

**Explanatory Memorandum To The
Financial Services and Markets Act 2000 (Market Abuse) Regulations
2005**

2005 No.

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.