

**EXPLANATORY MEMORANDUM TO THE
FINANCIAL SERVICES AND MARKETS ACT 2000 (MARKET ABUSE)
REGULATIONS 2005**

2005 No.381

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 These Regulations give effect in part to the EC's Market Abuse Directive¹ ("the Directive") and to certain secondary EC legislation² adopted under it. The Directive seeks to provide a common European framework for the prohibition of insider dealing and market manipulation, and to promote market integrity by ensuring prompt and fair disclosure of information about financial instruments to the public. The main substantive changes to existing legislation will take effect from 1 July 2005.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 The Regulations are made under section 2(2) of the European Communities Act 1972, which enables the implementation of European Community legislation by statutory instrument.

4.2 In addition to these Regulations, the Directive will be implemented through changes to the Financial Service Authority's (FSA) Handbook of rules and guidance, made under the Financial Services and Markets Act 2000 ("FSMA"), and by the Investment Recommendation (Media) Regulations 2005. The latter regulations give effect to Article 6.5 of the Directive and to Commission Directive 2003/125/EC of 22 December 2003³. A transposition note setting out how the main elements of the

¹ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (OJ No L 96, 12.4.2003, p.16.).

² Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC as regards the definition and public disclosure of inside information and the definition of market manipulation (OJ No L339, 24.12.2003, p.70); Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions (OJ No L 162, 30.4.2004, p.70.); Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC as regards exemptions for buy-back programmes and stabilisation of financial instruments (OJ No L 336, 23.12.2003, p.33.).

³ OJ No L 339, 24.12.2003, p73.

Directive, and the secondary legislation adopted under it, will be given effect in UK law is attached at Annex A.

4.3 The Regulations amend:

- Parts 6 and 8 and certain other provisions of FSMA
- Schedule 1 to the Criminal Justice Act 1993
- the Prescribed Markets and Qualifying Investments Order 2001 (SI 2001/996)
- the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995), and
- they repeal the Traded Securities (Disclosure) Regulations 1994 (SI 1994/188).

4.4 Part 6 of FSMA enables the FSA to make rules governing the continuing obligations of companies whose securities are admitted to the official list. The regulations amend Part 6 so as to distinguish between rules relating to the official list ('listing rules') and rules relating to the disclosure of information requirements regarding any financial instruments admitted to trading on a regulated market ('disclosure rules'). A new section 96A provides that the disclosure rules must deal with the publication of inside information about companies, the drawing up of lists of those with access to inside information and the reporting of transactions in shares of the companies for which they work, by senior management and those closely associated with them. These rules will extend not just to companies with securities admitted to the official list but also to non-listed securities which are admitted to trading on what are defined as EEA regulated markets.

4.5 Part 8 of FSMA provides the framework for the UK's civil market abuse regime. Section 118 of FSMA contains definitions of market abuse, and section 119 requires the FSA to issue a code containing guidance on the operation of the market abuse regime. These definitions cover behaviour in relation to inside information, giving a false or misleading impression and distorting a market. Section 118 also provides that behaviour is only market abuse if it is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour to be reasonably expected of such a person ("the regular user test").

4.6 The Regulations replace the existing section 118 of FSMA and insert new definitions e.g. of who are "insiders" and of what constitutes "inside information". Instead of three categories of abusive behaviour in section 118, there are now seven categories which cover similar ground to the existing three but offer more precise descriptions of the behaviour that is prohibited. Most significantly, the regular user test does not appear in the Directive and is therefore retained only for those categories of abusive behaviour which are not drawn from the Directive. There is no change to the requirement for the FSA to issue a code, but section 119 is amended

to provide that the code may contain descriptions of behaviour that are 'acceptable market practices' in line with the Directive.

4.7 Section 118 of FSMA also sets the scope of the market abuse regime. It applies to behaviour in the UK or behaviour abroad in relation to qualifying investments traded on prescribed markets. The Prescribed Markets and Qualifying Investments Order 2001 lists the markets and investments covered by the regime. All markets run by UK Recognised Investment Exchanges are covered and the Ofex market. The investments covered are those traded on prescribed markets which are investments for the purposes of section 22 of FSMA (this includes shares and financial futures and options).

4.8 The Regulations amend the scope of the UK's market abuse regime in Part 8 of FSMA and in the Prescribed Markets and Qualifying Investments Order 2001. Prescribed markets now include all EEA regulated markets (except for the prohibited categories of abuse which are not drawn from the Directive) and the investments now covered are all 'financial instruments' within the meaning in the Directive (which covers any instrument admitted to trading on a regulated market). So where Part 8 gives effect to the categories of market abuse set out in the Directive, behaviour may now be covered if it happens (a) in the UK in relation to financial instruments traded on prescribed markets which are based outside of the UK (EEA regulated markets), and (b) in the UK or abroad in relation to financial instruments traded on prescribed markets which are based in the UK.

4.9 The changes to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 and the repeal of the Traded Securities (Disclosure) Regulations 1994 are linked. In both places, provisions relating to the disclosure of inside information (by companies to investors) are being deleted. These implemented the insider dealing Directive⁴ which the Directive replaces. The provisions are effectively being replaced by the changes to Part 6 and new FSA rules.

4.10 An Explanatory Memorandum (EM 9763/01 COM (2001) 281 – Market Abuse) on the Commission's proposal for a Directive was approved by the Scrutiny Committee in the House of Lords on 11 December 2001 and the Scrutiny Committee in the House of Commons on 20 March 2002.

5. Extent

5.1 The Regulations apply to all of the UK.

6. European Convention on Human Rights

⁴ Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing (OJ L334, 18.11.1989, p.30).

6.1 The Financial Secretary to the Treasury, Stephen Timms MP, has made the following statement regarding Human Rights:

“In my view the provisions of the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005 are compatible with the Convention rights (as defined in the Human Rights Act 1998).”

7. Policy Background

7.1 The European Commission proposed a Directive on market abuse to bring convergence amongst differing national regimes in the EU and thereby to achieve greater confidence in the integrity of the financial system in Europe. Subsequently, the European Parliament and the Council adopted a Directive providing a basic framework for the prohibition of market abuse, covering both insider dealing and market manipulation. To help prevent market abuse, the Directive included provisions aimed at ensuring there is prompt and fair disclosure of information about financial instruments to the public. This includes prompt release of inside information to the market by companies and fair presentation of investment recommendations.

7.2 The main challenge the Treasury faced in transposing the Directive was to decide how much change was appropriate to the civil market abuse regime that was put in place as part of FSMA in 2000. The FSMA regime and the Directive cover similar ground but adopt a slightly different approach to prohibiting abusive behaviour. The original FSMA regime defines market abuse in fairly broad terms and then qualifies this by the requirement that behaviour is only abusive if it is likely to be regarded as such by a “regular user” of the market. The Directive sets out more specific descriptions of the type of behaviour which is to be prohibited.

7.3 It was decided that implementation required significant change to the wording in Part 8 of FSMA. For instance, the Directive has no equivalent to the “regular user” provision. It was decided therefore that this should be removed from Part 8, to the extent that it is giving effect to the Directive, in order to preclude possible under-implementation of the Directive. Conceivably, a regular user might not regard as unacceptable, behaviour which is proscribed by the Directive

7.4 The prohibitions in Part 8 have been brought into line with those in the Directive to provide consistency and to ensure that the boundaries of the UK’s regime are similar to those elsewhere in Europe.

