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Submission on a Revision of the Market Abuse Directive

Public Consultation by the European Commission
Directorate General Internal Market and Services

23 July 2010

WEED Interest Representative Register ID number: 73788681242

About WEED

WEED – World Economy, Ecology & Development is a Berlin based specialist think tank and advocacy organization that has worked on global finance issues for about 20 years. It has outstanding expertise on the development impact of the international financial system. WEED regularly testifies to the German parliament, and recently also to the IMF on financial transactions levies. WEED has been part of several EU funded projects on international financial markets, currently implementing two of them (one of them called "Towards a Global Finance System at the Service of Sustainable Development"). For more information please see www.weed-online.org.

General remarks

The current crisis has highlighted how prone modern financial markets are to market abuse, both in a criminal manner and in abusing market power or inside information. It is not occasionally this happened but is a result of a severe lack of regulation. As best-informed insider Michael Lewis in his 2010 book "The Big Short" puts it, ***"Bond salesmen could say and do anything without fear that they'd be reported to some authority. Bond traders could exploit inside information without worrying that they would be caught.*** *Bond technicians could dream up ever more complicated securities without worrying too much about government regulation."*[1] *(emphasis added)*

Financial innovations often were created in order to circumvent regulation respectively prudential risk management. The difference between smart financial engineering and market abuse vanished, as for example the recently settled action of SEC against Goldman Sachs has shown. A lot of the acclaimed and very well-paid business of some market players, especially big investment banks, essentially seems to be an abuse of market power. **Therefore, the Commission should also think about the general market structure and the size and influence of big banks and funds if it wants to fight market abuse effectively.**

Because of the relevance to all people, especially poor ones, **commodity markets deserve particular attention.** Recently, there have been some commodity market disruptions in the cocoa and coffee markets. The London coffee futures market was squeezed by traders who wanted delivery of coffee which speculators had sold forward.[2] On the weekend 17/18 July 2010, an apparent 'corner' of the cocoa futures market happened by a London hedge fund which acquired £658 million worth of cocoa.[3] Before, 16 cocoa trading organisations had wrote a strongly-worded letter to the London Liffe exchange to say they were *"shocked with what is happening on the cocoa market"* and demand that it introduce US-style limits on speculators' activity, or they would move their own 'hedging' trade to New York.[4]

Another example of possible market abuse is short selling. In the latest scientific discussion, the economic ratio of short selling in general has been questioned, suggesting that it is economically dysfunctional and generally driven by abusive market power. Hans-Werner Sinn, one of Germany's highest esteemed economists, in his 2009 book C*asino Capitalism* compares short selling to forward contracts, concluding that short selling is only of advantage for the speculator if he is able to borrow enough securities to influence the market: ***"As the private advantage of short selling only exceeds the one of forward contracts if market power is exercised, short selling has no additional economic benefit"*** **(our translation, emphasis added).**

[1] Michael Lewis (2010): The Big Short. Inside the Doomsday Machine. London: Allen Lane / Penguin. Page 62.
[2] www.reuters.com/article/idUSLDE66F18T20100716
[3] www.ft.com/cms/s/0/e50feefc-9120-11df-b297-00144feab49a.html
[4] www.guardian.co.uk/business/2010/jul/06/commodities-cocoa-futures-liffe

We thank the commission for the opportunity to participate in the consultation and would like to comment as follows on the consultation paper's questions:

(1) Should the definition of inside information for commodity derivatives be expanded in order to be aligned with the general definition of inside information and thus better protect investors?

It should be indeed expanded, but beyond what the Commission suggests. In the case of the commodity markets, the concern should not be to protect *investors* but to protect individuals or entities that participate in those markets for the purposes of *trade*, for example by buying or selling a commodity either spot or forward as part of the production and distribution process (rather than directly for financial gain), or by hedging purchases or sales that are similarly undertaken. Also, the interest of other stakeholders as for example consumers has to be taken into account.

Generally, the Commission's definition of abuse seems to be inadequate. The document says, *"Manipulative behaviours are defined in a largely satisfactory manner in the Directive"*, Section A.3, p. 5. However, this definition would not cover the manipulation of the London cocoa futures market (NYSE LIFFE) mentioned above in the general remarks. An *outcome* of this sort is covered in Article 1.2 of the Directive: *"conduct by a person, or persons acting in collaboration, to secure a dominant position over the supply of or demand for a financial instrument which has the effect of fixing, directly or indirectly, purchase or sale prices or creating other unfair trading conditions"*. That is about as severe an abuse of commodity futures trading as can occur, leading at its extreme to a so-called 'corner' such as the respective hedge fund (Armajaro) seems to have built up on the cocoa market. However, on this occasion it does not appear to have been achieved through any of the practices listed in paragraphs (a), (b) and (c) of Article 1.2, but simply by the purchase of a very large number of futures contracts (a large 'long' position) and taking physical delivery on them when they fell due. That sort of manipulative behaviour is covered (or can easily be covered) in the U.S. by the rules of the Commodity Futures Trading Commission (CFTC), but not, as far as we are aware, in Europe. It would be necessary to have public transparency of all futures trades, and limits on participants' positions in the market. Market participants could be divided in two categories, 'commercial' and 'non-commercial' (i.e. speculators and financial investors), as the CFTC has done for very many years.

