during a pre-sounding. It ruled that the disclosure of information breached France's insider trading regulations. The AMF rulings underscored the huge legal risks faced by banks and investment firms that carry out pre-soundings, owing to the lack of a precise framework. This raised the concern that market participants on both the buy side and the sell side might be unwilling to get involved in pre-sounding exercises. As a result, the basic principle behind primary issuance would be called into question, since many new issues are unlikely to take place unless professionals have some idea of whether their clients will be interested in the paper and what they would be prepared to pay for it. One of the major problems was the definition of what constitutes inside information. Stéphanie Hubert, AMAFI's Compliance Director, put it: "The AMF gives regulated firms a degree of leeway in characterising the information they disclose. But they need to be rigorous on this point because, in the event of an inspection, it's the AMF that ultimately decides whether or not the information is inside information!".

1. Article 216-1

Contents of the AMAFI Code

Before a wall-crossed or non wall-crossed pre-sounding is carried out

- Determining what information to disclose
- Characterising the information to be disclosed
- Obtaining the issuer's agreement
- Determining which investors to question

Conducting a wall-wrossed pre-sounding

- Employees responsible for conducting the wall-crossed pre-sounding
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- Period during which the investor is wall-crossed
- Practical organisation of the wall-crossed pre-sounding
- Confirmation of the agreement and of its implications
- Wall-crossed pre-sounding that involves questioning the same investors several times

Preparing and updating the procedure governing wall-crossed and non-wall-crossed pre-soundings

Record keeping

Compliance with the AMAFI Code

The AMAFI Code of Conduct

Amid the prevailing uncertainty, AMAFI was approached not only by its members but also by the AMF to map out a consistent framework that would harmonise the definitions and practices used in pre-soundings. In response, it set about preparing a code of conduct to provide reliable guidance for all stakeholders. The basic procedure has not been radically overhauled by the code; instead, it has been structured so that participants in a pre-sounding can determine whether or not they are dealing with inside information and thus behave accordingly. First, the members of the banking syndicate that plan to sound out potential investors have to decide whether the details they will disclose should be characterised as inside

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information. (The AMAFI Code provides for cases where syndicate members disagree on this point.) If such is the case, then the exercise is known as a wall-crossed pre-sounding. Second, the employees chosen to conduct the exercise – who must be limited in number – have to state clearly that they will be disclosing inside information and the persons receiving it will be prohibited from acting on it or sharing it with anyone else. They must then officially obtain the potential investor's agreement, using a standard, formal script that spells out the groundrules and warns that civil and criminal penalties apply in the event of misconduct. Care must also be taken to ensure that inside information is disclosed to the smallest possible number of people and that all telephone calls and other communications are recorded in order to keep an audit trail that can be presented to the regulator on request, regardless of whether inside information is actually disclosed.

For pre-soundings that do not involve wall-crossing, the code describes various questioning techniques that can be used to ensure that no inside information is divulged and that the person being sounded is unable to guess the identity of the potential issuer. The two main techniques are the no-names approach, where the person conducting the pre-sounding refers only to a sector or an industry, and the multiple-names approach (also known as "leaf in the forest"), where a number of companies are named, one of them the potential issuer. However, since both techniques are based on not identifying the issuer, or even hinting at its identity, they are not necessarily the most effective way of determining whether a transaction is feasible or how it should be priced.

Q&A with…

Nicolas Dot, Head of Compliance & Internal Control, AXA Investment Managers IF

As a French investor, what is your view of the AMF regulation on pre-soundings?

The old version of Article 216-1 of the AMF General Regulation made a clear link between pre-soundings and disclosure of inside information. But because the types of transactions covered by pre-soundings were not clearly defined, the interpretation of the article – and the internal organisational arrangements resulting from it, such as Chinese walls and trading restrictions – sometimes varied from one investment services provider to another.

That confusion was especially harmful since recent events have shown that the AMF imposes stiff penalties on ISPs that fail to meet their duties to prevent undue circulation of inside information. As a result, some buy-side firms started feeling uncomfortable. Aside from the direct consequences for issuers, who were no longer able to gauge market appetite for their paper, the practice of pre-sounding seemed likely to disappear from the banking sector in France. That was why it was so important for the various stakeholders to get together under the auspices of the AMAFI in order to define common terms, rules and methods with a view to discussing the need to recast Art. 216-1 with AMF, and also to draw up a best practice guide on pre-soundings for ISPs.