7.5 There are two main areas in which the implementation will go beyond the minimum standards required in the Directive. We will continue to include in the scope of the market abuse regime, instruments trading on markets of recognised investment exchanges which are not regulated markets (this includes the London Stock Exchange’s AIM market, the London Metal Exchange, and the International Petroleum Exchange), and Ofex. All the operators of these markets have indicated they want them

to remain inside the regime to protect their integrity, and it was a proposal supported by market participants in the consultation on the implementation of the Directive.

7.6 Respondents to the consultation were split on whether the UK should go beyond the minimum requirements of the Directive in respect of the offences covered. Some thought it made the regime too complicated, others that it was important for investor protection. On balance, it was decided to retain the scope of the existing market abuse prohibitions to the extent that these go beyond the prohibitions in the Directive. The prohibitions not drawn from the Directive (the new sections 118(4) and 118(8) of FSMA in Schedule 2 to the Regulations) will, as at present, be subject to the regular user test and they will not apply to markets outside the UK; moreover, these provisions will expire after a period of three years. It is intended that before the end of the three-year period, the Treasury will review the effect of these provisions and decide whether or not they should be renewed.

7.7 The Treasury held a three-month consultation on a draft of the regulations between June and September 2004. This was as part of a joint HM Treasury/FSA consultation on the implementation of the Directive. Over 30 responses were received. Subsequent drafts were shown to interested parties. Details of the Treasury's response to the formal consultation are included in the feedback statement on the consultation on HM Treasury's website (www.hm-treasury.gov.uk). A summary is included in paragraphs 71 to 77 of the Regulatory Impact Assessment at Annex B to this memorandum.

8. Impact

8.1 A Regulatory Impact Assessment is attached as Annex B to this Memorandum.

8.2 As now, the FSA will be responsible for investigating and prosecuting market abuse in the UK. The Directive should not significantly impact on the size of their task. Individuals in the public sector who have access to inside information as part of their work are subject to the prohibitions in the Directive, just as they are subject to existing prohibitions on insider dealing.

9. Contact

9.1 Stephen Hanks at HM Treasury: Tel: 020 7270 5912 or e-mail: stephen.hanks@hm-treasury.x.gsi.gov.uk can answer any queries regarding the Regulations.

Transposition Note for Directive 2003/6/EC – The Market Abuse Directive (MAD)

The note and table below set out the main elements of the UK's implementation of the EU's Market Abuse Directive (Directive 2003/6/EC). The directive was passed under the "Lamfalussy" process for financial services legislation in the EU. Under this process, the Market Abuse Directive is a framework directive designed to provide a high-level approach and set the scope within which more detailed measures, including secondary EC legislation, should be drawn. The relevant secondary legislation: (Directives 2003/124/EC, 2003/125/EC & 2004/72/EC and Regulation 2273/2003) provide the greater detail and were adopted by the Commission after receiving the opinion of the Committee of European Securities Regulators.

The directive aims to create a European civil framework for the description, detection and punishment of market abuse. It prohibits insider dealing and market manipulation. The directive also has preventative measures aimed at making market abuse less likely to occur. These include a requirement that companies disclose new information affecting their prospects to the market in a timely and even-handed fashion, and that those making investment recommendations to investors disclose any interests they have in the shares or other financial instruments they are recommending.

The directive is being implemented through two sets of regulations and changes to the Financial Services Authority's (FSA) Handbook of rules and guidance. The first set of regulations are the Financial Services and Markets Act (FSMA) 2000 (Market Abuse) Regulations 2005 ("the market abuse regulations"). Schedule 1 of the regulations changes Part 6 of FSMA to give the FSA the power to make rules to cover some of the preventative measures in the directive. Schedule 2 of the regulations changes Part 8 of FSMA to revise the UK's definitions of market abuse. The market abuse regulations also amend the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001, which sets the scope of the markets and investments covered by the market abuse prohibitions in Part 8 of FSMA. The second set of regulations, the Investment Recommendation (Media) Regulations 2005 ("the media regulations"), cover those producing investment recommendations or disseminating investment recommendations produced by others who are not subject FSA rules.

Once the regulations are in force, the FSA will make changes to provisions in its Handbook. These will include changes to the Code of Market Conduct, the Listing Rules, the Conduct of Business Sourcebook, and the Supervision Manual.

Because the EU secondary legislation relates to provisions in the framework directive, it is covered in the table below under the articles of the framework directive to which it relates, rather than as separate pieces of legislation.

Transposition Note for the Market Abuse Directive

Articles	Objectives	Implementation	Responsibility
<p>1.1 and 5 (includes article 1 of 2003/124/EC and article 4 of 2004/72/EC)</p>	<p>To define and prohibit “insider dealing” ie profiting from privileged access to information regarding companies which has not been made public. This includes trading or inducing others to trade on the basis of inside information, or the unauthorised disclosure of this information</p>	<p>The implementation of the definition and prohibition of insider dealing is contained in amendments to Part 8 of FSMA, in schedule 2 of the market abuse regulations. The description of the offence is in the new sections 118 (2) & (3), the definition of inside information is in section 118C and the list of the categories of person with access to inside information is in section 118B.</p> <p>There are significant similarities between the provisions in the directive and existing UK provisions (trading or inducing others to trade on the basis of inside information, or the unauthorised disclosure of this information is already prohibited in the UK), but there are two important differences:</p> <ul style="list-style-type: none"> • The existing provisions prohibit a wider range of behaviours (all inappropriate behaviour in relation to inside information and not just trading or inducing others to trade on inside information and unauthorised disclosure of inside information) • The existing provisions have a wider definition of inside information (they include information which is relevant to investment decisions and not just information which would have a significant effect on prices). <p>The existing provisions have been retained in section 118 (4). This provision is intended to capture the wider set of behaviour covered by the existing regime which does not fall into the definitions drawn from the directive. This provision will lapse three years after it comes into force, unless the Government proposes new legislation. It is intended that before the end of the three years the effects of this provision should be reviewed.</p> <p>The FSA’s Code of Market Conduct will provide guidance on what is covered by the inside dealing offences in Part 8 of FSMA.</p>	<p>HM Treasury and Financial Services Authority</p>
<p>1.2, 5 (includes articles 4 & 5 of 2003/124/EC and 2& 3 of</p>	<p>To define and prohibit market manipulation ie profiting from behaviour which artificially distorts the</p>	<p>The implementation of the definition and prohibition are contained in amendments to Part 8 of FSMA in schedule 2 to the market abuse regulations. The directive’s definitions are transposed in Part 8 of FSMA</p>	<p>HM Treasury and Financial Services Authority</p>