Another example of market abuse is the role of passive investment funds (Index Swaps/Funds, Exchange Traded Funds, Exchange Traded Notes and similar). As hedge fund manager Michael W. Masters testified to the Commodities Futures Trading Commission on 8 August 2009 regarding the commodity derivatives markets, *"passive investment provides no benefits to the markets while it exacts a heavy toll. (…) Every contract traded for reasons other than supply and demand is a contract that damages the price discovery function of the market."*[5]

Lastly, the possibly damaging effects of short selling should be included into the MAD even though this issue will be also covered by other regulation as well.

(2) Should MAD be extended to cover attempts to manipulate the market? If so why? Is the definition proposed in this consultation document based on efficient criteria to cover all cases of possible abuses that today are not covered by MAD?

Yes, attempts should be covered, as it is proposed by the Commission. This is necessary both for deterrence and for effective prosecution.

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[5] www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_masters.pdf

(3) Should the prohibition of market manipulation be expanded to cover manipulative actions committed through derivatives?

It should certainly be extended. Derivatives are particularly prone to market abuse as they are often designed and traded more opaquely than the underlying stocks, bonds, commodities, or else themselves. As Gary Gensler, head of the CFTC, testified to the European Parliament on 16 March 2010, *"OTC derivatives were at the center of the 2008 financial crisis. They added leverage to the financial system with more risk being backed up by less capital. U.S. Taxpayers bailed out AIG with $180 billion when that company's ineffectively regulated $2 trillion derivatives portfolio […] nearly brought down the financial system. As we later learned, much of the bailout money flowed through AIG to U.S. and European banks. These events demonstrate how over-the-counter derivatives – initially developed to help manage and lower risks – can actually concentrate and heighten risk in the economy and to the public."*[6] Also, the Consultative report "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs" from May 2010 notes that the "*crisis highlighted a severe lack of market transparency in OTC derivatives markets"*[7].

We also refer to our comment on question 1. The various attempts at cornering important markets that we are aware of have taken place on commodity derivative (futures and forward) markets: copper on the London Metal Exchange in the mid-1960s and then again, more successfully by a Sumitomo trader, in the 1980s and 1990s; silver by Nelson Bunker Hunt in 1980; and now cocoa on NYSE LIFFE.

(4) To what extent should MAD apply to financial instruments admitted to trading on MTFs?

In its entirety, as it is proposed by the Commission. However, we wonder why OTC instruments are mentioned in the introduction but do not appear in the text later on. Of course, also **all OTC derivatives** must be covered. It was especially the OTC derivatives with their opaqueness that caused the crisis.

Also, the regulation should not only apply to EU MTFs but to **all EU companies**.

(5) In particular should the obligation to disclose inside information not apply to issuers who only have instruments admitted to trading on an MTF? If so why?

Yes, there should be an obligation like this, as proposed by the EC. However, it should certainly apply without exception. The financial sector often argued in the past that regulating them would be harmful and destabilising to the markets. Eventually, we got the financial crisis which is much more harmful and destabilising than any regulation.

(6) Is there a need for an adapted regime for SMEs admitted to trading on regulated markets and/or MTFs? To what extent should the adapted regime apply to SMEs or to "companies with reduced market capitalisation" as defined in Prospectus Directive? To what extent can the criteria to be fulfilled by SMEs as proposed for such an adapted regime be further specified through delegated acts?

We do not think there should be such an adapted regime. A special regime for SMEs, or for any other category, could be used as a loophole enabling others to undertake manipulations indirectly which they would not be permitted to do in their own names.

The finance sector in some respects has a freedom that is unimaginable for other sectors of our economy. Every little business in other sectors faces regulations of all different kinds. Given this, it is not justifiable to still let parts of the finance sector highly unregulated.

[6] http://useu.usmission.gov/031610_gensler.html
[7] www.bis.org/publ/cpss89.pdf?noframes=1

(7) How can the powers of competent authorities to investigate market abuse be enhanced? Do you consider that the scope of suspicious transactions reports should be extended to suspicious orders and suspicious OTC transactions? Why?

