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Summary

The MPCP met on the 24 June 2009 in Paris to discuss five issues with the following result:

- Despite some signs of improvement, MPCP members continue to be concerned about the financial crisis and exit strategies from current policies.
- The future framework for EU financial regulation and supervision: members strongly argued in favor of binding powers, and the subsidiary principle which should be respected; they highlighted the danger of "watering down" the process in case implementation is delayed.
- The message concerning short selling was very clear: the decline in bank stocks was due to the general market perception not to short sellers; tightened regulation on market abuse should be sufficient to deal with many potential problems linked to short selling; the best way to deal with problems linked to naked short selling is by heavily sanctioning settlement failures – though this might not be sufficient; short and well as long positions should be disclosed to regulators (but not to the market) on a frequent basis so that they are sufficiently informed in extreme situations – one member argued that, with respect to naked short sales, transparency should be market-wide; any measure with respect to short selling needs to be carried out in an equivalent form across borders.
- MPCP members are concerned about "empty voting" and would like to see regulatory action in this area – though there was a recognition that a change in company law is very difficult to achieve.
- The MPCP members were very critical towards the recent proposals for the regulation of alternative investment find managers (AIFMs) which is mainly perceived as a hasty, ill-designed protectionist measure against U.S. market players.

Agenda item 1 | Update on market developments

Concerning financial markets developments, MPCP members continue to be concerned about current crisis – though there are some signs of improvement. Funding was found to be still difficult for a range of banks, although not all of them. Difficulties in funding means problems to have a proper ALM. It was recognized that carrying out stress tests would likely result in the need for higher capital needs for banks. A relief through revised accounting rules would be welcome as otherwise capital needs would significantly increase on the basis of the results of the internal models. Related, a change in the behavior of credit rating agencies was noted.

In some, but not all EU countries, some areas of the banking sector face serious difficulties (and a reduction of dividend payouts is likely more generally). In others, the biggest risk stems rather from a possible severe economic slowdown. Members regretted that policy responses within the EU were largely based on national initiatives. Collateral, much of which is not liquid, might well become a problem as collateral requirements are likely to increase, particularly when there is no “pick up” in the 3rd or 4th quarter of 2009.

Members expressed the opinion that the CDS market does not serve so much to reduce risks, but rather to distribute losses linked to the risks.

Concerning exit strategies of monetary and economic policies, members agreed that these will need to be linked to clear signs of a recovery, i.e. economic growth. However, it was also recognized that the “exit” will not be easy and that an increase in inflation is likely.

Agenda item 2 | A future framework for EU financial regulation and supervision

After the publication of the de Larosière report in February, both the communication of the EU COM from 27 May 2009 and the ECOFIN Council meeting of 9 June gave further details about the future structure of financial regulation and supervision in Europe. CESR will continue giving input into the preparations by the European Commission in this process.

On this basis, MPCP members discussed the new framework for EU financial regulation and supervision. They stressed that the European Systemic Risk Board, which gives only recommendations, is too much geared towards central banks, and that its composition is too large (> 60 members). The impact on monetary policy is not clear. The overall competence of central banks in all areas of regulation and supervision (banking, insurance, and securities markets) was questioned. On the other hand, it was also recognized that central banks have a role with respect to the banking sector as they are potential providers of liquidity in crises situations.

Members highlighted the fact that the role of the new Authorities with respect to rule making on technical aspects is not clear as the powers need to be reflected in a given Directive, and problems might well arise in relation to, but outside that Directive. It was stressed that the Authorities would have a legal personality as they will be able to take binding decisions. Obviously, the principle of non-interference with fiscal responsibility at national level would need to be respected. It was recognized that this issue does not, however, put into question the need for CCPs. Concerning binding mediation, the Commission would need to be involved. MPCP members strongly argued in favor of binding powers, and the subsidiary principle, which should be respected.

Some not surprising controversy was recognized with respect to the power of direct supervision on individual institutions as there were strong objections in this field already in the past – except in the area of credit rating agencies.

