Title: UK implementation of the EU Regulation on Short Selling and certain aspects of credit default swaps **IA No:** HMT 1203 **Lead department or agency:** HM Treasury **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 27/09/12 **Stage:** Final Stage Impact Assessment **Source of intervention:** EU **Type of measure:** Secondary legislation **Contact for enquiries:** Victoria Gibbs

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£0	£0	£0	No	NA

What is the problem under consideration? Why is government intervention necessary?

In September 2010, the EC adopted a proposal for a 'Regulation on short selling and certain aspects of credit default swaps'. The objective of the proposal is to lay down a common regulatory framework to harmonise requirements and powers related to short selling and some aspects of CDS. The Short Selling Regulation was published in the Official Journal of the EU on 24 March 2012 and the deadline for implementation is 1 November 2012. An EU Regulation has binding legal effect in the UK. In order to be compatible with the Regulation amendments need to be made to domestic legislation where there are inconsistencies with the Regulation and appropriate provision for the FSA to enforce the Regulation.

What are the policy objectives and the intended effects?

The overarching objective is to ensure that the UK is complaint with EU law, by ensuring that there is no element of domestic legislation that is incompatible with the provisions of the Regulation and that appropriate provision is made for the FSA to enforce the Regulation. This will also ensure that the domestic regulations are coherent and properly enforced. This is achieved by making the changes proposed in this impact assessment.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The Regulation is binding in its entirety and directly applicable in all Member States in order to create a consistent treatment of short selling across Member States. The Regulation itself does not need to be transposed. However, the UK is obliged to ensure that there is no element of domestic law that is incompatible with the provisions of the Regulation, and that appropriate provision is made to enforce the Regulation.

The nature of EU legislation is such that updating the Financial Services and Markets Act 2000 – which sets out the FSA's powers to deal with short selling – is the only policy option available to the UK. As a Regulation, Member States have very little discretion as to its method of implementation. Moreover, as these amendments are designed to bring domestic law into line with the Regulation, this will create more legal certainty for market participants.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 11/2017

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A		**Non-traded:** N/A

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: [signature] Date: 2/10/12

Summary: Analysis & Evidence

Policy Option 1

Description: Do Nothing – "the baseline". In this scenario it is assumed that the directly applicable EU Short Selling Regulation comes into force but no action is taken to change UK domestic legislation.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate: £0**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	£0		£0	**£0**

Description and scale of key monetised costs by 'main affected groups'

N/A

Other key non-monetised costs by 'main affected groups'

The cost relates to legal ambiguity for market participants as there will be elements of the domestic law that will be incompatible with the provisions of the Regulation. It is difficult to assess the specific effect on behaviour of such an inconsistency and so estimate costs. However, we would expect inconsistency to have negative impacts on confidence, compliance, and the healthy functioning of the financial system at large. The UK would also not be compliant with the Regulation and infraction proceeding could be brought.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	£0		£0	**£0**

Description and scale of key monetised benefits by 'main affected groups'

None.

Other key non-monetised benefits by 'main affected groups'

None.

Key assumptions/sensitivities/risks | **Discount rate (%)** |

None to note.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £0	**Benefits:** £0	**Net:** £0	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Updating the Financial Services and Markets Act 2000

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: £0	High: £0	Best Estimate: £0

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	Optional
High	Optional		Optional	Optional
Best Estimate	£0		£0	£0

Description and scale of key monetised costs by 'main affected groups'

N/A

Other key non-monetised costs by 'main affected groups'

The main costs to market participants involve giving the FSA additional powers to regulate the regime effectively. Most of these powers broadly reflect the suite of enforcement powers available for the existing regime and the requirements introduced are likely to be familiar to new parties affected, such as third parties of market participants'. Overall we expect the total cost to increase; however, as the changes are anticipated to be incremental over an existing regime, the marginal cost of the Regulation should be smaller.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	Optional
High	Optional		Optional	Optional
Best Estimate	£0		£0	£0

Description and scale of key monetised benefits by 'main affected groups'

N/A

Other key non-monetised benefits by 'main affected groups'

The Regulation will be binding on market participants and the FSA. These amendments bring domestic law into line with the Regulation and will provide the FSA with the powers to effectively exercise their functions under the Regulation. This will provide legal certainty for market participants and will ensure confidence in and compliance with the new regime, which will ultimately ensure the healthy functioning of the financial system at large.