What are the advantages and drawbacks of the AMAFI Code?

The code covers the entire pre-sounding process. But I think it will take a little time for ISPs as a whole to implement the rules so that pre-sounding exercises can go ahead in a dispassionate and standardised context.

In your view, what action needs to be taken in future?

We have sorted out the problem in France, but not in Europe. Since foreign-based firms may also carry out pre-soundings, it would be useful to harmonise our principles so that competition takes place under the same constraints for everyone.

The way forward

Published in 2011, the AMAFI Code of Conduct is a landmark document – so much so that it has been incorporated into the AMF's General Regulation. Market participants now have a clear set of rules to abide by. But while this initiative may cater to France's penchant for centralising and regulating, is it necessarily an advantage in a globalised and fiercely competitive financial marketplace? The UK has no specific regulations on pre-sounding (though this can cause problems, as evidenced by the Greenlight affair); neither do countries such as Spain and Germany. In each case, the rules of ordinary law apply to pre-soundings conducted in the normal course of business. At a time when European legislation and regulations on market abuse are being overhauled, it is important to ensure that everyone is on the same page, particularly as regards the question of insider information. Which inevitably raises the question of pre-sounding. AMAFI's Code of Conduct is a salutary – and necessary – step in the right direction, as recognised by the French securities regulator. But it needs to evolve. From this perspective, France's rules must not be more stringent than those followed in other financial centres. Otherwise, firms based here will be at a disadvantage. It is high time to develop a harmonised framework that will protect the integrity of the entire European market.

Anthony Bulger

News

International

ICSA Annual General Meeting
Copenhagen, 10-12 June 2012

The International Council of Securities Associations (ICSA) held its 25th Annual General Meeting in Copenhagen in June, with the Danish Securities Dealers Association playing host. AMAFI was represented by CEO Pierre de Lauzun and Véronique Donnadieu, Director of European and International Affairs. As in years past, the meeting was divided into two parts. The first, reserved for ICSA members, was an opportunity to take stock of initiatives carried out over the past year and outline work programmes for the months ahead. The second part of the meeting took the shape of a conference with outside guests, including regulators, politicians and industry representatives, and a host of interesting discussions and presentations. ICSA also welcomed one new full member, Mexico's Asociacion Mexicana de Intermediarios Bursatiles, A.C. (AMIB), and one new correspondent member, the Association of Thai Securities Companies (ASCO).

Véronique Donnadieu

ICSA promotes mutual recognition between regulators

Noting widespread differences in national implementation of certain G20 commitments, and the rise of local regulations with extraterritorial scope, ICSA is alerting international institutions to the adverse effects of such developments and proposing an alternative approach.

Responding to a consultation by the Commodity Futures Trading Commission (CFTC) on the international application of Dodd-Frank Act provisions on derivatives, ICSA broadly welcomed the proposed substituted compliance approach but stressed the attendant difficulties. In contrast to mutual recognition, which works by providing a blanket exemption for all entities of a country whose regulatory framework has been previously recognised as equivalent or comparable, under a substituted compliance approach, any entity wishing to benefit from the arrangements must individually demonstrate that it complies with the requirements of its home country, whose regulatory framework has been recognised as being comparable and comprehensive to the US framework. As ICSA points out, this would mean a long and costly process for affected market participants.

ICSA also corresponded with Mark Carney, Chairman of the Financial Stability Board (FSB), on the question of multilateral and global coordination between regulators. ICSA called on the FSB to promote mutual recognition of regulations by preparing a multilateral framework to implement this approach.
Most recently, ICSA wrote to the International Organization of Securities Commissions (IOSCO), urging it to develop principles and a methodology for mutual recognition.

To see these letters, go to the AMAFI website and look under Library.