Different possibilities of “independence” were discussed, particularly in relation to funding – whereby a mixture of different ways of funding was favored (internal resources and Member States, EU COM funding, funding by the industry), and on the basis that the EU Commission would still have a role to play (which could consist in endorsing proposals).

The MPCP members stressed the need for a procedure for decision making whereby qualified majority voting was found to be likely at some stage.

Several MPCP members expressed the view that there is a clear danger of "watering down" the process in case implementation is delayed.

Agenda item 3 | Short selling

Short selling remains a hot topic among financial market participants. The MPCP Chair underscored the fact that in this field, regulatory measures continue to be heterogeneous across European countries and that after nine months of discussion there is still no common position – except a general agreement on more transparency whose specifics are however controversial. Some jurisdictions have lifted their bans, others are currently reviewing them, and still others have prolonged or adapted their prohibitions. Current areas of investigation and analysis by regulators are mainly naked short-selling, settlement cycles and settlement failures.

The message of the MPCP members on short selling was very clear (see also the documents in annex 1 and 2):

- by prohibiting short sales, regulatory authorities have given a strong signal that short selling is a technique of market abuse and as such detrimental to markets, whereas it rather is an irreplaceable hedging technique;
- as result of the bans, investors left the market;
- after the ban, it became clear that the decline in bank stocks was due to the general market perception not to short sellers;
- tightened regulation concerning market abuse should be sufficient to deal with many potential problems linked to short selling;
- the best way to deal with problems linked to naked short selling is by heavily sanctioning settlement failures – though this might not be enough, a prohibition could be considered;
- short and well as long positions should be disclosed to regulators (but not to the market, which should be informed about not more than the hedges of long positions if at all) on a frequent basis so that they are sufficiently informed in extreme situations – one member argued that, with respect to naked short sales, transparency should be market-wide;
- MAD should be enough to deal with many issues, except when the one of orderly markets is involved;
- regulatory coordination is needed: any measure with respect to short selling needs to be carried out in an equivalent form across borders.

It is likely that within the new EU financial architecture, measures like those relating to short selling would have to be taken at national level, and only in exceptional circumstances at the level of the Authority.

Agenda item 4 | Empty voting

MPCP members are very concerned about "empty voting", a term which can be used to embrace a variety of circumstances that result in a partial and total separation of the right to vote at a shareholders' meeting from ownership of the shares. Sometimes it is used as a synonym for the practice of borrowing company shares to influence the outcome of company votes.

With respect to empty voting, which is more prevalent in Europe than in the U.S. (as voting matters more in Europe than in the U.S.), it seems helpful to highlight that three practices of securities lending exist: 1) securities are bought and sold more or less immediately, 2) securities are borrowed, and 3) a subsidiary of a company or the company holds securities and lends them whereby the borrower exercises the voting power. This last practice is the most visible one in terms of empty voting, and it would probably be up to the directors to decide about disclosure.

Many MPCP members argued in favor of a prohibition of that empty voting with as the general principle that some economic interest should be connected to the voting and be disclosed (in some EU Member States related prohibitions exist at least with respect to specific securities, like Treasury stocks). There was a perception that the problem could well become more prominent. Empty voting is an area where the inter-linkages between company law and securities markets become very visible. Changing the company law is, however, difficult and unlikely to be successful as a way to address the issue of empty voting. One possible route for improvement currently seems to be disclosure.

Agenda item 5 | Proposals for the regulation of AIFMs

At the end of April 2009, the Commission published a proposal for a Directive on Alternative Investment Fund Managers (AIFM) which attracted interest well beyond the hedge fund community. MPCP members were very critical towards the recent proposals for the regulation of alternative investment find managers (AIFMs). The proposal is perceived to be a hasty, detailed, protectionist measure against US market players (see also annex 3). What is needed instead is a recognition of the global attempts to set standards in this area. Concerning the content of the proposal, concerns have been voiced that there is no economic foundation, that the Commission will be empowered to regulate in a much too detailed way, that the coverage of private equity unnecessary, and that the 100 million threshold is much too low.