Key assumptions/sensitivities/risks **Discount rate (%)**

The cost/benefit analysis is based on the changes to UK domestic law which are necessary to ensure compatibility with the Regulation. This impact assessment therefore does not consider the changes that will be introduced by the Regulation, but will not be implemented into domestic law. It is difficult to assess the costs and benefits, as these will mainly fall to a small subset of participants who are likely to be in breach of the Regulation which the changes are looking to address.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £0	**Benefits:** £0	**Net:** £0	No	NA

Evidence Base (for summary sheets)

PROBLEM, RATIONALE AND OBJECTIVE

At the height of the financial crisis in September 2008, competent authorities in several Member States and supervisory authorities in third countries such as the United States and Japan adopted emergency measures to restrict or ban short selling in some or all securities. While it is generally believed that short selling has a positive effect in ordinary markets – namely by increasing liquidity and enhancing price discovery for all market participants – there is a concern it can amplify price falls in unstable markets.

The UK already has in place a short selling regime. Since January 2009, the FSA has required short sellers to publicly disclose significant individual short positions in UK financial stocks and in firms undertaking rights issues. This disclosure regime has since been enshrined in the Financial Services and Markets Act 2000. In addition, the Act gives the FSA power to temporarily ban short selling in an emergency – as it did in Autumn 2008.

The measures adopted by Member States were divergent as the European Union did not have a specific common regulatory framework for dealing with short selling issues. Inconsistent treatment of short selling runs the risk of market fragmentation, regulatory arbitrage, and an uncertain cost base for firms that must comply with various, changeable regimes.

In September 2010, the European Commission adopted a proposal for a 'Regulation on short selling and certain aspects of credit default swaps'. The Regulation has two main objectives: (i) to lay down a common regulatory framework for the requirements and powers relating to short selling and credit default swaps (CDS) and (ii) to ensure a more coordinated and consistent approach by Member States when measures need to be taken in exceptional situations.

The Regulation should bring greater certainty to the market, ensure greater coordination and consistency between Member States in the event of a crisis, and increase transparency to understand and monitor the extent to which short selling may potentially pose a risk.

The Regulation was published in the Official Journal of the EU on 14 March 2012 and the deadline for implementation is 1 November 2012.

As the EU legislation is a Regulation, there is no need for the UK to transpose as Regulations are binding in their entirety and directly applicable in all member states. The UK is however obliged to ensure that there is no element of domestic law that is incompatible with the provisions of the Regulation, and that there are effective, proportionate and dissuasive penalties for contravention of the provisions of the Regulation.

The Regulation introduces a number of changes and there are elements of domestic law that will need to be amended in order to be compatible with the provisions of the Regulation. However, as the Regulation is directly applicable many of the changes will not need to be transposed into domestic law.

This impact assessment therefore considers the costs and benefits of the changes to UK domestic law necessary to implement the Regulation.

POLICY OPTIONS

Policy option 1: Do nothing – "the baseline"

It should be noted that the option of doing nothing is not possible as this is an EU Regulation that will come into force on 1 November 2012 and be binding on the UK. In this scenario it is assumed that the directly applicable EU Short Selling Regulation comes into force but no action is taken to change UK domestic legislation.

There is generally no need for the UK to transpose Regulations as they are binding in their entirety and directly applicable in all Member States. The UK is obliged however to ensure that there is no element of domestic law that is incompatible with the provisions of the Regulation, and that there are effective, proportionate and dissuasive penalties in place to address contravention of the provisions of the Regulation.

If appropriate provision is not made to enforce the Regulation or if incompatible domestic legislation is not removed, the Commission may bring infraction proceedings against the UK. The UK would then be forced to revise domestic law to make it consistent with the Regulation and to make proper provision for enforcement.

Current UK regime

The UK already has in place a short selling regime and the Financial Services and Markets Act (FSMA) 2000 sets out the FSA's powers to deal with short selling. The Financial Services Act 2010 amended FSMA 2000 to provide the FSA with the powers to:

- Impose a disclosure requirement on short positions in financial instruments as defined in the Markets in Financial Instruments Directive (under the current UK disclosure regime the FSA requires disclosure of short positions during rights issues and for all UK financial sector companies) – to increase transparency to the market, due to the potential vulnerability of UK financials. This is an ongoing part of the UK's regime today;
- Impose temporary bans on short selling in the event of an emergency, to safeguard financial stability;
- Require information or documents to be produced to determine whether short selling rules have been contravened; and
- Impose penalties or issue censures in the event a person has contravened short selling rules.