Articles	Objectives	Implementation	Responsibility
2004/72/EC)	price of financial instruments or involves creating a misleading impression about a financial instrument.	<p>in the new sections 118 (5) to (7). The directive's definitions of market manipulation are similar to existing definitions: they encompass creating a misleading impression in relation to financial instruments or distorting the market for a financial instrument.</p> <p>However, the directive's offences are narrower than the current ones as they relate to specific behaviour (transactions or orders to trade and the dissemination of information) as opposed to covering any behaviour which might create a misleading impression or distort a market.</p> <p>The existing provisions have been retained in section 118 (8). This provision is intended to capture the wider set of behaviour covered by the existing regime which does not fall into the definitions drawn from the directive. This provision will lapse three years after it comes into force, unless the Government proposes new legislation. It is intended that before the end of the three years the effects of this provision should be reviewed.</p> <p>The FSA's Code of Market Conduct will provide guidance on the behaviours that fall within the definition of market abuse and the signals they will look at in assessing whether behaviour is manipulative.</p>	
6.1 to 6.4 (includes 2 to 3 of 2003/124/EC and 5 to 6 of 2004/72/EC)	<p>To ensure there is prompt and fair disclosure of information to the public concerning new developments relevant to the prospects of companies who issue shares and bonds</p> <p>To ensure inside information is properly controlled by requiring lists to be kept of those with access to it</p> <p>To ensure investors have information about the trading in the shares of companies by the senior management (and those closely</p>	<p>The FSA already has the power under Part 6 of FSMA to make rules concerning the ongoing obligations of companies whose securities are admitted to the official list. Its rules made under these powers are known as the Listing Rules.</p> <p>Schedule 1 of the market abuse regulations amends Part 6 of FSMA to widen the FSA's rule-making powers so that they apply, in line with the directive, to companies whose securities are admitted to trading on EU regulated markets based in the UK as well as those admitted to the official list. The new section 96A of Part 6 sets the basic scope of the FSA's new rule-making powers.</p> <p>In line with its revised rule making powers, the FSA will revise the Listing Rules which set out the continuing obligations of companies.</p>	HM Treasury and Financial Services Authority

Articles	Objectives	Implementation	Responsibility
	associated with the senior management) of those companies.		
6.5 (Includes Directive 2003/125/EC)	To ensure that investment recommendations are fairly presented and relevant interests and conflicts of interest are disclosed.	<p>Most people making investment recommendations are subject to regulation by the FSA (advising on investments is an activity requiring authorisation by the FSA). The Conduct of Business section of the FSA's Handbook will be revised to apply rules based on Directive 2000/125/EC to those authorised by the FSA who are producing investment recommendations or disseminating recommendations produced by a third party..</p> <p>Investment recommendations made or disseminated by the media are outside the scope of the FSA's regulation (if they are contained in publications whose main purpose is not to give investment advice). These will be covered by the Investment Recommendation (Media) Regulations 2005.</p> <p>The media regulations exempt from their scope, in regulation 3 (3), those already covered by FSA regulation. Their substantive provisions are taken from directive 2003/125/EC (excluding the provisions which apply only to banks, brokers and independent analysts). Consistent with recital 22 of directive 2003/6/EC, the UK is allowing media organisations producing and disseminating investment recommendations to be covered by self regulation. Regulation 3 (4) of the media regulations provides for an exemption from the regulations for those covered by the main self-regulatory codes governing the media and for firm-specific codes as long as adherence to these Codes is disclosed.</p>	HM Treasury and Financial Services Authority
6.9 (Articles 7 to 11 of Directive 72/EC/2004)	To ensure that possible incidences of market abuse are reported to regulators by banks and brokers	<p>The people to whom this obligation applies are covered by FSA regulation. This obligation is therefore being implemented through a change to the FSA's Supervision manual.</p> <p>Article 11 of Directive 2004/72/EC requires that those notifying suspicious transactions reports are exempt from liability providing they act in good faith. This requires a substantive legal provision which has been enacted in the amendments to Part 8 of FSMA in schedule 2 to the regulations in the new section 131A.</p>	HM Treasury and Financial Services Authority
7	To ensure monetary,	The exemption has been included in the	HM Treasury and

Articles	Objectives	Implementation	Responsibility
	exchange rate and public debt management policies are not impeded by the directive	amendments to Part 8 of FSMA in schedule 2 of the market abuse regulations in the new 118A(5)(c).	Financial Services Authority
8 (Regulation 2273/2003)	To ensure that legitimate buy-back and stabilisation activities do not lead to market abuse charges by providing a 'safe harbour' for such activities	As an EU regulation, the safe harbour automatically applies in the UK. This is acknowledged in Part 8 of FSMA in the new s118A(5)(b) The FSA's Code of Market Conduct is also being altered to take account of the regulation	HM Treasury and Financial Services Authority
9 and 1.3	Sets the scope of the directive in terms of the financial instruments to which it applies	The current UK regime applies to investments, as defined for the purposes of s22 of FSMA, traded on certain prescribed markets. Under the directive it is required that the regime applies to all instruments admitted to trading on regulated markets. Regulation 10 of the market abuse regulations amends Statutory Instrument 2001/996 to make the necessary change by referring to the directive's definition of a financial instrument. This statutory instrument sets the scope of the instruments and markets covered by the UK's market abuse regime in Part 8 of FSMA. The directive requires that market abuse prohibitions apply to instruments admitted to trading on regulated markets. In the UK several of the markets covered by the existing regime are not regulated markets (a term which is defined in the Investment Services Directive 1993/22/EEC). These include the London Stock Exchange's AIM market, Ofex, the London Metal Exchange and the International Petroleum Exchange. Under regulation 10 of the market abuse regulations which amends SI 2001/996, these markets will continue to be covered by the market abuse regime. The operators of all these markets want their markets to continue to be covered.	HM Treasury and Financial Services Authority
10	Sets the geographical scope of the directive	The current UK regime applies to behaviour whether in the UK or abroad in respect of financial instruments traded on prescribed markets based in the UK. Under the directive the scope of the regime has to be expanded to include behaviour that happens in the UK in respect of financial instruments admitted to trading on regulated markets based in other EEA countries.	HM Treasury and Financial Services Authority

Articles	Objectives	Implementation	Responsibility
		The extension of scope required under the directive is being achieved through amendments to Part 8 of FSMA in schedule 2 of the market abuse regulations through section 118A(1), changes to Statutory Instrument 2001/996 in regulation 10 of the market abuse regulations.	
11	To have the directive enforced by a single regulatory body	This does not require a change to existing arrangements in the UK. The FSA is already the single regulatory agency charged with enforcing the UK's civil market abuse regime.	HM Treasury and Financial Services Authority
12	To ensure that regulators can enforce the directive effectively	This does not require a change to existing arrangements in the UK. The FSA already has wide-ranging enforcement powers in Parts 11 and 25 of FSMA.	HM Treasury and Financial Services Authority
13	To stop sensitive information in relation to market abuse leaking from regulators	This does not require a change to existing arrangements in the UK. Part 23 of FSMA already includes such restrictions.	HM Treasury and Financial Services Authority
14	To ensure appropriate sanctions against market abuse	This does not require a change to existing UK arrangements. The FSA already has the power to levy unlimited fines on those who engage in market abuse or break its rules.	HM Treasury and Financial Services Authority
15	To allow appeals against decisions from regulators in market abuse cases	This does not require a change to existing arrangements in the UK. Under Part 9 of FSMA, decisions of the FSA may be referred to the Financial Services and Markets Tribunal	HM Treasury and Financial Services Authority
16	To ensure that there is effective co-operation between regulators	This does not require a change to existing UK arrangements. Under Part 11 of FSMA, the FSA already has the powers to provide assistance to overseas regulators.	HM Treasury and Financial Services Authority
18	To ensure the directive was implemented by 12 October 2004	Because of the complications of fitting the directive with the existing market abuse regime, the UK will be implementing the directive late. Only one Member State implemented on time.	HM Treasury and Financial Services Authority

REGULATORY IMPACT ASSESSMENT

The Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005, and the Investment Recommendation (Media) Regulations 2005.

