



Report

to the President of the Republic
and the Parliament

2007

This report covers 2007 and the first months of 2008. It was produced by the departments of the AMF and completed on 18 April 2008.

It was adopted on 25 April 2008 by Michel Prada, Chairman of the Autorité des marchés financiers (AMF) and by the members of the AMF Board: Jacques Delmas-Marsalet, Martine Ract-Madoux, Philippe Adhémar, Jean-Paul Redouin, Jean-François Lepetit, Jean de Demandolx Dedons, Jean-Michel Naulot, Bernard Esambert, Marie-Ange Debon, Bernard Field, Jean-Pierre Hellebuyck, Dominique Hoenn, Yves Mansion, Jean-Pierre Pinatton and Jean-Claude Mothié. Pursuant to Article L. 621-19 of the Monetary and Financial Code, Michel Prada has the honour of presenting the report to the President of the Republic and the Presidents of the Senate and the National Assembly.



The Chairman

Paris, 2 June 2008

Mr President,

It is my distinct honour to present this fifth annual report of the Autorité des marchés financiers (AMF), for 2007, to you and to parliament.

Twenty years on from the 1987 bond crisis, the dominant event of 2007 was the subprime crisis that erupted in the summer, putting an abrupt halt to previously positive market trends both in France and abroad.

The AMF had to deal with the major fall-out from this event, cooperating closely with banking authorities to manage the domestic impact and playing an active part in international efforts to cope with the crisis. In addition, it took an active part in the work done by international bodies to analyse market failures and devise short-term and medium-term measures to address them and prevent a repeat occurrence.

At the same time, the AMF made an active contribution to the regulatory developments needed to adapt the French markets to the new paradigm created by the European Commission's action plan to unify the European market in financial services.

Furthermore, in line with its remit to safeguard savings and investment, ensure proper investor information and maintain orderly markets, the AMF unceasingly pursued its routine activities – approval, registration, authorisation, supervision and policing – in respect of the many transactions coming within its jurisdiction.

In conducting its activities, the AMF continued to implement the Better Regulation approach that it crafted in association with the French financial community in 2006 and that now informs all its initiatives and operating procedures.

For 2007, a comparison of year-end data fails to reflect the contrast between the first half-year, which was broadly promising, and the second half, which all but wiped out the first six months' gains.

The combined market capitalisation of the companies listed on Euronext Paris amounted to €1,874 billion at end-2007, up slightly on 31 December 2006 and roughly equivalent to France's gross domestic product for the year.

The gradual decline in the number of companies listed on the regulated market, Eurolist, continued in 2007, with 707 companies recorded at year's end compared with 730 at end-2006. However, this was offset by the relative success of Alternext, an organised market for medium-capitalisation growth companies, which ended the year with 111 listings compared with 75 at end-2006. Paris is now the world's sixth most highly capitalised stock market, behind London and Shanghai. Net equity issuance in 2007 amounted to €21 billion, a slight year-on-year increase. This stands in contrast to a negative balance of nearly €30 billion in the USA, due to a high level of share buybacks. Amid uncertainty about market trends and the subprime crisis, trading volumes reached record levels and volatility increased sharply. Mergers and acquisitions also rose to new heights but later fell back as the crisis undermined confidence.

Regulated derivatives markets reported strong growth and sustained activity, which contrasted – as was also the case for cash equity markets – with the gradual seizing-up of the over-the-counter markets for securitisation and debt instruments.

The asset management industry had a satisfactory first half-year but was subsequently hit heavily by the subprime crisis. Assets under management at year-end 2007 were on a par with the end-2006 figure, while the number of investment management companies increased to 536 by 31 December.

Several aspects to the subprime crisis

The crisis corresponds firstly to a major disruption of trends that had resulted from a lengthy period of ample liquidity and a deep-seated imbalance in world trade. Inflows of liquidity reinvested in the USA, combined with low inflation stemming from competition from low-cost countries, put downward pressure on interest rates and prompted investors to seek higher returns without properly measuring their risk exposure. It also encouraged laxer lending discipline, especially as regards subprime mortgages, doubtless facilitated by large-scale reliance on securitisation techniques.