The Short Selling Regulation introduces a number of changes and there are elements of domestic law that will be incompatible with the provisions of the Regulation. There are a number of changes which will need to make to ensure consistency with the Regulation. This includes repealing existing provisions which are in conflict with the Regulation, amending provisions to reflect the Regulation and giving the FSA additional powers to regulate the regime effectively.

With domestic law conflicting with the EU Regulation, there will be cost to market participants due to legal ambiguity. It is difficult to assess the specific effect on behaviour of such an inconsistency and so estimate costs. However, we would expect inconsistency to have negative impacts on confidence, compliance, and the healthy functioning of the financial system at large.

As outlined above, the UK would also not be compliant with the Regulation and infraction proceeding could be brought against it by the Commission.

There are no benefits for market participants or the FSA who will administer the regime.

Policy option 2: Updating the Financial Services and Markets Act 2000

This impact assessment considers the costs and benefits of the changes to UK domestic law that are necessary. As the Regulation is directly applicable many of the changes outlined below will not need to be transposed into domestic law and are therefore not considered in this impact assessment. The costs and benefits of the changes that will be introduced by the Regulation, but will not be implemented into domestic law, were considered in the European Commission's impact assessment[1] which accompanied the original proposal published in September 2010 and the Level 2 Delegated Acts in July 2012. The costs and benefits of the key changes as set out in the Commission's impact assessment are briefly summarised below to help illustrate the overall impact of the regime.

The EU Short Selling Regulation introduces a number of changes, some of which differ from the current UK regime. In particular, the Regulation:

- Covers all financial instruments admitted to trading on a trading venue in the EU, derivatives relating to such financial instruments, and debt instruments issued by Member States or the Union (and related derivatives) and uncovered sovereign Credit Default Swaps (CDS). Provided that a financial instrument is traded on an EU venue, trading in that instrument outside a trading venue is also caught.
- Creates a two-tier disclosure regime of public and private disclosure in relation to issued share capital, and also introduces disclosure requirements for the shorting of sovereign debt and trading in "naked" sovereign CDS.
- Introduces restrictions on uncovered short sales in shares and sovereign debt, to facilitate settlement of a short selling transaction.
- Central counterparties that provide clearing services for shares are required to ensure that adequate procedures are in place for them to buy-in shares to ensure delivery for settlement or to provide an equivalent payment in the event that a settlement failure arises.
- Competent authorities will be responsible for the administration and enforcement of the Regulation provisions, including in relation to investigating short selling practices, sanctions and pecuniary measures. Competent authorities may also intervene in market activities in two main situations: (i) when there is a significant fall in the price of a security; and (ii) during stressed markets.
- ESMA primarily provides a coordination role and ensuring consistency of application across the EU. During times of financial crisis, ESMA also has powers to intervene where a situation has cross-border implications and competent authorities have not adequately addressed the issue.

In addition to the above provisions during negotiations a prohibition on entering into uncovered positions in sovereign CDS was included, which has some safeguards in order to avoid any unintended effect on the liquidity of sovereign debt markets.

Benefits

The Regulation has two main objectives: (i) to lay down a common regulatory framework for the requirements and powers relating to short selling and CDS, and (ii) to ensure a more coordinated and consistent approach by Member States when measures need to be taken in exceptional situations. In particular, the Regulation will:

- Reduce market fragmentation due to different disclosure regimes and restrictions imposed by Member states at present. Similarly, allow greater communication and coordination between competent authorities, resulting in a more harmonised regime across the EU, and giving greater predictability for market participants.
- Reduce regulatory arbitrage between markets, and cross border-risks to market integrity in cases where trading can easily migrate to different trading venues.
- Reduce the cost and complexity imposed on market participants who currently must comply with various regimes across the EU.

[1] European Commission: Impact Assessment for Proposal for a Regulation on short selling and certain aspects of credit default swaps.

- Reduces risks to financial stability, by ensuring greater coordination and consistency between Member States in the event of a crisis, and increasing transparency to understand and monitor the extent to which short selling may pose a risk.