PURPOSE AND INTENDED EFFECT OF MEASURE

Objective

2. Both sets of the regulations introduce the legislative changes necessary to implement the EU's Market Abuse Directive⁵ (implementation will also involve changes to the Financial Services Authority's rules and guidance in its Handbook). The aim of the directive is to achieve greater confidence in the integrity of the financial markets in the EU by introducing a common administrative framework for deterring and punishing market abuse. The Government's objectives in implementing the directive are to create a regime which is:

- proportionate;
- comprehensible;
- effective;
- and consistent with the UK's obligation to implement the directive.

3. The Market Abuse Directive defines two broad categories of behaviour as abusive: insider dealing and market manipulation. That is:

- Where someone seeks to use information which has not been made public but which if it were made public would be likely to have a significant effect on the prices of financial instruments, to their advantage or the advantage of others;
- Where someone seeks to distort the price of financial instruments, or effect transactions or orders to trade, or disseminates information in a manner which gives, or is likely to give, false or misleading signals about financial instruments

4. The directive prohibits this behaviour to provide reassurance to investors that they will not be unfairly disadvantaged by others when using financial markets. At the same time there are defences and qualifications to the prohibitions to ensure that legitimate trading behaviour and strategies are not prohibited.

5. The directive also contains preventative provisions aimed at making market abuse less likely. This include requiring that:

⁵ Directive 2003/6/EC and its implementing measures Directive 2003/124/EC, Directive 2003/125/EC Regulation (EC) No. 2273/2003 and Directive 2004/72/EC

- there is proper dissemination and control of price sensitive information by companies who issue financial instruments;
- companies who issue financial instruments compile lists of those with access to inside information about them;
- the senior management of a company which issues financial instruments, and those closely associated with those individuals, disclose their dealing in the shares of the company and in derivatives linked to those shares;
- investment recommendations made by those commenting on the prospects of companies which issue financial instruments are fairly presented and interests and conflicts of interest are disclosed as appropriate.

6. The preventative provisions are quite diverse, but one thread running through them is ensuring that investors are properly informed about developments relating to financial instruments.

Background

7. The Market Abuse Directive was proposed by the European Commission because it believed the European legal framework dealing with market abuse was incomplete (there were no common provisions against market manipulation) and needed updating to reflect market developments (the previous EU legislation in this area, the Insider Dealer Directive⁶, was passed in 1989).

8. The Market Abuse Directive is part of the EU's Financial Services Action Plan which seeks to deliver an effective single market in financial services. The directive seeks to contribute to this aim by promoting greater confidence in financial markets across the EU.

9. The UK has a civil justice regime dealing with market abuse. The legislative elements of this are mainly contained in Parts 6 and 8 of the Financial Services and Markets Act, 2000 (FSMA). The UK's existing regime, as with that in the directive, provides a framework for deterring and punishing market abuse, (both insider dealing and market manipulation), and ensures a proper flow of information to the market from companies whose securities trade on exchanges.

10. Under the market abuse powers in FSMA, there have been eight final notices issued in enforcement cases. Five individuals have been fined (with one fine of £18,000, three fines of £15,000 and one of £1,000) for misuse of information; there have been two cases of giving a false and misleading impression leading to one company being fined £17 million and in the other case an individual being fined £290,000 and a company £65,000; and one case of the distortion of the market for the shares of a company for which an investment services firm was fined £500,000 and one of its employees was fined £75,000. Since 2000, four final notices have been issued in enforcement cases taken for breaches of issuers' disclosure obligations under the Listing Rules (which are akin to aspects of the preventative provisions of the directive).

⁶ Directive 1989/592/EEC

11. In the year from 1 April 2003, the Financial Services Authority (FSA) opened 30 enforcement investigations in respect of market abuse and 2 in respect of breaches of the Listing Rules. At 31 March 2004 there were 25 market abuse enforcement investigations still open and 6 Listing Rules enforcement investigations still open. The figures for ongoing investigations include some investigations opened in earlier years.

12 The UK's existing regime for market abuse substantially overlaps that in the directive but is not identical to it. This means that implementation of the directive in the UK requires that changes are made to the UK's existing regime to ensure that the UK has given effect to the directive's provisions.

13. The main legislative changes that the directive requires are as follows:

- **Definition of market abuse.** Under the existing regime there are only three offences of market abuse, which are defined in general terms, and a general definition of inside information. The directive defines the behaviour prohibited more specifically and has a more detailed definition of inside information. Implementing the directive requires that the UK regime clearly prohibits the specific behaviour mentioned in the directive and uses the directive's definition of inside information.
- **Defences and qualifications.** Under the existing regime, behaviour is only market abuse, inter alia, if a regular user of the market regards the behaviour "...as a failure on the part of the person ... concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market". The directive does not include a 'regular user test' in its definitions of market abuse. Instead there are a series of specific defences and qualifications in respect of each of the offences, although most are likely to be considerations that a regular user would take into account in the existing UK regime. Implementing the directive requires that in relation to the offences in the directive, the regular user test is replaced by the defences and qualifications in the directive.
- **Geographical scope.** The current UK market abuse regime does not prohibit market abuse which takes place in the UK in relation to instruments admitted to trading only on markets based in other EU countries. The directive requires that such behaviour is prohibited.
- **Ongoing obligations.** In part 6 of FSMA, the FSA have the power to make rules specifying requirements to be complied with by the issuers of listed securities. The directive requires that the FSA have power to impose certain specific continuing obligations on issuers whose securities are admitted to trading on regulated markets in the UK. Two of those obligations go beyond what is currently required under the rules made under the FSA's existing powers: companies or their advisers are required to keep lists of those with access to inside information about the company and the requirement to report transactions in the shares of their own company applies to senior management and not just board members. Implementation therefore requires an extension of the FSA's rule making powers.

- **Investment recommendations.** The directive requires that those making investment recommendations comply with obligations relating to fair presentation and disclosure of conflicts of interest. Most people making investment recommendations will be covered by FSA regulation. But there is a need to ensure that those making such recommendations who are not authorized persons, which will be those operating in the media, are covered by relevant provisions.

14. Two groups will be most directly affected by the legislative changes required to implement the Market Abuse Directive: the approximately 2,900 firms (and their staff) who are authorised by the FSA to manage investments or trade securities and futures, and companies whose securities are admitted to trading on regulated markets (there are approximately 1,500 UK firms whose securities are traded on the London Stock Exchange's main market).

15. The authorised intermediaries will be affected because they are the people engaging in trading and giving orders to trade in securities on a daily basis. It is important to them therefore to ensure that their day-to-day activity falls outside of prohibitions on market abuse. Committing market abuse could cause significant reputational damage to any firm involved.

16. Companies which issue financial instruments are affected by the provisions relating to the release and control of inside information. Specifically they will be required to make arrangements to report to the market the share dealings of a wider range of their management, including executives below board level, and to keep lists of those whom they employ with access to inside information about their company.