Véronique Donnadieu

News

Europe

Market abuse and the LIBOR scandal

Reacting to the LIBOR-fixing scandal, the European authorities decided to amend proposals for a new market abuse regulation and directive (MAD/MAR) in order to sanction benchmark-rigging. It also intends to lay down specific organisational rules governing indices. Two public consultations have been launched, one by ECON on the measures needed to prevent manipulation in future, the other by the European Commission on proposals for regulating the production and use of key indices.

AMAFI obviously considers that benchmark-rigging must be punished, but it has reminded the authorities that a wide variety of indices are used in the financial sector *(AMAFI / 12-40)*. It believes there is little point in applying the same rules to all indices, since those that are tailor-made for a limited number of financial instruments are already subject to strict rules.

Regarding MAR in particular, work is ongoing at the European Council and the Parliament.

And although discussions are far from over, the issues with which AMAFI is particularly engaged, such as pre-soundings (see Feature), accepted market practices – first and foremost the use of liquidity contract – and the definition of rule breaches and inside information, are advancing satisfactorily at both the Council and the Parliament. A number of amendments are due to be examined shortly.

Stéphanie Hubert

Prospectus Directive Delegated acts

The European Securities and Markets Authority (ESMA) conducted a consultation on the technical advice that it is proposing to submit to the European Commission on certain delegated acts concerning the Prospectus Directive. A key focus was the prospectus disclosure requirements for issuance or admission to trading of convertible or exchangeable debt securities.

Following discussions within its Corporate Finance Committee, AMAFI rejected the proposal to submit these instruments to the same obligations as those applicable to shares, particularly the proposal to require a working capital statement and, under certain conditions, a statement on indebtedness and capital *(AMAFI / 12-35)*. AMAFI pointed out that these two types of instruments have a different legal nature, justifying a different disclosure regime, all the more so since ESMA's proposal would be likely to result in significant costs for issuers, which AMAFI deems disproportionate to the expected benefits.

Sylvie Dariosecq

Short selling

With the European Short Selling Regulation due to take effect on 1 November, a number of issues have yet to be resolved. Financial institutions need answers to these questions in order to parameterise and develop their systems. The draft Guidelines published by the European Securities Market Authority (ESMA) on 16 September provided some clarification of the exemptions granted to market makers and primary dealers. However, these exemptions are interpreted narrowly, as they apply instrument by instrument and to members of a trading venue only. There are still problems in identifying how to implement the appropriate notification arrangements and restrictions.

In the sovereign debt market, questions remain about the procedures for calculating net positions, a key aspect for implementing the notification requirements but also for complying with the ban on shorting sovereign CDS.

AMAFI has entered into discussions with the AMF in order to shed light on these issues, and is preparing its response to the ESMA consultation.

Stéphanie Hubert, Emmanuel de Fournoux

News

France

Financing small businesses
Creating an "Entrepreneurial Exchange"

NYSE-Euronext set up a Strategic Planning Committee in early 2012 to reinvigorate the small business market. In early July the committee published an interim report containing proposals to create an exchange devoted to small companies. The proposals were then put out to consultation.

Overall, AMAFI warmly welcomes the recommendations put forward in the report *(AMAFI / 12-41)*. As it has stated many times, AMAFI sees the need for companies, and particularly small businesses, to step up their use of market financing as a crucial collective challenge facing France, for two key reasons. First, insurers, which have traditionally had the biggest presence in share and corporate bond investing, owing to the lack of long-term pension fund type investors, are having to pull back significantly to comply with Solvency 2 requirements. Second, households are becoming increasingly risk averse, a situation compounded by the tax treatment of savings, which favours short-term guaranteed investments.

While AMAFI believes that creating an "entrepreneurial exchange" in line with the proposals made by the Strategic Planning Committee is crucial, this needs to be part of a three-part initiative that should also:

- Ensure that there are no inappropriate domestic regulatory constraints that might impede small businesses from listing, or, more importantly, hinder institutional investors in their ability to invest in the shares or bonds of these companies;
- Make profound changes to the tax treatment of savings by recognising the collective usefulness of savings placed directly or indirectly in long-term corporate funding.