Costs

A cost analysis of the changes introduced as a result of the Regulation was outlined in the Commission's impact assessment, and is summarised in the below table:

Measure	Cost breakdown by Commission	Evaluation & impact on UK market
Disclosure regime: equities and equity-related instruments	(i) EU wide one-off IT and compliance Upgrade cost of €137m Upgrade & Maintenance estimated at 10%, or €13.7m per year (ii) Ongoing labour (administrative) cost of EU disclosure regime estimated at €2.1m *n.b. Commission provides estimates for each Member State*	(i) 471 firms estimated to be affected – equating to around a third across the EU: €44.7m one-off cost and €4.5m maintenance per year. **It should be noted however that as the UK already has in place a disclosure regime for financial stocks, today's regime would carry forward largely intact. Therefore the transition cost for extending the equity disclosure regime, is likely to be lower. These costs appear high.** (ii) Commission estimates cost to UK of €169,000 Cost analysis has been extrapolated from indications given by market participants and regulators across the EU.
Disclosure regime: sovereign bonds and related instruments	In absence of data, no independent cost provided by European Commission (i) Commission assumes EU one-off Upgrade cost at 25% of equities: €34.2m Upgrade & Maintenance estimated at 10%, or €3.4m per year (ii) Ongoing labour (administrative) cost of EU disclosure regime estimated at 75% that of equities	In absence of data, we assume that the UK impact is a third of the EU (as above) €11.3 m €1.1m €127,000
Temporary restrictions on short selling	No cost provided by Commission	No cost given to temporary restrictions on short selling – estimated in the UK to have cost individual firms £40,000 one-off costs and £6,500/month (for the UK ban of Autumn 2008). These costs arguably may be built into the cost of a disclosure regime (above), and these may be offset by the wider benefits of coordinated action, as outlined above.
Buy-in procedure in event of settlement failure	No cost provided by Commission as it argues this is largely harmonisation, as many trading venues across Member States have in place some form of buy-in or fining arrangement	We expect an increase in the costs for market makers supporting SME markets, and retail investors participating in these markets. This could adversely impact on the liquidity of SME markets, which in turn could impact on SME access to financial markets.
Locate rule to restrict naked short selling	No cost provided by Commission. It assumes a low cost as market participants have intimated they tend to have in place arrangements to ensure securities are located prior to entering into a short sale	No cost available. Cost impact unclear.
Other regulatory powers and requirements	Commission estimates quarterly report will take 2 hours to produce. EU-wide annual cost of €6,800	€422 No cost provided by Commission for regulatory

	n.b. Commission provides estimates for each Member State	cost of monitoring regime as a whole. However, this is anticipated to increase with the expanded scope of the disclosure regime and additional market players being brought into the regime. Other requirements will also introduce one-off and ongoing costs to the FSA. For example, the FSA will be required to assess whether firms qualify for the market making exemption. Assumptions in terms of time taken are optimistic.
ESMA intervention powers	No cost provided by the Commission.	It is not clear how this would work in practice and there is therefore some regulatory uncertainty brought about by ESMA's intervention role. This would theoretically take the decision of imposing the cost of a ban on firms – estimated in the UK by the FSA to be in the region of £40,000 (one-off) and £6,500 (monthly, ongoing cost) per firm – out of the hands of the national competent authority.
Prohibition on entering into uncovered positions in sovereign CDS.	No cost provided by the Commission, as this was not part of the original proposal.	No cost available. Cost impact unclear. The aim of this ban is to prevent speculation on the price of sovereign debt. However, there is a risk that certain hedging activities could be prohibited which may impact liquidity of member states' debt markets and could mean extra costs for participants wanting to hedge their exposures.

Scale of affected parties

It should be noted that the range of participants affected by any short selling regime is substantial and includes most notably: hedge fund managers, traditional fund managers, investment banks, market makers, and individuals.

These participants will already be affected in some form by the various different requirements in place across Member States, although several (including the UK) apply disclosure and restrictions only to financial stocks.

The Regulation will also **widen the net** of affected market participants. This can be summarised as follows:

- Buy-in procedures and the requirement to "locate and reserve" securities to ensure delivery for settlement will impose costs and new responsibilities on **short selling participants and other parties** involved in wider clearing and settlement operations. No cost is provided by the Commission as it argues that this is largely harmonisation, as many trading venues across Member States have in place arrangements for buy-in, fines, or ensuring that securities are located prior to entering a short sale.
- The calculation requirements in relation to aggregation across groups is likely to impose increased costs on **short selling participants** as it is a significant change from other aggregation requirements in other regimes;
- **Securities lenders** may be required by competent authorities to notify any significant changes in the fees requested for such lending;
- **Market makers and authorised primary dealers** must apply to the relevant competent authority to use the exemption from the Regulation; and
- A number of new regulatory requirements are introduced for **Competent Authorities** which will increase their costs. Competent authorities will be required to make quarterly reports to ESMA, assess exemption applications (referred to above); monitor markets for significant price falls; establish reporting procedures and maintain a list of exempt shares; system development and

oversight for receipt and publication of notifications, in addition to ensuring the continued compliance of all market participants – introducing a regulatory cost of administering the new regime. It should be noted that no cost estimate is provided by the Commission for the regulatory cost of monitoring the regime as a whole.