17. Individual investors are potentially affected. As with intermediaries, they need to avoid behaviour which falls within the prohibitions. For small scale retail investors this should be no more troublesome than currently. Most retail investors do not have access to inside information. The media also come within the scope of the investment recommendation regulations, but should be unaffected as a result of its recognition of existing self-regulatory regimes.

Risks

18. The directive - like the current UK regime - is aimed at reducing market abuse and ensuring that markets are properly informed. At a basic level this is a matter of investor protection. Without an effective market abuse regime, ordinary investors would be in danger of suffering financial loss as a result of the activities of others. For example, if a false and misleading impression is created as to the supply and demand for a security, investors might be induced to buy or sell on terms which they would not otherwise have considered.

19. More generally, market abuse regimes are aimed at promoting market confidence. Where there is doubt about the standards to which markets operate, this can potentially have an adverse affect on both investors and companies by reducing liquidity. People will be less willing to deal if they cannot be sure about the probity of markets.

20. Less liquidity implies higher transactions costs for investors. It is likely to drive up the spread between bid and offer prices and increase the market impact of orders. Higher transaction costs will reduce the overall returns available to investors. This has potentially significant consequences. Around 11 million individuals in the UK hold shares directly, and individuals have around £800 billion invested indirectly in securities through various forms of collective investment products. Spreads on the London Stock Exchange's main market have narrowed since the introduction of the FSMA regime for market abuse although it is very difficult to say what role, if any, the regime has played in this. Other explanations are likely to include the creation of new equity derivative products, the providers of which hedge in the cash market, and efforts by the exchange to make trading through its systems more attractive.

21. Lower liquidity means a higher cost of capital for companies. This in turn is likely to lead to a lower level of investment, lower growth of revenues and profits and a lower rate of overall economic activity.

OPTIONS

Option 1

22. **Do nothing.** Taking no action to implement the directive would still mean that the UK would have a legislative regime aimed at deterring and punishing market abuse and promoting market integrity and there would be no significant additional short-term costs for industry. But it will not allow us to meet the objective of fulfilling our obligations under the directive. The UK's existing regime falls short of the regime in the directive in some areas. For example, the scope of the current regime is narrower than that in the directive in the areas set out in paragraph 13.

23. The main risk of this option is that the UK would be infracted by the Commission for failure to implement the directive correctly. We judge that if such proceedings started they would have a reasonable chance of succeeding. We would then be forced to revise our market abuse regime to make it consistent with that in the directive.

24. Not implementing will create potential complications for those in other jurisdictions trading in securities on UK markets and those in the UK trading in securities trading on non-UK markets. They will need to be familiar with two different regimes. But the overlap between the two regimes is such that the complications should be modest. They should not create a significant barrier to cross-border trading.

Option 2

25. **Implement the regulations.** The regulations seek to meet our objectives by incorporating the directive's provisions into the UK's existing market abuse regime. Where the scope of the UK's existing regime is broader than that in the directive, the current scope is retained. In respect of the wider offences in the current regime, the provisions retaining these are subject to sunset clauses so that they will lapse three years after implementation. It is the government's intention that there will be a review of the impact of these provisions to be completed before the sunset clauses take

effectso as to inform a decision on whether to re-enact the provisions. In respect of the regulation of investment recommendations, the directive permits countries to opt for self-regulation of the media. The government intends to exercise this option to ensure that the directive is implemented in a proportionate fashion that is consistent with existing practice.

26. This enables the UK to comply with its obligations to implement the directive, ensuring that the UK retains an adequate breadth of regime, and provides greatest continuity for those affected by the UK's existing regime. The sunset clauses and review mean that there is sufficient time to collect evidence about the effect of retaining provisions which go beyond the offences in the directive and to make an evidence-based decision about their effectiveness or otherwise.

27. The main risk to our objectives from this option is that it is not proportionate. If the review determines that the provisions which are subject to sunset clauses are not proportionate, then the UK will have had a disproportionate regime for three years.

Option 3

28. **Align the UK's market abuse regime with that in the directive.** Adapt the UK's existing regime to align its scope with that in the directive. This would give certainty that the UK had complied with its implementation obligations. It would also provide the UK with a regime for deterring and punishing market abuse broadly consistent with that in other member states. The UK could still under this option exercise discretion to regulate the production and dissemination of investment recommendations by the media through self regulation.

29. Relying on the scope of regime in the directive would represent a bigger change to existing arrangements than the second option. Relative to adapting the existing regime, there are three changes that would be needed to the regulations to implement this option (there are other areas in which the language in the regulations departs from that in the directive but this is to provide clarity rather than to change the regime). All three changes would narrow the scope of the UK's market abuse regime.

30. The three main provisions that would be removed from the regulations under this option are as follows:

- **Insider dealing.** The provision in schedule 2 of the regulations (the proposed new s118(4) of FSMA) drawn from the existing regime which would prohibit behaviour (not covered by the offences drawn from the directive) in relation to relevant information not generally available, subject to the 'regular user test'.

Omission of this provision would no longer explicitly prohibit people from trading to their advantage and to the disadvantage of others on the basis of information not generally available to investors.

- **Market manipulation.** The provisions in schedule 2 of the regulations (the proposed new s118(8) of FSMA) drawn from the existing regime which would

prohibit behaviour (not covered by the offences drawn from the directive) which gave a false or misleading impression or distorted markets.

- **Scope.** The provisions in the regulations (the amendments to the Prescribed Markets and Qualifying Investments Order), which would prohibit market abuse in relation to financial instruments traded on Ofex and the London Stock Exchange's AIM market (and before the Markets in Financial Instruments Directive⁷ is implemented in mid-2006, the London Metal Exchange and the International Petroleum Exchange).

Omission of this provision would mean that markets aimed at providing a platform for new and growing companies would no longer provide the same level of protection to investors from market abuse as they enjoy in respect of the securities of larger more established firms trading on the London Stock Exchange's main market. These are markets which rely more heavily on individual investors as opposed to institutional investors. Several of the first eight decisions reached under the new regime related to trading in a securities on AIM and Ofex. Under the minimum regime in the directive, the FSA would have been prevented from taking action in these cases.

The UK is the only European country with large equity markets which are not regulated markets. AIM and Ofex are also the two largest junior equity markets in Europe.

It would also be disruptive to the UK's commodity derivatives exchanges who would be outside of the regime for a period. The London Metal Exchange and International Petroleum exchange are markets of international importance.

The markets affected have indicated that they wish to remain inside the scope of the civil market abuse regime.

31. The main risk to our objectives from this option is that it produces a less effective market abuse regime than we have at the moment. Less effective in two ways. First, because it would not afford protection to key UK financial markets. Second, because it would be less well adapted to tackling the full breadth of potentially abusive behaviour. This would expose investors to a possible risk of detriment at the hands of unscrupulous market participants. It would potentially add to the costs of trading. And it would potentially adversely affect investment by companies.

32. A less effective market abuse regime in the UK could also have adverse consequences for the single market in financial services. London is Europe's major center for securities trading. The integration of Europe's capital markets is most complete in wholesale financial markets where much of the trading activity takes place in London. Anything therefore that potentially damages the reputation of London as a financial centre damages Europe's wholesale financial markets.

⁷ Directive 2004/39/EC

BENEFITS AND COSTS

33. The sections below on benefits and cost do not take into account any environmental or social impacts arising out of the options considered. This is because none of the options directly impact on them. The operation of financial markets may have significant implications for sustainable development, but the directive does not directly impact on the environment or our natural resources. Likewise the operation of financial markets may have significant implications for the distribution of wealth and income, but the directive does not directly impact on the distribution of wealth and income. The focus of the analysis is therefore on the economic costs and benefits.