Risk transfer developed quickly against a backdrop of financial innovation and was ill-managed. The originate-to-distribute model flourished amid the technical and legal ambiguities arising from unreliable and often nontransparent securitisation techniques, an unsuitable rating system, and excessive investor confidence in the quality of products and robustness of mechanisms in over-the-counter markets. As early as 2005, then again in 2006 and yet again at the start of 2007, the AMF called attention to the more worrying aspects of these developments through a series of reports and publications, particularly on credit rating agencies. When the US property bubble burst as a result of rising interest rates, it unsettled the entire system, shattered the confidence of market participants and triggered a downward spiral in securitised assets. Banks, fettered by poorly identified contractual arrangements or facing serious reputational risk, had to bring huge amounts of devalued securitisation instruments back onto their balance sheets. This led to a crisis of confidence and then to an unprecedented liquidity crunch, compounded in some cases by a solvency crisis.

Financial regulators reacted swiftly to these events. Firstly, central banks and banking authorities and then market authorities intervened to restore transparency and normal market operations and also to protect the interests of retail investors. (This is not the appropriate place to comment on the key role played by central bankers and banking supervisors in managing the liquidity crisis or, in some countries, dealing with bank defaults.)

Collaborating closely with the Banque de France and liaising with representatives of the asset management industry, the AMF moved into action to deal with the first manifestations of the crisis in France, when certain investment funds were adversely affected by sudden massive demand for redemptions. As far as possible, it sought to protect investors' interests and ensure they received equal treatment, be it for the valuation of their assets, subscription / redemption freezes or the liquidation of certain funds.

In parallel, the AMF was involved in the international bodies charged with analysing the crisis and seeking ways of tackling it. As chair of the Technical Committee of the International Organization of Securities Commissions (IOSCO) until May 2008, when IOSCO held its annual conference in Paris, it headed a task force set up to react to the subprime crisis. The task force focused in particular on the issues of transparency, valuation and integrity that arise at various stages of the securitisation process. The AMF also helped to relaunch the work of the IOSCO task force on the code of conduct for credit rating agencies. And as a member of the ad hoc working group of the Financial Stability Forum, along with the Banque de France, it helped to draft the report presented to the G-7 in April 2008, and endorsed the report's conclusions.

Regarding the regulation of corporate financing and listed company disclosures, the highlights of 2007 included the transposition of European directives, several major decisions on actions in concert that could trigger the obligation to file a tender offer, and ongoing efforts to adapt to IFRS. All of this took place in a context of relatively slower activity.

Applying its Better Regulation method, the AMF sought to calibrate its requirements to the size of different companies and the importance of the issues at stake, without losing sight of the need for transparency, good governance, and fit and proper behaviour. It marked out clear boundaries for creeping takeovers and continued its deliberations on shareholder democracy. In the latter area, the key areas of focus were the exercise of voting rights, the transparency of major holdings, and the possibility of overseeing shareholder activism by entities motivated by short-termist considerations, which use roundabout methods to influence general meetings of shareholders without assuming the economic risks inherent in share ownership. The AMF also took account of data concerning competition among financial centres to list foreign companies. In consequence, it officially recognised the professional investor compartment on Euronext Paris, accepted prospectus filed by US companies

and compliant with SEC standards, and signed a memorandum of understanding with the Israel Securities Authority to facilitate the listing of Israeli companies in Paris.

As regards the regulation of investment services providers, the AMF has exclusive powers over asset managers and it shares jurisdiction with the banking authorities to oversee other types of services providers as well as trading and post-trade infrastructures.

Aside from the impact of the financial crisis, the AMF concentrated mainly on three areas of improvement in the asset management industry:

- > simplifying authorisation and approval procedures to make market participants accept greater responsibility and, wherever possible, to replace a detailed system of rules with a principles-based approach;

- > emphasising the conditions for marketing financial products, particularly the disclosure of management fees and commissions and the assurance that commercial information and advice is appropriate to the type of client and to his or her objectives;

- > modernising the French regulatory framework to foster the development of home-grown hedge funds.

Concerning investment services providers in general, 2007 was marked by preparations for the entry into force of the Markets in Financial Instruments Directive (MiFID), which took effect on 1 November. MiFID has not only radically overhauled the rules of organisation and conduct applicable to intermediaries; it has also abolished the rule requiring trade orders to be centralised on the regulated market. Praise is due to all market participants whose involvement and efforts enabled the Paris financial centre to transpose this seminal, innovative European legislation in a timely manner.

Unprecedented changes are taking place in trade infrastructures (exchanges, electronic trading facilities, and the order internalisation systems of major intermediaries) and post-trade systems (clearing, settlement and delivery of financial instruments). These changes concern legal aspects, such as demutualisation and competition; technologies, with a shift to electronic operations; and industrial issues like cross-border concentration. They raise many questions in terms not only of regulation but also of financial centres' strategic interests. The AMF has been highly visible in all these areas, cooperating with the banking authorities and its foreign counterparts to keep pace with ongoing changes while ensuring the orderly operation of market systems (Euronext Paris, LCH.Clearnet SA, Euroclear France) and protecting the interest of the French markets.