Scope and impact

The Regulation introduces a number of changes (outlined above) and there are elements of domestic law that will need to be amended in order to be compatible with the provisions of the Regulation. The costs and benefits of the changes to UK domestic law are considered below.

The main changes that will need to be made to domestic law involve: giving the FSA additional powers to regulate the regime effectively, repealing existing provisions which are in conflict with the Regulation as well as minor consequential amendments.

Repealing existing provisions

The UK already has in place a short selling regime. FSMA 2000 gives the FSA power to make short selling rules. The sections of FSMA 2000 which give the FSA power to make short selling rules are being repealed, as they are superseded by the Short Selling Regulation and are inconsistent with it. For example, the Short Selling Regulation will introduce a disclosure regime for equity securities, the shorting of sovereign debt and trading in "naked" sovereign CDS, whereas currently the FSA requires disclosure of short positions during rights issues and for all UK financial sector companies.

Benefits

The Regulation will be binding on market participants and therefore these amendments to FSMA 2000 will bring domestic law into line with the Regulation providing legal certainty for market participants and hence maintaining confidence, compliance, and the healthy functioning of the financial system at large

Costs

No costs are envisaged as a result of the changes to FSMA 2000. This Impact Assesement only evaluates changes to domestic law. Since the Short Selling Regulation will be binding in both the "do nothing" and updating FSMA options market participants will face the costs associated with it in both cases.

Designating the FSA as competent authority

The Regulation requires Member States to appoint a competent authority for the purposes of the Short Selling Regulation. This provision is implemented by appointing the FSA.

Benefits

This will provide clarity to market participants on who will be administering and enforcing the new regime.

Costs

The impact of this change is expected to be limited as the FSA already administers the UK's short selling regime, which most of market participants, such as hedge fund managers, traditional fund managers, investment banks, market makers, and individuals, will already be affected in some form.

However, as outlined above the Regulation will also widen the net of affected market participants, to include parties involved in wider clearing and settlement operations, securities lenders and market makers and authorised primary dealers. Despite this most of these market participants, if not already affected by the

current regime in some form, will be familiar with the FSA, as they are likely to be subject to the supervision of the FSA for other regulatory activities.

Additional powers to the FSA

The main changes that will need to be made to domestic law involve giving the FSA additional powers to regulate the regime effectively.

Firstly, the Regulation requires competent authorities to have all the **supervisory and investigatory powers necessary for the exercise of their functions**. The Regulation defines the supervisory and investigatory powers which the competent authority is required to have. This includes having the power to gain access to any document in any form and to receive or take a copy thereof; the power to require information from any natural or legal person and if necessary to summon and question a natural or legal person with a view to obtaining information; and the power to carry out on-site inspections with or without prior announcement. It is therefore necessary to amend FSMA so that the FSA has the powers as set out under the Regulation. This includes giving the FSA the power to:

(i) require information and documents which it reasonably requires for the purposes of the exercise by it of functions under the short selling regulation;

(ii) carry out on-site inspections by means of a compulsory power of entry under a warrant[2];

(iii) appoint persons to carry out investigations in relation to suspect or actual contraventions of the Regulation;

(iv) apply to the court for an injunction in relation to actual or likely breach of the Regulation; and

(v) give the court power to make a restitution order in respect of breaches of the Regulation.

Benefits

These amendments provide the FSA with powers to effectively exercise their functions as required under the Regulation. This is important to maintain confidence in and compliance with the new regime, which ultimately is crucial to the healthy functioning of the financial system at large.

Costs

These new powers broadly reflect the suite of enforcement powers available for the existing domestic short selling regime. The amendments will therefore already affect market participants, such as hedge fund managers, traditional fund managers, investment banks, market makers, and individuals. This change is therefore anticipated to be incremental over an existing regime, so the marginal costs of applying this to the Regulation should be smaller.

It is assumed that the wider net of market participants (excluding market makers and authorised primary dealers when they are undertaking non-market making activities as they would fall under the category above) would not be affected by such provisions, as these powers focus on the broader activity of short selling, whereas the requirements related to the wider net of market participants have more specific and separate regulatory requirements under the Regulation.