34. The main effects of potential changes to the market abuse regime will be felt by investors, financial intermediaries trading securities and by companies whose securities are admitted to trading on an exchange. The benefits and costs set out below are based on the impact on the around 2,900 companies authorised by the FSA at the end of March 2003 to conduct investment management and securities and futures business and the around 1,500 UK companies whose securities are admitted to trading on the main market of the London Stock Exchange. Some of the authorised firms will be small businesses. There are no small business amongst those admitted to trading on the main market of the London Stock Exchange.

35. When the market abuse regime was introduced in 1999 it was estimated that there was a cost of £500 an hour for firms in seeking advice on the regime (made up of internal costs and the costs of external legal advice). The calculations below have updated this to £610 an hour on the basis of increases in average earnings of those working on financial intermediation.

36. All the options involve the UK continuing to have a significant civil market abuse regime alongside a criminal regime. What they offer are variations on the boundaries of the civil regime. There are good grounds for believing that having an effective market abuse regime bring significant benefits; but it is less easy to determine the point at which the marginal benefits of a wider scope equal the marginal costs to investors and the industry of complying with the regime.

37. Market integrity matters for investors, intermediaries and companies. This is because it potentially impinges on liquidity of markets, which is the ability of markets to absorb fluctuations in trading activity without huge movements in prices. The lower the liquidity, the higher the risks and costs for investors and intermediaries and the more expensive raising capital is for issuers.

38. One crude measure of liquidity is spread – the difference between the best bid and offer prices in the market place. A calculation of the weighted average spread for FTSE 100 shares at a point on 16 June 2004 was 19 basis points (ie about a fifth of a percentage point). Based on total turnover in UK equities in 2003 of £1,540 billion, the spread cost was £2.9 billion. A 1 basis point increase in the spread using these figures would increase costs to the market of trading by £150 million. As one of the factors affecting liquidity and spreads, a market abuse regime has the potential to bring significant benefits.

39. Reduced interest in trading securities in the UK would also have direct effects on economic activity in a sector of the UK economy. Figures collated by International Financial Services London show that securities dealing in the UK accounts for 0.05 per cent of GDP and employs about 58,000 individuals.

40. The fact that all of the options involve the UK having a significant civil market abuse regime alongside a criminal regime limits the extent to which any of the options will change the compliance costs currently faced by industry. The one-off costs of change are likely to significantly outweigh any overall addition to annual compliance costs.

BENEFITS

Option 1

41. The main benefit of this option is that it would involve no change to the existing regime. Everyone could continue to work under a regime with which they are familiar. However, because the UK's existing regime does not give effect to all of the provisions in the directive (paragraph 13 above outlines the main differences), it is probable that the UK would be successfully infringed by the Commission for failure to implement the directive properly. At that stage the UK would have to change its regime, choosing either of the second or third options.

Option 2

42. Implementation of the regulations would minimise the changes to the UK's market abuse regime, including the regulation of investment recommendations. For those involved in the markets, the regime should be familiar. It should also eliminate the risk of infraction proceedings by the Commission.

43. This option would maintain the breadth of the current market abuse regime. Examples of the kinds of behaviour inside the breadth of the current regime but potentially not that of the directive are as follows:

(i) Behaviour that is broader than the MAD insider dealing offences of dealing based on information and improper disclosure of that information

The directive prohibits those who possess inside information from acquiring or disposing of financial instruments on the basis of the inside information. To commit an insider dealing offence under the directive it is therefore necessary to deal in financial instruments. However, the existing UK regime covers behaviour in relation to inside information, which is not restricted to dealing in financial instruments. Examples of the importance of this distinction include the following:

Fixed Odds Bet

Fixed odd bets on company share prices (eg placing £100 at 3 to 1 against that XYZ's share price will rise to £3.50 by the end of the month) are not financial instruments within the meaning of the directive. Placing a fixed odds bet on a company's share price on the basis of inside information cannot therefore be insider dealing under the directive, although it is behaviour based on inside information.

Pre-Hedging Convertible Bond Issues

The knowledge that a company is to make an issue of bonds which are convertible into shares in specified circumstances is inside information. Often the announcement of such an issue causes the price of the shares into which the bond can be converted to fall. To reduce their possible exposure to the price fall if not all of the bonds are purchased, once an announcement is made of the issue, the underwriter for the bond may seek to short sell the shares. If prior to the announcement they enter into an informal agreement to borrow shares to enable them to undertake the short selling this potentially disadvantages other market participants. Others may have difficulty locating shares to borrow to execute their own hedging strategies. But because the informal arrangement is not a deal as such, it could not be regarded as insider dealing under the directive, although it is behaviour based on inside information.

Stocklending

Investment institutions may lend out stock that they own. The price that they can charge for this service will partly depend on the demand to borrow a particular stock. In order to profit from inside information which they believe will lead to an increase in demand to borrow a stock they own, an investment institution may pull that stock from the stocklending market. This action also falls outside the directive definition of dealing, although it is behaviour that is based on inside information.

(ii) Behaviour based on relevant information that is not generally available ("RINGA")

The directive defines inside information as precise information which if made public would have a significant effect on the price of a financial instrument. However, the existing UK regime defines inside information as precise information which is relevant to the terms on which transactions in investments of the kind should be effected.

A general illustration of the difference between the two concepts is as follows. A company enters into negotiations with a possible major customer. Negotiations progress well. But before they have been completed and the final terms settled, someone with knowledge of the negotiations buys shares in the company. It is probable that the information is not sufficiently firm for a determination to be made as to whether it would have a significant impact on the share price. However, this information could still be relevant information, and behaviour based on that information would still be unacceptable, under the existing UK regime.

(iii) Behaviour that is likely to amount to market manipulation

The directive defines, in part, market manipulation as transactions or orders to trade that distort a market or give false or misleading impressions about the market for a financial instrument. However, the existing UK regime covers behaviour which is likely to distort a market or give false or misleading impressions about the market for a financial instrument. Examples of the importance of this distinction include:

Movement of physical commodities

Someone might seek to benefit from positions taken out in commodity derivatives (eg metals and oil futures) by creating a misleading impression as to the supply of a commodity. This could be done, for example, by the movement of an empty cargo ship which encourages people to think that supply of the commodity is higher than it actually is, potentially pushing futures prices down. There is no transaction or order to trade in commodity derivatives giving a false or misleading impression, but it is behaviour which gives a false or misleading impression about the market for a financial instrument.

Behaviour as a result of inaction

Behaviour as a result of inaction can also result in market manipulation, in particular a false or misleading impression. For example, failure to disclose information required by the UK Listing Rules could result in a false or misleading impression as to the price of a security.