The AMF performed its market surveillance and discipline function without let-up throughout 2007. The automated daily processing system for market data handled 450 million orders and 107 million trades in 2007, generating 39,000 alerts. The automated system that allows the AMF to exchange information with its European counterparts went live in November. Some 200 in-depth inspections and investigations were launched during the year. The Enforcement Committee initiated 33 proceedings that resulted in 65 sanctions against 39 individuals and 26 legal entities. The sanction system set up by the market regulator has evolved over the past two decades and has now reached a satisfactory balance. It was redefined when the AMF was created four years ago and now meets the requirements of the European Convention of Human Rights. Moreover, its underlying model was not without influence on the European system established under the Market Abuse Directive, with which it fully complies. The system can certainly be further improved and I have submitted proposals to that effect to the government. I hope these will be implemented in the near future. In my view, therefore, it would be both inappropriate and dangerous to destabilise the system through new, radical changes that could undermine its efficiency and harm the reputation of the Paris financial centre.

The AMF pursued its efforts to educate the general public, notably through its support for the Institute for Public Financial Education, which was set up on its initiative in April 2006, and through the mediation and consumer information department, which handled nearly 2,000 cases, including 493 mediation cases.

At this writing, France is preparing to take over the Presidency of the European Union, the financial crisis is still unfolding, and competition among financial centres is relentless.

Selective improvements can always be made, naturally, but I believe that France's system of market oversight is one of the most comprehensive in the advanced world. The effective relationship between the banking authorities, which are responsible for prudential supervision of intermediaries, and AMF, whose remit is to ensure the integrity, transparency and orderly operation of financial markets, has proved its worth and bears favourable comparison with that found in other models. That said, the majority of our rules are now influenced, if not dictated, by international standards, particularly those in force in Europe.

It is at this level, therefore, that we must make our views known. To that end, the priority of the French Presidency should be to consolidate the European supervisory system, the principles of which stem from the Lamfalussy report. This is necessary because the proper functioning of the single market hinges on being able to direct the network of national regulators much more effectively than the Committee of European Securities Regulators is able to do at present.

It is also necessary to quickly give concrete shape to ongoing efforts – boldly led by the Minister for the Economy, Industry and Employment – aimed at making the Paris financial centre more attractive. Improving the tax and labour environment, entry conditions for foreign executives and transport infrastructures will be crucial in this regard.

Last but not least, a powerful and independent financial centre needs a solid domestic base. France has an ample pool of savings, but it is hindered by a serious lack of long-term investment to provide sustainable financing for listed companies. At present, foreign investors – whom we warmly welcome – provide the financing for nearly 50 per cent of the capitalisation of the CAC 40 index. Progress has certainly been made in recent years but it has been tentative and erratic. This should be the third focal point of a proactive policy to develop the Paris financial centre in the years ahead.

To conclude this introduction to the AMF's annual report, the last I shall have the honour of presenting, I wish to pay tribute to the men and women who have given us such an efficient, fair and effective regulatory system:

> The some 370 members of staff in the AMF's operational departments, who possess a rare blend of complementary talents and skills. They come mostly from the private sector but also from a variety of public institutions, and all of them are devoted to their public interest duties. Under the outstanding leadership of Secretary General Gérard Rameix, they have adopted the Better Regulation and internal control approach, which admittedly entails new constraints but also delivers a more efficient system of regulation that is better understood and more highly regarded;

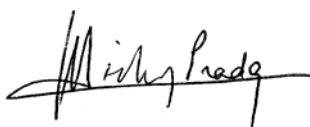
> The one-hundred or so members of our five Consultative Commissions, who have accepted to share their hands-on experience with us voluntarily and who assist us in preparing regulatory developments and designing the practical mechanisms that govern our daily relations with market participants and their representatives;

> The French and foreign researchers who make up our Scientific Advisory Board and who help us to interpret ongoing events and identify future trends;

> The twelve members of the Enforcement Committee, headed by Daniel Labetoulle and Claude Nocquet, who ultimately ensure that the AMF's actions are credible. They operate under the watchful eye of the appellate courts, which generally uphold their decisions, thereby confirming that the committee's procedures are robust and its decisions judicious;

> My fifteen fellow Board members, who have shaped the AMF and who regulate our financial market according to collegiate principles that are driven by the search for consensus, underpinned by the diversity of the members' skills, and constitutionally impartial and fair-minded.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Michel Prada', with a long horizontal flourish extending to the left.

Michel Prada