However, the power under point (iii) above to appoint persons to carry out investigations in relation to suspect or actual contraventions of the Regulation, will give the investigator slightly more investigative powers than are currently available for the existing short selling regime. Most of the new investigative powers do not introduce a burden on market participants. This is because they set out the procedures that the competent authority or investigator must comply with, for example. The impact on the FSA and investigator is expected to be incremental as the FSA, and it is anticipated that the investigator also, must already follow this procedure for similar provisions, so the marginal cost of extending this power under the Regulation should small.

[2] The detail of this power is subject to a separate Home Office Power of Entry gateway, as any amendment to an existing power of entry is required to be formally submitted to the Home Office for approval. Due to the tight transposition timetable this is being considered at the same time as this impact assessment, so the detail of whether the existing power will be made more extensive is not considered here, as this is subject to consideration by the Home Office.

A new burden will be introduced for third parties of market participants, where it appears that a document is in their possession. If this is the case the FSA or an investigator has power to require such a person to produce a document. This could apply to a person who -

(a) has been or is or is proposed to be a director or controller of that person;

(b) has been or is an auditor of that person;

(c) has been or is an actuary, accountant or lawyer appointed or instructed by that person; or

(d) has been or is an employee of that person.

The Authority or an investigator may also be allowed to take copies or extracts from the document; or require the person producing the document, or any relevant person, to provide an explanation of the document. If a person who is required under to produce a document fails to do so, the Authority or an investigator may require him to state, to the best of his knowledge and belief, where the document is. A lawyer may also be required to furnish the name and address of his client.

There are certain exemptions, where no person may be required to disclose information or produce a document in respect of which he owes an obligation of confidence by virtue of carrying on the business of banking unless, unless certain conditions are met.

These kinds of requirements would only apply to third parties where it appears that a document is in their possession, which is necessary for regulatory or investigatory purposes.

As these powers are ultimately about ensuring effective enforcement, and are the steps ahead of action being taken, such as a penalty for a non-compliant market participant, they are only anticipated to be used where it is considered there has been an actual or likely breach of the Regulation by a market participant. Consequently, this burden will not be applicable to all third parties of market participants, but only those who FSA believe are in contravention of Regulation. We therefore expect such occurrences to be rare.

It is difficult to monetise this, as the degree of cost could vary depending on a number of variables, such as whether the third party has easy access to the document required and the number of documents required. Despite this, the powers available are not anticipated to introduce requirements significantly different beyond which the third party currently undertakes as a result of them being a third party to the market participant, and as mentioned above are anticipated to be used seldom.

Gathering data on how often similar provisions might be used and the associated costs that these types of requirements impose on third parties in related areas is not possible given the time allowed for transposition under the Regulation and the risk of infraction would be disproportionate since these are incremental changes over existing legislation and the requirements introduced are likely to be familiar to third parties.

Secondly, the FSA is required in the Regulation to **cooperate with competent authorities of other member states where they request assistance for an on-site inspections or investigations**. The competent authority which receives the request may take one of a number of actions, ranging from carrying out the investigation itself to allowing other competent authorities to investigate. It is necessary to partially implement this through FSMA 2000. The amendment enables the FSA to exercise its powers to require information (set out above) at the request of the competent authority of an European Economic Area (EEA) member state or ESMA, as required by the Regulation. It also makes provision for the FSA to apply for a warrant for entry of premises at the request of a competent authority of an EEA member state.

Benefits

These amendments will assist competent authorities from other member states in the exercise of their functions under the Short Selling Regulation. As noted above, this is important to maintain confidence in and compliance with the new regime, which ultimately is crucial to the healthy functioning of the financial system at large. Effective coordination and communication between member state competent authorities, as enabled by this provision, should result in a more harmonised regime across the EU and great predictability for market participants as well as reduce the potential regulatory arbitrage between markets. This reduces cross-border risk to market integrity as the nature of trading currently is such that it can easily migrate to different trading venues or over-the-counter.

Costs

As set out above, this power is already available to the FSA under the current UK regime. By extending the scope of who can request the use of such a power (to competent authorities of other Member States), it is reasonable to assume that the likelihood of such a power being used will increase and therefore the marginal cost.

However, these powers are not anticipated to be used frequently, and therefore the associate cost is low. The Transparency Directive has a similar requirement and the FSA has not received such a request since the Directive was implemented in January 2007. It should be noted that this could increase as a result of the introduction of these powers under the Regulation.

As discussed above it is anticipated that such a power would only be used where competent authorities believe there has been an actual or likely breach of the Regulation. It will also be for the FSA to decide whether the use of such a power is appropriate under the Regulation.