44. Perhaps the most significant benefit of retaining the existing scope is that it ensures that the Ofex and AIM remain within the scope of the regime. These are the two most successful junior equity markets in Europe (in terms of the number of companies traded on the markets), and many companies have graduated from them to the London Stock Exchange's main market. Both markets wish to remain within the scope of the regime. They see it as being an important component of encouraging investor interest in the companies traded on their markets, by providing reassurance that abusive behaviour in relation to the markets will be punished. Such protection benefits the markets, investors and the companies whose securities trade on these markets. Over 800 UK companies have securities trading on AIM and over 130 UK companies have securities trading on Ofex. Retaining the existing scope would also avoid disruption in respect of commodity derivatives markets run by the International Petroleum Exchange and the London Metal Exchange. They are caught in the scope of the UK's existing regime but outside the scope of the directive until the Markets in Financial Instruments Directive is implemented, at the end of April 2007.

45. The main benefits from subjecting to sunset clauses the provisions which go beyond the directive in respect of the range of offences covered are:

- It enables an evidence-based approach to be taken to the determination of whether these provisions should be incorporated in the UK's market abuse regime in the long term;
- It creates a clear presumption that the benefits of having these provisions have to exceed the costs for them to be renewed.

Option 3

46. Replacing the UK's existing regime with that in the directive would eliminate any risk of proceedings by the Commission for failure to implement properly. It would also leave the UK with a regime dealing with the main aspects of market abuse and market integrity, and allow self-regulation of investment recommendations produced by or disseminated through the media.

COSTS

Option 1

47. There would be no new costs for investors, intermediaries or companies in the short term. But potentially the government would have to bear the costs of infractions proceedings. Such proceedings would involve policy and legal input within government and the use of external legal resources. The internal input might require 200 hours of policy input and 200 hours of legal input. At an average cost of £30 an hour this would cost £12,000. About 50 hours of external legal advice might be required. At an average cost of £250 an hour this would cost £12,500.

48. If the infraction proceedings proved successful, the European Court of Justice could levy unlimited infraction fines for each day that the directive is not implemented. At this point investors, intermediaries and companies would then need to bear the costs of either of options 2 or 3 depending on which was chosen to bring the UK's regime into compliance with that in the directive.

Option 2

49. Adapting to a new regime will involve costs. The one-off compliance costs for intermediaries will vary from firm to firm depending upon their involvement in the market. At the time of the introduction of the market abuse regime in FSMA it was estimated that intermediaries would require, on average, ten hours of time to prepare for the new regime. There is likely to be dispersion around this average. Costs are likely to be lowest for smaller brokerage firms executing straightforward client orders for retail customers. They are likely to be highest for firms executing more complex trades whether on a proprietary basis or on behalf of institutional clients.

50. There is no reason to believe that the introduction of the directive should be more costly than the introduction of the regime in FSMA. It may well be less costly. The FSA do not believe that there will be significant costs for business arising out of the changes to their Code of Market Conduct which flow from changes to legislation. Updating the costs of introducing the original UK regime to provide an upper limit of the estimate of one-off implementation costs produces a figure of approximately £17 million.

51. There should be little incremental addition to the ongoing compliance costs of financial intermediaries relative to the position before the implementation of the regulations. The main new obligation arising out of the directive for intermediaries, to report suspicious transactions, is being implemented through FSA rules rather than new obligations in primary or secondary legislation.

52. Companies with securities admitted to trading on regulated markets would also need to adapt to the provisions arising out of the requirements to keep lists of those with access to inside information and the widened obligation to disclose managers' transactions in the shares of their own companies. The compliance costs arising out of the requirements for insider lists should not be significant. Whilst there is currently no formal legal requirement in this area, issuers already maintain insider lists as a matter of good practice. The widening of the obligation to report managers'

transactions is likely to add to costs. The FSA estimates one-off costs of £21 to £34 million. This is based on the costs of taking legal advice in relation to the new obligation and the costs of educating those required to disclose their transactions. The detail of how the figures are arrived at are set out in the table below:

	Smaller UK quoted companies £000s	Large UK quoted companies £000s	UK multinational corporations £000s
One – off legal advice	5 - 10	15 - 20	15 - 30
One-off training costs	5 – 10	10 - 20	15 - 30
Total numbers	900	250	100
Total cost	£9 to £18 million	£9 to £10 million	£3 to £6 million

The figures are based on an average charge out rate of £300 for a partner and £150 for an assistant in a law firm. The figure is expected to be higher for issuers with multi jurisdictional and complex structures. The assumption has been that a partner will spend up to 15 hours and an assistant up to 40 hours of chargeable time on advising on the matter. This assumption increases to up to 30 hours for a partner and 70 hours for an assistant advising on the matter for a large corporate and up to 45 hours for a partner and 70 hours for an assistant advising on the matter for a large corporate and up to 45 hours for a partner and 110 hours for an assistant for a FTSE 100 issuer.

53. The FSA also estimates additional annual compliance costs of £260,000 for extra announcements to the market. This is based on the average cost of a dealing announcement being £50 and a 50 per cent increase in the number of dealing announcements from their current level of 42 per day (which was the average between 1 June 2003 and 31 May 2004).

Option 3

54. Those dealing on UK markets would not be subject to a wider market abuse regime than those dealing on non-UK markets. Implementation of the directive across the EU will actually serve to narrow the existing differences between the UK and other EU countries. We are not aware of any evidence that the current breadth of the UK's regime has led to any trading activity moving to other financial centres with narrower regimes. Implicitly any additional costs are lower than the benefits of continuing to trade in securities on these markets. Over 800 UK companies have securities trading on AIM and over 130 UK companies have securities trading on Ofex.

55. This option will involve one-off costs of adjustment. The costs for issuers would be identical to those under the previous option (£21 to £34 million) as the obligations would be identical. The costs for intermediaries are also likely to be very similar to the previous option (a maximum of £17 million). Whilst the regime would be less broad than under the previous option, it would represent a bigger change to the status quo.

56. Again the ongoing additional costs for issuers relative to their existing costs will be identical to the previous option (£260,000 a year). Ongoing compliance costs for intermediaries might be lower than currently for two reasons: this option narrows the differences between the UK's regime and those in other countries making life easier for those doing business in other countries as well as the UK; and it has a narrower scope relative to the existing regime. If, on average, companies trading in securities save 2 hours of compliance/legal advice a year, there would be an annual cost saving of £3 million a year.

EQUITY AND FAIRNESS

57. The proposal impacts equally and fairly across all sectors of society and does not disadvantage any particular group.

THE SMALL FIRMS IMPACT TEST

58. The two main groups who will be affected by the regulations were identified above as firms authorized by the FSA to conduct investment management and securities and futures business and firms whose securities are admitted to trading on regulated markets in the UK. There will be some small firms in the former category, there are none in the latter category.

59. All the firms authorized to conduct investment management and securities and futures business currently have to work within a market abuse regime. Implementation of the directive will not therefore impose significant new burdens on the small firms in this sector. And there is no reason to believe that behaving in an ethical manner, which is in effect what the directive is about, is any more difficult for small than large firms.

60. Option 2 above would involve more complexity than option 3. This may be more difficult for small firms to handle than large firms. But the extent of the difficulties should not be great. Option 2 would leave the market abuse regime very close to where it is now.

61. One of the respondents to the consultation document was a trade association whose membership includes smaller firms authorised to conduct investment management and securities and futures business. They said that they agreed that the scope of the markets covered and offences in FSMA should remain unchanged as per option 2 above, provided this minimised the impact on their member firms.

COMPETITION ASSESSMENT

62. Given that the regulations would introduce largely incremental change to an existing regime, they should not have a significant effect on competition.