Agenda item 6 | Any other business

The Panel agreed to hold its next meeting on 15 September 2009 and to discuss the issue of sanctions, as well as the evolution of the structure of trading (related to MTFs, dark pools, etc).

Annex 1

CESR's Market Participants Panel position on short selling bans

1. Short selling is a technique which allows investors to make money when stock prices fall. It is widely used by active investors when there is a perception that stocks are overvalued and are bound to decline in price. Although there are some specialists who use short selling as the major source of their gains, in general short selling is used by all types of investors to hedge against price falls. As a result, without short selling markets would be much less efficient, investors would be left without no coverage when markets are expected to decline, many important funding instruments would not be viable, and many investment strategies would be impossible. Many significant investors would withdraw from the markets, especially when prices are falling, which would significantly amplify market cycles.

2. As with any arbitrage activity, short selling makes the market more liquid and more efficient. Price discovery is enhanced, bid-ask spreads are reduced and overall liquidity is enhanced. This certainly reduces the cost of capital, with obvious benefits for the whole economy. By allowing active investors to intervene more forcefully, short selling is particularly useful to deal with price bubbles.

3. However, it is as a hedging technique that short selling is almost irreplaceable. If prices are expected to fall, investors may still stayed invested, by shorting the stocks they think will fall the most and investing in the others, or shorting the whole market and investing in stocks which do not fall as much as the market. Thus, even in situations of market decline, investors can still play a significant role, by differentiating between stocks which do not fall as much as the market. Without short selling, many investors simply leave the markets altogether, as witnessed in the fall of 2008.

4. Some important capital raising instruments are quite dependent on short selling. Convertible bonds, in particular, are far more attractive to most investors when the buyers have the possibility of shorting the stock and become therefore hedged against price falls. Without short selling, the convertible bond market suffers a severe shortfall in demand.

5. Short selling bans were introduced in several countries in the fall of 2008 to prevent the alleged practice of price manipulation during rights issues of weak banks. This proved to be a serious mistake. Even after short selling was banned the stocks of the weaker banks kept falling precipitously, showing that the cause of the decline was the general market perception and not the attitude of the short sellers. Furthermore, the bans drove many investors from the markets, which made the downturn more severe and amplified the problems of the banks that were supposed to be protected.

6. By banning short selling, securities regulators were actually admitting that they believed that stocks could be manipulated through the intervention of a small group of short sellers. This, of course, would have been market abuse. However, even though no case of market abuse was detected and sanctioned, many investors followed the opinion of the regulators and, afraid of market manipulation, actually withdrew from the market. This greatly exaggerated the market's downturn.

7. Short selling can, in theory, be used to manipulate markets. Regulators should be sufficiently informed of short selling to be able to detect if there is any suspicion of market abuse, which, if confirmed, has to be sanctioned.

8. Naked short selling occurs when a security is sold by an investor who does not have the security in his or her possession. Naked short selling may well be banned , given its potential to create market disruption. However, this is better done by sanctioning heavily settlement failures, which may well be enough to a put an end to naked short selling.

9. To deal with concerns with respect to short selling in cases of extreme market volatility, regulators need to have access to information. Short positions as well as long positions should be disclosed to regulators on a frequent basis, and every time the regulator so requests. The broad market does not need to have this information, except to the extent that short selling creates doubt with respect to the control or owner ship of a particular company. In this context, short positions should be disclosed to the market when they go beyond thresholds which should be symmetric to those for the disclosure of long positions.

10. Any regulatory intervention with respect to short selling should be carried out in equivalent form across borders. In other words, securities regulators should, to the extent possible, agree on a framework to deal with severe market disruption and act in common and along similar lines.

Annex 2

Message from Rudiger von Rosen on short selling

I clearly see a need for a comprehensive framework for short-selling. Amongst others we have therefore already approached CESR and IOSCO with our views on this issue.

Concerns. Basically, there are three main regulatory concerns with regard to shortselling that need to be taken into account; disorderly markets, market abuse and settlement disruption (see IOSCO's consultation report "Regulation of Short-selling" as of March 2009, appendix II). Rudiger basically shares the analysis provided by IOSCO on these issues but would like to add some further concerns that are not yet properly addressed.