It is difficult to monetise the cost, as it would be necessary to know the increased frequency of such an event, which is difficult given that these are new powers being introduced by the Regulation. Overall we expect the total cost to increase. However, as market participants are already familiar with the burden that the use of such powers may pose (as they would already be required to cooperate with the competent authority in the home state, for inspections or investigations), this change is therefore anticipated to be incremental over an existing regime, and therefore the marginal cost of should be smaller.

Thirdly, the Regulation requires Member States to **establish penalties for infringement of the short selling regulation**. The UK is obliged under the Regulation to ensure there are effective, proportionate and dissuasive penalties in place. Amendments are being made to FSMA 2000 to apply the FSA's power that it currently has for breaches of the short selling rules to the Regulation.

Benefits

This amendment is important in ensuring compliance with the new regime as well as maintaining confidence in it, which ultimately is crucial to the healthy functioning of the financial system at large.

Costs

Both the FSA and market participants are already familiar with these provisions as they currently apply to the short selling rules. Whilst we expect the total cost to increase, this change is anticipated to be incremental over an existing regime, so the marginal costs of applying this to the Regulation should be smaller.

Cooperation agreements with third countries

The Regulation requires competent authorities of member states, where possible, to enter into cooperation agreements with competent authorities of other countries outside the EU ("third countries") on the exchange of information to allow the competent authorities to carry out their duties under the Regulation. The Regulation defines when it is permissible to share information with a third country. These restrictions require cooperation arrangements to be put in place under the restriction that information disclosed is subject to guarantees of professional secrecy. Amendments are being made to the *Disclosure of Confidential Information Regulations* in FSMA 2000 to give effect to the restrictions, as required under the Regulation.

Benefits

These secure that important restrictions around the disclosure of confidential information set in the Regulation are effective in UK law.

Costs

These amendments are not anticipated to introduce a burden to the FSA or market participants as they merely outline when it is permissible for the FSA to share information with third country competent authorities.

From discussion with the FSA we are not aware of similar agreements that are in place, however, further investigation is necessary to confirm this. Making more efforts to gather the data is not possible given the time allowed for transposition under the Regulation and the risk of infraction would be disproportionate since these are incremental changes over existing legislation.

Consequential amendments

The UK implementing Regulations contain supplementary provision allowing the FSA to specify the format of applications and notifications required to be made to it under the Regulation and to specify what information needs to be included in an application.

Costs and benefits

The costs and benefits will be dependent on the ESMA guidelines in this area, which are currently being developed and will not be published until after the implementation deadline. It is anticipated to have minimal impact on market participants and should assist the FSA in its role as regulator, by making applications and notifications more standardised and therefore easier to analyse and report to ESMA. As this is dependent on the detail of the ESMA guidelines and given the time allowed for transposition under the Regulation it is not possible to monetise the impact of these provisions.

A number of consequential amendments are made to FSMA as a result of the changes outlined in this impact assessment.

Review clause

In line with better regulation requirements, a review clause has been inserted which requires the Treasury to review the operation and effect of the Regulations which the Treasury is introducing to give effect to the Short Selling Regulation. The Treasury is required to report within a five year period after the Regulations come into force and within every five years after that. Following a review it will fall to the Treasury to consider whether the Regulations should remain as they are, or be revoked or amended.

One in One Out

These measures are out of scope of one in one out since they do the minimum required by an EU regulation.

Risks and assumptions

The cost/benefit analysis is based on the changes to UK domestic law which are necessary to ensure compatibility with the Regulation. This impact assessment therefore does not consider the changes that will be introduced by the Regulation, but will not be implemented into domestic law. The costs and benefits of those changes were considered in the Commission's impact assessment[3] which accompanied the original proposal published in September 2010. They are not considered here.

It is difficult to quantify the costs and benefits, as the main cost is expected to fall to a small subset of participants who are suspected to not be compliant with the Regulation, which the changes in themselves are looking to combat. We therefore anticipate that these changes will rarely apply in practice.

The benefits are felt more holistically through confidence in and compliance with the new regime, which will ultimately ensure the healthy functioning of the financial system at large.

[3] European Commission: Impact Assessment for Proposal for a Regulation on short selling and certain aspects of credit default swaps.

It is also assumed in the analysis that as the UK already has in place a short selling regime, which is familiar to market participants, this will help to ease the transition to the new changes which are being made to FSMA 2000.