63. Two main markets are likely to be affected by the implementation of the Market Abuse Directive. The market for the provision of exchange services, and the market for the provision of intermediary services linked to securities dealing.

64. Because of the network externalities associated with liquidity, the market for exchange services is dominated by a small number of companies. However, the market is contestable. For example, there is currently three-way competition between exchanges in the trading of Dutch equities. Exchanges have two main assets: their brand and their trading technology. An important part of their brand is a reputation for probity. Requirements under the directive for exchanges to have structures to prevent and detect market abuse (which already exist in UK legislation) do not constitute a barrier to entry but an essential component for any exchange wanting to attract liquidity.

65. There are around 2,900 firms in the UK authorised by the FSA to manage investments and to deal in securities and futures. In addition there are branches of firms authorised elsewhere in the EEA doing the same business in the UK. Together these firms include major international investment banks as well as a large number of others, including some small firms. All face the same market abuse regime and all need to understand it. The regime should not, however, bear disproportionately on smaller firms. It is no more difficult for a small firm to act with integrity towards the market than for a large firm. The day to day obligations directly imposed on those trading securities by the directive are limited; (the main obligation is to report suspicious transactions). For the same reason, the regulations should not constitute a barrier to entry to the securities trading industry.

ENFORCEMENT AND SANCTIONS

66. The Government, through the Financial Services and Markets Act 2000 (FSMA), delegated the power of enforcement of the market abuse regime to the Financial Services Authority (FSA). FSMA requires a separation between those investigating possible cases of market abuse and those taking decisions on enforcement action. Investigation and recommendations for decisions are carried out by FSA staff. Decisions on enforcement are made by the Regulatory Decisions Committee which is composed of market practitioners and lay persons. Appeals against decisions of the RDC can be made to the Financial Markets and Services Tribunal, a separate body run by the Department for Constitutional Affairs. The existing enforcement arrangements would remain as they are under each of the three options above.

Sanctions

67. Article 14 of the directive requires administrative sanctions as a minimum standard. Currently, under FSMA, the FSA has the power to impose, on those that have engaged in market abuse, a financial penalty of such an amount as they consider appropriate. They can also choose not to impose a penalty but to publish a statement to the effect that a person has engaged in market abuse. Under each of the options above, the range of sanctions remain the same.

MONITORING AND REVIEW

68. A suggestion has been made by a group of financial markets experts appointed by the Commission that there should be a “...*full and public assessment of the impact of the FSAP within four years of its completion...*”. This is a suggestion that is endorsed by the UK.

69. Once the Market Abuse Directive is implemented, the Government will look seriously at any examples brought to its attention where our implementation is more onerous than that in other member states. The UK authorities will also press for the effective co-operation of European securities supervisors to address different approaches to implementation. Under option 2, the UK would review how the regime is operating, before the sunset clauses on the provisions which go beyond the requirements of the directive (in respect of the offences covered) take effect.

70. The sort of factors that the review would consider include the following:

- the types of enforcement case brought under the FSMA and post-directive market abuse regime;
- how well, and easily, the scope of the UK's market abuse regime is understood by financial market participants;
- the processes required to train people to understand their obligations under the regime;
- the processes that in-house legal and compliance functions and external legal advisers go through in providing advice on compliance with the regime;
- evidence of the impact, of going beyond the minimum requirements in the directive, on the costs of compliance of financial market participants;
- evidence of the impact, of the UK going beyond the minimum requirements in the directive, on the conduct of cross-border business, either out of or into the UK;
- how the directive has been implemented and enforced in the other EU member states;
- how the operation of the UK's market abuse regime compares with that in the United States.

CONSULTATION

71. Prior to 18 June 2004, the Treasury held informal consultations, including two roundtables, with assorted industry representatives, from both trade associations and individual companies, from exchanges and from investment banks. These consultations helped to shape the regulations which were put out in a consultation document on 18 June 2004.

72. In particular, the informal consultations influenced the broad architecture of the new s118 of Part 8 of FSMA. The shape of the part of the regulations dealing with investment recommendations was also influenced by a discussion of broad options with representatives of media organisations including working journalists.

73. The public consultation closed on 10 September 2004. There were over 30 responses from companies and from trade bodies, representing markets, intermediaries, issuers, the media and lawyers. The main points to emerge from the consultation were as follows:

- **Coverage of markets.** There was very widespread support, including from the markets affected, to the proposition that the UK's regime should cover non-regulated markets run by recognized investment exchanges and the Ofex market.

- **Offences covered.** There was a mixed reaction to the proposal to have offences going beyond the minimum required in the directive. Those on the buy side and companies who issue financial instruments, were content on the grounds that the scope of the existing regime is familiar and that its breadth provided important protections for investors. The proposal was opposed, particularly in respect of insider dealing, by major intermediaries who argued it created complexity for little additional benefit.
- **Trading information.** Concern was expressed, particularly by the major intermediaries, that a “trading information” defence, included in section 5 of the Criminal Justice Act 1993, when implementing the 1989 Insider Dealing Directive, was not included in the legislation implementing this directive.
- **Investment recommendations.** Respondents mainly wanted clarification about the scope of the regulations.

74. Given the broad support for including more markets than required by the directive, it is being proposed that the UK should press ahead with covering the list of markets indicated in the consultation document.

75. Reflecting the mixed responses to the consultation on going beyond the directive in respect of the offences covered, the proposal is that these provisions should be subjected to sunset clauses and their effect reviewed.

76. On the trading information issue, it has been decided that including a defence on the face of the legislation which defines market abuse would not be appropriate. There is no such defence on the face of the directive. The recitals in the directive which industry has pointed to as providing the basis for such a defence are paralleled in the FSA’s Code of Market Conduct. The effect of these recitals will be clarified in the Code to meet the concerns expressed.

77. The investment recommendation regulations have been clarified. They make it explicit that they cover the media and relate to activities taking place in the UK.

RECOMMENDATION

77. **Option 2** is recommended. The UK’s civil market abuse regime is an important tool for helping to achieve two of the statutory objectives for the Financial Services Authority set out in the Financial Services and Markets Act: the promotion of market confidence and the reduction of financial crime. In the light of these objectives it seems premature to narrow the scope of the offences covered by the regime, given that we currently only have limited evidence of the way in which the regime works and how the directive will be implemented in other member states.

78. Making the provisions relating to offences which go beyond those in the directive subject to sunset clauses has two beneficial effects. Firstly, it makes clear that the retention of the provisions has to be based on evidence gathered. Secondly, it provides the time for more evidence to emerge about the operation of the existing

regime and the impact of the implementation of the directive in the UK and elsewhere.

Costs and Benefits

Option	Total cost per annum	Total benefit per annum
(1) Do nothing	No incremental costs £24,500 cost of fighting infractions proceedings Fine of uncertain amount if infractions proceedings are successful	No incremental change in benefits
(2) Implement regulations	£17 million one-off implementation costs for intermediaries. £21 million to £34 million one-off implementation costs for issuers £260,000 addition to annual compliance costs for issuers.	No incremental change in benefits
(3) Implement scope of directive	£17 million one-off implementation costs for intermediaries. £21 to £34 million one-off implementation costs for issuers. £3 million annual reduction in annual compliance costs for intermediaries.	Unquantifiable incremental reduction in the benefits of the existing regime through a narrowing of the market abuse regime.