We generally welcome the proposed enhanced powers, including the new requirements on Transaction Reporting. The scope of suspicious transactions certainly should be extended. We refer to our above comments, especially on OTC transactions. A **Large-Trader Report** for Financial Futures Markets could be published, as the CFTC has recently begun to do.[8]

However, we think that the **possibility of limiting positions should also be included in the MAD**, as well as in the MiFiD. Limiting positions is crucial, especially in the commodities markets and for non-commercial participants (see comment on question 1), in order to ensure the functioning of the market. The absence of position limits has led to the 2008 food and oil price bubbles. As hedge fund manager Michael W. Masters testified to the US FCIC on 30 June 2010, *"The specific risks associated with excessive speculation in commodities derivatives would also have required aggressive speculative position limits."*[9] The authorities in London have consistently refused to contemplate such limits, even though – after the July threat by 16 cocoa market participants to leave the European market – LIFFE (not the regulator) might decide to do so for cocoa, as a pure matter of self-preservation.

As France's Finance Minister, Christine Lagarde, has called for, the European Union should create a **regulatory body** similar to the Commodity Futures Trading Commission in the US, which would have the power to place limits on the market.

(8) How can sanctions be made more deterrent? To what extent need the sanction regimes be harmonised at the EU level in order to prevent market abuse? Do you agree with the suggestions made on the scope of appropriate administrative measures and sanctions, on the amounts of fines and on the disclosure of measures and sanctions? Why?

Sanctions have to be really deterring. Therefore, they should be disclosed to the public in any case. There should be no exemption on grounds of jeopardizing the financial market or cause damage to the parties involved. This would only weaken the effect of the sanctions.

Fines should be in accordance with the huge profits being made in the financial sector. Otherwise, the risk of being fined will only be weighed against the profits.

(9) Do you agree with the narrowing of the reasons why a competent authority may refuse to cooperate with another one as described above? Why? What coordination role should ESMA play in the relations among EU competent authorities for enforcement purposes? Should ESMA be informed of every case of cooperation between competent authorities? Should ESMA act as a binding mediator when competent authorities disagree on the scope of information that the requested authority must communicate to the requesting authority?

The financial markets are international, so supervision has to be as well. In the case of the German DEPFA, the German Bundesbank and BaFin (Financial Services Authority) could not effectively regulate the DEPFA because of a lack of authority, although they were aware of dangers. Therefore, EU coordination of supervision is crucial. If anything similar should happen with a market abuse, national competent authorities should be obliged to cooperate, or ESMA should have the authority to coordinate.

(10) How can the system of cooperation among national and third country competent authorities be enhanced? What should the role of ESMA be?

[8] www.cftc.gov/PressRoom/PressReleases/pr5857-10.html
[9] www.fcic.gov/hearings/pdfs/2010-0630-Masters.pdf. Page 2f.

The cooperation with third countries should be enhanced, because the crisis has demonstrated the lack of international coordination. Also, the possibility of regulatory arbitrage needs to be minimized.

(11) Do you consider that a competent authority should be granted the power to decide the delay of disclosure of inside information in the case where an issuer needs an emergency lending assistance under the conditions described above? Why?

Companies in the crisis did not fail because of too much transparency but because of too little and too late of it. Delayed disclosure will only cause suspicions and thus lead to insecurity.

(12) Should there be greater coordination between regulators on accepted market practices?

Yes, in order to prevent regulatory arbitrage.

(13) Do you consider that it is necessary to modify the threshold for the notification to regulators of transactions by managers of issuers? Do you consider that the threshold of Euro 20,000 is appropriate? If so why?

No, we think that the threshold is fine. The fact that remuneration has grown so much in the financial sector is part of the problem, and should not serve as justification for less supervision. Regulation must not keep pace with the growth in executive remuneration but rather slow it down. This is both a moral and an economic imperative.

(14) Do you consider that there are other areas where it is necessary to progress towards a single rulebook?

We have nothing to comment.

(15) Do you consider that it is necessary to clarify the obligations of market operators to better prevent and detect market abuse? Why? Is the suggested approach sufficient?

The authorities should also investigate the model of investment banking itself. One reason for the crisis was the role of the banks as traders for their clients and on their own account. This will inevitably lead to various kinds of interest of conflict. As Michael Lewis states, *“That the panic inside Wall Street firms had begun before June 25 [2007] suggested to [hedge fund manager] Michael Burry mainly that the Wall Street firms might be working with inside information about the remittance data.“*[10] This also led to the demands by Paul Volcker, former FED chairman, to prohibit the banks’ trade on own account, of which a lighter version has now been implemented in the US reforms. Especially the Deutsche Bank is engaged in so many roles in the financial markets that they presumably are enabled to manipulate markets or take advantage of insider information for their own benefit. So, the authorities have to consider rules similar to the ones that Paul Volcker proposed.

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We thank commodity expert Tom Lines for contributing to this submission.

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[10] Michael Lewis (2010): The Big Short. Inside the Doomsday Machine. London: Allen Lane / Penguin. Page 197.