More broadly the transposition timetable has been particularly tight in the case of the Short Selling Regulation, with the Regulation only published in the Official Journal of the European Union on 24 March 2012. Level 2 measures setting out the detail behind the Regulation were also only recently adopted and are yet to be finalised. The objection period for the European Council and Parliament to the Delegated Acts expires in mid-September. This has added to the difficulty in quantifying the impact of the changes but do not affect the analysis of the impact of the changes to domestic law. The FSA will be launching a consultation on its proposed rule changes shortly, which are necessary to effect the Regulation ahead of 1 November 2012 deadline. This will consider the costs and benefits of such changes.

Wider impacts

Competitiveness

As the Regulation applies across the EU and is directly applicable, the regime should not pose concerns relating to the competitiveness of UK markets in respect of the EU. The amendments to domestic legislation are important as they help to establish a clear EU-wide regime and ensure that the UK has the same standards and rules as the rest of the EU. The Regulation is likely to result in some convergence with the US market, but these elements are not brought about by the changes to domestic regulation and are therefore not considered here.

This is also the case for competitiveness implications relative to third countries.

Impact on small and micro businesses

It is clear that reform to short selling will impact the market at large, including its smaller players. In addition to the impact on small brokers, it would be reasonable to expect that other affected firms may include smaller hedge funds or alternative investment managers engaged in short selling, and other players across the wider trading, clearing and settlement process.

It is difficult to draw a fair picture of the distribution of the market and the likely cost to participants. It is also impossible, and undesirable, to exempt smaller firms from the Regulation as this would hinder its effectiveness, and run the risk of regulatory arbitrage based on firm size. Since the regulation is directly applicable micro-businesses cannot be exempted from it.

Equalities Impact

The Government has considered the proposed reforms in relation to its public sector equality duties under the Equality Act 2010. It has concluded that no relevant issues arise. It does not think the regulations will have an impact on discrimination, equality of opportunity or good relations between people who share relevant protected characteristics under the act.

Summary and implementation

Summary

The UK supports having an EU framework on short selling and credit default swaps, which is both transparent and provides regulators with legal and workable powers within a common European framework.

Differing short selling regimes across the EU has resulted in market fragmentation, scope for regulatory arbitrage and compliance costs for market participants active in different markets. The benefits of a common regime are clear: a more consistent treatment of short selling across the EU, increased

transparency in order to understand the financial stability risks short selling may pose, efficiencies of scale to compliance across European markets and increased predictability for firms.

These amendments are essential to bring domestic law into line with the Regulation and will provide the FSA with the powers to effectively exercise their functions under the Regulation. This will provide legal certainty for market participants and will ensure confidence in and compliance with the new regime, which will ultimately ensure the healthy functioning of the financial system at large.

The main costs to market participants involve giving the FSA additional powers to regulate the regime effectively. Most of these powers broadly reflect the suite of enforcement powers available for the existing domestic short selling regime and the requirements introduced are likely to be familiar to new parties affected, such as third parties of market participants'. Overall we expect the total cost to increase; however, as the changes are anticipated to be incremental over an existing regime, the marginal cost of the Regulation should be smaller.

It is difficult to assess the specific impact and so estimate costs, as the main cost will be to participants who are suspected to be non-compliant with the Regulation. However, we anticipate that this will only apply to a small subset of participants and be used seldom.

As the UK already has in place a short selling regime, which is familiar to market participants, this will help to ease the transition to the new changes which are being made to FSMA 2000, with some of the changes being incremental over an existing regime, so the marginal costs should be smaller. These amendments are also essential in achieving the associated benefits.

Implementation

There is generally no need for the UK to transpose regulations as they are binding in their entirety and directly applicable in all Member States. The UK is however obliged to ensure that there is no element of domestic law that is incompatible with the provisions of the regulation, and that there are effective, proportionate and dissuasive penalties in place to address contravention of the provisions of the regulation. A statutory instrument, under section 2(2) of the European Communities Act 1972, will be required to meet the UK's obligations in this regard. This will include repealing existing provisions in FSMA 2000, which set out the FSA's powers to deal with short selling, providing FSA with the necessary powers required under the Regulation and ensuring the existing provisions on penalties are sufficient. The Regulation comes into force on 1 of November 2012.

The Regulation requires that the European Commission, by June 2013, shall, in light of discussions with competent authorities and ESMA, report to the report to the European Parliament and the Council on the impact and appropriateness of key articles and requirements in the legislation. Ministerial review of the implementing Regulations will take place in November 2017.