On major concern with short sales is that they may worsen downturn trends in stock prices which, in turn, may have further negative consequences for the respective issuers and the economy as a whole. For example, access to finance usually depends on the level of share prices. Therefore any pressure imposed upon share prices by short-selling may worsen (re-)financing conditions even for companies which are basically solvent. These are two of the reasons why regulators imposed constraints on short-selling - at least for some shares - during the financial crisis.

But short sales may be problematic even in less turbulent times as shortselling may be linked to attempts to manipulate the market. By selling shares short and subsequently floating rumours about an unsustainable overvaluation in the market one can extract enormous private profits from a later decline of share prices during a very short period of time.

Manipulative behaviour of this kind seriously damages market integrity and efficiency, but cannot be easily uncovered. The same is applies when other events with negative consequences for issuers and their shareholders are caused or promoted by short-selling. There is, for example, evidence that speculators massively shortened shares in order to achieve a company being excluded from a stock market index, which normally leads to a long-term loss of liquidity and a long-term fall of the price in the respective share at the expense of all other shareholders.

For the above mentioned reasons, I am of the opinion that regulations to prevent market manipulation by floating rumours should be reviewed and, if necessary, tightened. Additionally, there is a need to implement a specific regulation with regard to short-selling that does not eliminate its positive effects while at the same time taking into account negative effects on market integrity and efficiency.

Prohibition of naked short sales. The danger of market manipulation is particularly virulent with so-called naked short sales which are not covered by ex-ante stock lending, so that risks clearly exceed benefits for this kind of short-selling. As a consequence, naked short sales should be prohibited internationally and any violation of this prohibition should be sanctioned appropriately and effectively.

I strongly recommend making short sales transparent to all relevant parties (i.e. authorities, issuers, investors) as this would strengthen market integrity for several reasons:

- If short-selling positions were to be made transparent, market participants and issuers could assess whether there are investors interested in falling stock prices and, accordingly, rumours could be judged against this background.

- As a consequence, manipulative behaviour could be much better prevented. Additionally, a transparency obligation for short-selling would be the logical complement to the existing one with respect to long position in shares and financial instruments.

- Furthermore, transparency obligations for short sales would prevent extreme shortenings of certain shares and would therefore protect short sellers themselves. Each potential short seller would be more cautious if there was already a high level of short sales in a respective share. This would prevent extreme increases in stock prices in case that many short sellers had to buy shares for any price in order to limit losses or to meet contractual commitments.

- If there was a complement obligation to notify stock lending, transparency of short sales would indirectly enhance knowledge about the potential of so-called "empty voting". There is evidence that stock lending has been used to raise voting power in general meetings without being invested long-term in the respective company or even interested in the long-term performance of the share. Furthermore, any transparency regime should be comprehensive to cover both all relevant short sales and attempts of circumventing transparency obligations.

- There should be safeguards to prevent notification obligations in the cash-market from being circumvented by building up synthetic positions, so that - principally - synthetic shortening should be included in the regulation. It is well-known that there is a close correlation between the prices of derivative financial instruments and the prices of underlying securities. Therefore a synthetic short sale has similar effects on the price of a (underlying) share as a short sale in the cash market. Also, in both cases short sellers are interested in falling prices and cash market regulations will become ineffective, if loopholes for synthetic positions persist.

- Building up and reducing short positions should be made transparent immediately starting from a low threshold (for example 0.25 percent of outstanding shares). A low threshold is important as short sales influence the trading of securities and the level of prices. To the contrary, obligations to notify long positions aim at informing the market on the longterm voting power of important shareholders, so that long positions should be treated differently to short positions.

- To prevent market abuses and disorderly markets it is of particular importance that information on short-selling is provided to authorities and all market participants. Short sales should be notified to a supervisory authority which, in turn, summarises the notifications and makes them transparent immediately to all market participants. For this purpose a central and international register could be created. This would pay tribute to the fact that it is possible to shorten the same stock in different local markets. In order to achieve market integrity it is important to know both the worldwide level of short sales and the short-selling investors.