Without this combination of measures, the efforts and commitments expected from a market operator may prove short-lived. In any event, they cannot have an impact unless they are part of a genuine collective strategy to promote investor and issuer interest in the new exchange. An effective trading tool that meets the needs and expectations of the market ecosystem is of little value if issuers – and especially investors – do not use it.

AMAFI is watching closely to make sure that swift action is taken in all three areas.

Emmanuel de Fournoux

Taxation

Financial Transaction Tax (FTT)

Introduced on 1 August, France's new financial transaction tax (FTT) system was amended almost straightaway by the 2012 Supplementary Budget Act, which raised the tax rate on shares to 0.20%. Two implementing decrees and a tax instruction were published at the same time, giving guidance on the new arrangements.

With our members still wrestling with the new arrangements, we continue to devote considerable attention to the FTT, pursuing work on themes we have been exploring in partnership with the Treasury and Tax Department since the start of the year. In the second half of July, we sent members the provisional version of a new guidance memo, updating and building on a document published in March. We are working with the Association for Financial Markets in Europe (AFME) to prepare an English translation for publication alongside the French version.

Key issues right now include identifying the legal taxpayer and sharing out collection, reporting and payment responsibilities when multiple firms – some outside the country – are involved. A working group of tax and legal specialists has got together several times since early July to look at these questions. We are coordinating our efforts with those of the AFG and FBF, two industry groups.

We are also surveying members on the operating impact of the new system on the taxation of share and equivalent purchases, particularly in terms of:

- collection issues;
- a possible decline in trading volumes or prices;
- visible changes in the behaviour of some investors.

With a multi-country FTT in prospect, the European Council on 28 and 29 June 2012 established a timetable for implementing the enhanced cooperation called for by France, Germany, Belgium, Austria, Finland, Greece, Portugal, Spain and Italy.

Eric Vacher, Emmanuel de Fournoux, Sylvie Dariosecq

Amafi Highlights

New Members

Palico SAS, an investment firm whose main business is placing without a firm commitment basis of shares in private equity funds for professional clients. Its senior managers are Antoine Dréan (Chairman) Cédric Teissier (CEO) and Arthur de Catheu (CEO).

BIL Finance is a subsidiary of Banque Internationale à Luxembourg. Its main business is corporate advisory and equity and bond trading for issuers and institutional investors. The senior managers are Didier Chaudesaygues (CEO) and Sophie Langlois (COO).

Amafi Staff

Julien Perrier joined AMAFI at the beginning of September as a legal and compliance adviser. He served an internship with the Association in early 2012, where he familiarised himself with the legal and compliance issues under review at that time. Julien holds a master's degree in banking and finance law from Paris II University and a Corporate and Financial Law LLM from the University of Glasgow.

Contacts

Should you require further information about any of the topics discussed in this Newsletter, contact the person(s) named at the bottom of the article in question. Dial (+ 33 1 5383) followed by the extension number, or send an email.

- **Philippe Bouyoux**
  Ext. 00 84
  pbouyoux@amafi.fr
- **Sylvie Dariosecq**
  Ext. 00 91
  sdariosecq@amafi.fr
- **Dominique Depras**
  Ext. 00 73
  ddepras@amafi.fr
- **Véronique Donnadieu**
  Ext. 00 86
  vdonnadieu@amafi.fr
- **Emmanuel de Fournoux**
  Ext. 00 78
  edefournoux@amafi.fr
- **Stéphanie Hubert**
  Ext. 00 87
  shubert@amafi.fr
- **Alexandra Lemay-Coulon**
  Ext. 00 71
  alemaycoulon@amafi.fr
- **Julien Perrier**
  Ext. 00 76
  jperrier@amafi.fr
- **Bertrand de Saint-Mars**
  Ext. 00 92
  bdesaintmars@amafi.fr
- **Eric Vacher**
  Ext. 00 82
  evacher@amafi.fr

Director of Publication: Bertrand de Saint Mars
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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.

ASSOCIATION FRANCAISE DES MARCHÉS FINANCIERS
FRENCH FINANCIAL MARKETS ASSOCIATION
AMAFI
13, rue Auber – F-75009 Paris
Phone: + **33 1 5383-0070**
Fax: + **33 1 5383-0083**
www.amafi.fr