CFA INSTITUTE | Centre for Financial Market Integrity

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FSA Consultation Paper 08/13 – Disclosure of Liquidity Support

Dear Mr. Bell,

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the FSA's Consultation Paper 08/13 – Disclosure of Liquidity Support (the "Consultation"), which addresses an amendment to the FSA's Disclosure Rules and Transparency Rules sourcebook ("DTR") to permit a financial institution in receipt of liquidity support from the central bank to delay public disclosure of this fact.

The CFA Institute Centre acknowledges that the CFA Society of the UK, one of the largest member societies of CFA Institute, has responded separately to the Consultation.

The CFA Institute Centre[1] promotes fair and open global capital markets and advocates for investors' protection. Accordingly, we place great importance to the EU's market abuse regime, which forms the context of the proposal to amend the DTR.

Broadly, we disagree with the FSA's proposal to insert an explicit paragraph in the DTR to permit an issuer in receipt of liquidity support from delaying public dissemination of this fact. Whilst we recognise the intention behind this proposal – namely, to help reduce the likelihood of individual financial institutions facing difficulties – we are concerned by the precedent such a proposal would set.

The over-arching priority, above that of individual issuers, should be the efficient functioning of the formation of market prices. To that end, timely, transparent information is paramount. Initiatives that provide additional scope for firms to delay public disclosure of inside information – regardless of the best intentions of those initiatives - set dangerous precedents in the context of the market abuse regime. Such initiatives may be viewed by other market participants as a means of exploiting the

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

existing provisions of the Market Abuse Directive. These 'unintended consequences' weaken the market abuse framework.

Moreover, delaying the disclosure of liquidity support *ex post,* as would be permitted under this proposal, may only exacerbate the liquidity problems faced by the financial institution. The provision of central bank liquidity support is an act of last resort, by which time all other sources of private funding are likely to have evaporated. Under such circumstances, if investors notice the higher yields offered by the troubled bank, the reduced willingness of wholesale funding sources to deal with the bank, and steps by large depositors to move their funds elsewhere, they may have reason to believe that short selling the bank's shares is a viable investment strategy in anticipation of the bank's imminent failure. Without notice that the central bank has provided liquidity support, the bank's shares could collapse leading to even greater problems for the institution.

Our detailed comments in response to the Consultation follow below. Please do not hesitate to contact us should you wish to discuss any of the issues raised.

Yours faithfully,

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Our response to the Consultation's question is set out below.

Q1: Do you have any comments on the proposed amendment?

The proposed amendment to the DTR relates to Directive 2003/6/EC[2] and Directive 2003/124/EC[3] of the market abuse regime. Under Article 6(1) of the MAD, issuers in possession of inside information are required to inform the public as soon as possible. However, Article 6(2) of the MAD contains a provision that permits delaying public dissemination of inside information under certain circumstances:

> *"An issuer may under his own responsibility delay the public disclosure of inside information… such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information."*

The implementing measures of the MAD, under Article 3(1), clarify "legitimate interests" as follows (also quoted in para. 2.4 of the Consultation):

> *"negotiations in course… where the outcome or normal pattern of those negotiations would be likely to be affected by public disclosure. In particular, where the financial viability of the issuer is in grave and imminent danger… public disclosure of information may be delayed for a limited period where such a public disclosure would seriously jeopardise the interests of… shareholders by undermining the conclusion of specific negotiations…"*

The FSA states in paragraph 2.16 that "we consider the proposed amendment to be consistent with the exceptions from immediate disclosure already provided for by the MAD." However, in the case of liquidity support from a central bank, the disclosure of such negotiations is unlikely to impair the conclusion of the specific negotiations in the same way that it might jeopardise negotiations with private providers. On the contrary, disclosure in this case may speed the facilitation of liquidity to the ailing institution if the situation is seen as quickly worsening.

Moreover, the MAD exception deals specifically with disclosure of negotiations prior to their conclusion. In the case of central bank liquidity support, the negotiations for such support would continue to benefit from the exception noted in paragraph 2.4 of the Consultation. It is the ex-post disclosure of the liquidity provision, however, that concerns this proposal. We do not see anything in the way the MAD exception is written that

[2] Referred to as the "Market Abuse Directive", or "MAD".

[3] Implementing measures of the MAD regarding the definition and public disclosure of inside information and the definition of market manipulation.

suggests that it was intended to permit such delays in ex-post disclosures, regardless of the type of issuer involved.

Consequently, we do not share the FSA's view that this exception to the MAD's disclosure requirements for inside information applies to a central bank's liquidity support to a financial institution.

A second consideration is that a disclosure blackout under MAD is permitted only provided that, as the Consultation notes in paragraph 2.3, "such omission would not mislead the public." It is the view of the CFA Institute Centre that delaying the disclosure of such information by as much as four to five months (as noted in paragraph 2.18) amounts to misleading the public, depositors, investors, and taxpayers, alike about the condition of this institution. Indeed, some depositors and investors, unaware of the liquidity support, may face loss as a consequence of placing their funds with the institution or, conversely, may withhold funds for lack of knowledge that the institution has received needed assistance. Consequently, the CFA Institute Centre further disagrees with the FSA's interpretation of MAD.

An institution that does not have funding difficulties does not need central bank liquidity support. Instead, funding is available from insured deposits and other non-insured, market sources such as repurchase agreements, loan sales, commercial paper sales, and other mechanisms. It is only when these other sources disappear that an institution is forced to turn to a central bank.

But for these sources to disappear, private liquidity providers must have already concluded that the institution is in jeopardy of failure. A telltale sign is that the institution is willing to pay a premium on insured deposits to shore up its funding base. Those who provide wholesale funding, too, must have discovered that the institution is near failure because they have obviously refused to transact with it.

So large depositors and institutional counterparties, who previously provided the bulk of the private liquidity support have decided to move their funds elsewhere out of fear of the institution's imminent failure, which is why the institution is seeking support from the central bank. Delay, therefore, only penalizes small depositors (whose funds are in many cases insured) and small shareowners who are not privy to critical inside information about the institution's dire funding condition. While shareowners are, by law and by nature of the corporate structure, the first to experience losses from bad corporate decisions, that does not mean that the state should conspire against them by withholding critical information that could allow them to take steps to reduce their losses, even if only incrementally.

Finally, delay of disclosure could create more liquidity problems for an institution in trouble. If investors notice the higher yields offered by the troubled bank, the reduced willingness of wholesale funding sources to deal with the bank, and steps by large depositors to move their funds elsewhere, they may have reason to believe that short selling the bank's shares is a viable investment strategy in anticipation of the bank's imminent failure. Without notice that the central bank has provided liquidity support, the bank's shares could collapse leading to even greater problems for the institution.

For all of these reasons, we do not support the FSA's proposal to delay ex-post disclosure of receipt of liquidity support from a central bank.

In our view the proposed amendment seeks to put the interests of the issuer above the interests of the market. Ex-post, the most effective form of regulation is to change the behaviour of firms, such that the likelihood of a financial institution facing funding difficulties again is substantially reduced. This proposal only serves to strengthen the 'backstop' provided to banks in financial difficulty, and in doing so exacerbates the 'moral hazard' problem.

The efficient functioning of capital markets is dependent on timely, transparent information. Additional measures to delay public disclosure of inside information could create frictions in the price formation process. This is not in the best interests of investors. We therefore urge the FSA to carefully consider the implications of its proposal, which we believe could impact negatively on market efficiency, and investors alike.

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