Annex 3

Observations from Antonio Borges on the European Commission's draft Directive on Alternative Investment Fund Managers

The draft Directive was drawn up without proper process and creates a dangerous precedent for financial regulation in Europe. It introduces a protectionist anti-American element, opts for radical black-and-white norms contrary to the British principles-based approach and creates a substantial regulatory burden for small fund managers, which will undoubtedly hurt the entrepreneurial and innovative nature of the Hedge Fund industry. The main losers from this approach will be European based institutional investors, whose options will be severely limited.

1. The draft Directive ignores the transatlantic cooperative process underway within the G20 framework. For an industry that is dominated by the US, with a significant but smaller British component, transatlantic efforts to reach a global consensus must be the most advisable approach. Since the November meeting of the G20, the Financial Stability Forum has been orchestrating a cooperative effort, involving standard setters and industry representatives from Europe and the US, with the aim of defining a global set of standards or principles. These may later form the basis for additional regulation or for private sector code of conduct initiatives. It is remarkable that the Americans are willing to participate in this dialogue, since until recently their dominance of the industry led them to consider it unnecessary to reach a consensus with the rest of the world. This project is coming along very satisfactorily, with a first presentation of agreed conclusions to be made in the next few weeks. It is a great pity that the European Commission has now decided to go ahead unilaterally with a very protectionist and anti-American proposal, precisely at a time when we were beginning to make progress on a set of global standards.

2. Contrary to the best European traditions, this proposal was drafted without involving or seriously consulting interested parties before publication. The project was rushed through, due to the electoral calendar. No input from market participants – fund managers or investors – was solicited or accepted when the Directive was being drafted. And there is evidence that the final version was the outcome of very hard political negotiations at the highest level. This politicization of the regulatory process is a very bad precedent, which will likely lead to a low quality final result.

3. There is no firm analytical basis behind many of the initiatives and much of the content of the draft Directive. The Commission's own study of the financial crisis – the well received De Larosiere report, produced at the Commission's request by a group of Europe's best experts on economics and finance – does not recommend any initiative of this type, nor does it not point at alternative investments as a factor in precipitating the financial crisis. Similarly, the Turner Review of the banking crisis does not provide any foundation for the proposals in the Commission's draft Directive. It states simply that additional regulation may be necessary in the case of alternative investment funds which are systemically relevant, a point on which there is general consensus. In addition, the Turner report highlights that Hedge Funds are generally not bank-like in their activities.[1] The Commission Draft does not provide sound and well founded evidence that the activities of AIFM presently pose a systemic risk. Indeed, the draft states only that AIFM "may in some cases have contributed to market turbulence". Overall, the assessment of risks to the financial system does not justify the regulatory response as set out in the Directive.[2]

4. The draft directive sets a dangerous precedent by proposing to regulate from Brussels an industry which is – in Europe – essentially based in the UK, and which does not represent any threat to the rest of Europe. The UK regulatory system for financial markets – and, in particular, for

[1] Turner Review, p. 74: "Hedge fund leverage is typically well below that of banks – about two to three on average (...). They do not in general deal directly with retail customers (though they may have indirect contact via funds of funds). And they typically have not promised to their investors that funds are available on demand, and are able to apply redemption gates in the event of significant investor withdrawals. They are not therefore at present performing a maturity transformation function fully equivalent to that performed by banks,investment banks, SIVs and mutual funds, in the run-up to the crisis."

[2] The EC directive talks about HF contributing to asset price inflation as well as a pro-cyclical impact on declining markets and that HF may have impaired market liquidity (p.3). However, this applies to any (long only) investor or fund, who has experienced inflows in the years prior to the peak, and outflows during the turmoil of last year. In addition, it is debatable if the process of investors re-assessing their risk appetite and therefore selling risky assets (leading to a drop in asset prices of risky assets) is a "systemic risk", since it is ultimately just a market price adjustment. Also, there is no evidence that markets have been disorderly.

alternative investments – is the best in the world and has proven its value and its robustness. Proposals that seek to introduce new regulations that sideline the FSA and sweep aside many years of carefully developed regulatory philosophy and practice have to be regarded with great suspicion. The draft Directive transfers substantial powers to Brussels, since it states that all the detailed norms will be defined by the Commission.[3] It opts for hard black-and-white prescriptive rules, as opposed to the UK's principles based approach. It does not provide for any comply-or-explain option, even though this has proven a very positive component of many of the UK's regulatory efforts. And it is clearly disproportionate, since it applies a substantial regulatory burden to even very small funds, which cannot possibly create any systemic risk.

5. As it stands, the draft Directive forbids access to the European market for any managers that are based in countries which do not have "equivalent" regulation.[4] Since there is no equivalent regulation in the US – and most likely there will never be, since the provisions of the Directive are very far from American standard practice – US based fund managers will not be able to sell to European investors. French and German politicians are arguing that the Directive creates an important new facility – the so called European passport – which allows a fund managed in the European Union to sell in any member country; this will undoubtedly prevent certain member country governments from restricting access to their investors by funds based in the UK, for example. But American fund managers will have to first be based in the European Union – thus accepting the jurisdiction of this Directive - before they can apply for the European passport. For those who are not prepared to submit themselves to the Directive – American or Swiss based, including those UK funds who may choose to relocate – European domiciled investors will be off limits. This is not a problem for high net worth individuals, who will go off-shore anyway. But institutional investors – in particular pension funds – who cannot go off-shore and who have to abide by the law, will not be allowed to invest in funds managed by American or Swiss or Singapore based managers.

6. The draft Directive covers the same points that all existing standards and guidelines focus on. But in each case it opts for the most radical position, making it difficult for other countries to follow the Commission's example. On manager authorization, for example, the Directive establishes that authorization depends on the strategy proposed by the manager and will have to be renewed if the manager ever wants to change strategy.[5] On valuation, the Directive opts for absolute independent valuation[6], which is likely to raise strong objections across the Atlantic[7] There are also severe restrictions on delegation of functions. Furthermore, because the threshold for application of these norms is very low (€100 million), even very small fund managers will be forced to comply. This is likely to hurt the very entrepreneurial nature of the Hedge Fund industry, the ability of anyone with a good idea to test it in the market place, and the freedom of investors to choose to support new and innovative fund managers, who may well deliver outstanding performance.
In its present form this Directive is likely to result in reduced competition and an industry that is far more conservative and slow moving and that offers fewer options to investors.

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[3] Examples: Section 1 (Conduct of Business): Article 9.2 (General Principles); Article 11.5 (further specification of "risk management requirements") Article 12.3 (further specification of the "liquidity management requirements")

[4] Article 39 (Authorisation of AIFM established in third countries): "(...) that its legislation regarding prudential regulation and on-going supervision is equivalent to the provisions of this Directive and is effectively enforced".

[5] Authorisation of AIFM (Article 7)/Changes in the scope of authorisation: "AIFM shall, before implementation, notify the competent authorities of the home Member State of any change regarding the information provided in their initial application that may substantially affect the conditions under which the authorisation has been granted, in particular changes of the investment strategy and policy of any AIF managed by it, of the AIF rules or instruments of incorporation and the identity of any further AIF the AIFM intends to manage.
The competent authorities shall, within a month of receipt of that notification, either approve, or impose restrictions, or reject those changes."

[6] Section 3, Organisational requirements, Article 16 (Valuation): "AIFM shall ensure that, for each AIF that it manages, a valuator is appointed which
is independent of the AIFM to establish the value of assets acquired by the AIF and the value of the shares and units of the AIF.

[7] HFSB recommends valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation and highlights that the most satisfactory way to achieve this is to appoint an independent and competent third party valuation service provider. The HFSB allows managers to explain to their investors their approach, thereby allowing to accommodate differing practices, and providing investors with transparency and choice.