FSMA market abuse regime: a review of the sunset clauses

A consultation

February 2008

HM TREASURY

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Executive Summary

Market abuse is a serious offence that damages investor confidence and the integrity of financial markets. A robust and effective regime for tackling market abuse is therefore a key component of the regulatory architecture. This consultation seeks views on the appropriate scope of the UK's civil market abuse regime.

The UK currently has a wider definition of market abuse than that established in the EU's 2003 Market Abuse Directive (MAD). The UK definition retained the then existing (and wider) scope of the UK market abuse regime that had been introduced in 2001. There were mixed views as to the merits of a 'superequivalent' regime and so HM Treasury committed to review the regime's scope by May 2008 to assess whether the superequivalences remained justified. This consultation paper considers whether the wider scope remains desirable.

Superequivalences can create costs for firms and can hinder the establishment of an effective single market. They create particular challenges for firms operating across Europe - UK firms have not benefited fully from the work the Committee of European Securities Regulators (CESR) has undertaken to harmonise market abuse regulation. The Government has committed only to introduce superequivalences where there are demonstrable benefits that exceed the costs.

The practical benefits of the superequivalent elements of our market abuse regime have arguably been quite limited to date. The offences have not been used since 2005 and industry has a mixed understanding of the specific offences that are prohibited. However, the superequivalences have provided welcome reassurance to investors that the FSA has a wide range of powers to protect their interests. The costs of the superequivalences are hard to determine – best estimates suggest the additional work involved, such as obtaining legal advice, could amount to around £4.8 million a year.

The directive itself has largely been regarded as a success. While there is limited quantitative analysis of whether it has delivered clean markets, it has been successfully used to bring prosecutions in the UK and elsewhere.

There are, however, aspects of the MAD regime that have been identified as problematic where the UK superequivalences may offer benefits. An EU industry group has criticised the use of a single definition of 'inside information' for determining both disclosure obligations and market abuse offences and has called upon the EU to address this in its 2008 review of the MAD. The UK currently has different definitions of inside information for these two requirements. There is also uncertainty as to whether Credit Default Swaps are covered by the MAD regime.

The EU review of MAD means that changes to the UK regime in June 2008 as a result of our domestic review could rapidly be overtaken. Two sets of changes in short order appears to pose unnecessary costs on industry – particularly where some of those costs could be to re-introduce requirements which had only just been removed.

Our aim is that the EU review should deliver an outcome that we consider fully satisfactory for combating market abuse. Therefore we consider a short extension to the current superequivalences beneficial, until the outcome of the EU review is known. This would enable a wider consideration of the benefits of the superequivalences in the context of the forthcoming EU review and would minimise transition costs for industry. We would welcome views from industry by 7 May 2008.

1 INTRODUCTION

1.1 This consultation paper seeks views on the appropriate scope for the UK's civil market abuse regime. The UK currently has a wider definition of market abuse than that established in the EU's 2003 Market Abuse Directive (MAD or the Directive). The UK definition retained the then existing (and wider) scope of the UK market abuse regime that had been introduced in 2001. There were mixed views as to the merits of a 'superequivalent' regime and so HM Treasury committed to review the scope of the regime by May 2008 to assess whether the superequivalence remained justified. This consultation paper considers whether the wider scope remains desirable.

What is market abuse?

1.2 Market abuse is defined in the Directive as either insider dealing or market manipulation. The UK regime is superequivalent in relation to both these types of behaviour.

- insider dealing: where insiders use or seek to use certain information that is not publicly available ('inside information'), to their own advantage or to the advantage of others.
- market manipulation: where someone seeks to distort the price of financial instruments, or effect transactions or orders to trade or disseminates information in a manner that gives or is likely to give false or misleading signals about financial instruments.

1.3 Market abuse results in some investors being unfairly and unreasonably disadvantaged. Controlling market abuse is therefore important to maintain market integrity and investor confidence. Clean markets are an essential part of the integrity of London as an international financial centre.

1.4 Tackling market abuse is a key objective for the FSA. Nevertheless incidences of market abuse remain high. The FSA's research suggests 24% of takeover announcements in 2005 were preceded by informed price movements, which may be indicative of suspicious trading activity. This level that has changed little since the introduction of the market abuse regime in 2001.[1] It is therefore important to continue to review and where necessary improve the legislative framework.

The Review

1.5 The objective of this Review is to decide whether or not to keep the superequivalent provisions within the UK's market abuse regime. In deciding this, HM Treasury will have regard to:

- The importance of ensuring adequate powers for delivering market integrity and maintaining confidence in London's financial markets.
- The principles of 'Better Regulation': regulation should be proportionate, accountable, consistent, transparent and targeted.
- The support of innovation, competition and efficiency in the financial system.

[1] http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/031.shtml

Scope of the Review

1.6 The transposition of the Market Abuse Directive involved a range of changes to UK legislation and FSA rules. This consultation focuses solely on the two superequivalent elements of our market abuse framework: 118(4) and 118(8) of the Financial Services and Markets Act (FSMA)[2]. These elements were made subject to sunset clauses. This means that the provisions will fall away on 30th June 2008 unless extended.

- Section 118(4) of FSMA concerns behaviour not covered by the Directive's prohibitions on insider dealing. This uses a different definition of information that can be abused, 'RINGA' – relevant information not generally available rather than 'inside information' used in the Directive provisions.
- Section 118(8) of FSMA covers behaviour giving rise to false or misleading impressions or distorting markets. This uses a broader range of behaviours than those in the Directive provisions.

1.7 These superequivalences are not related to the obligations placed on firms under the Market Abuse Directive to disclose price sensitive information. Separate work is being taken forward to consider whether reform of these obligations is required.[3]

1.8 A third area of superequivalence extends the scope of the market abuse provisions (but not the disclosure obligations) to 'junior' markets in the UK, such as the AIM and PLUS markets. The Directive itself only covers the regulated markets (such as the LSE's main market). The coverage of these 'junior' markets was not contentious, is not subject to a sunset clause, and so is not being reviewed.

Next steps

1.9 There will be further meetings with interested stakeholders during the consultation period – anyone wishing to be included in this process should contact Sarah Parkinson at HM Treasury (contact details below). After the consultation period closes, a feedback statement will be published collating the responses and explaining how we have reflected them in the final proposal. The agreed policy will come into effect by 30 June 2008.

Organisation of the consultation paper

1.10 The main body of the consultation paper is organised into four sections:

- Chapter 2. UK Market Abuse Policy – this gives an overview of the UK regime and explains the nature of the superequivalences.
- Chapter 3. Evidence on the Operation of the Superequivalances – the impact of the superequivalences since implementation of the Directive.
- Chapter 4. Policy Proposals – this sets out the preferred policy proposal.
- Chapter 5. Impact Assessment – this looks at the costs and benefits of the policy proposals under consultation.

[2] Full copy available at: http://www.opsi.gov.uk/si/si2005/20050381.htm

[3] http://www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf

Responding to the consultation

1.11 This consultation document represents part of a wider process of discussion and engagement with industry. In particular we have discussed our ideas with representatives of the investor community as well as the banking sector.

1.12 HM Treasury invites comments on this consultation by 7 May 2008. A specific list of questions is included in subsequent sections, but respondees are, of course, free to frame their responses as they see fit.

Please could comments be sent to:

Sarah Parkinson

Market Abuse consultation

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1 Horse Guards Road

London

SW1A 2HQ

Email: Sarah.Parkinson@hm-treasury.x.gsi.gov.uk

NB: Our preference is to receive responses in electronic format only (all e-mail responses will be acknowledged).

Queries about this consultation document should be addressed to:

Sarah.Parkinson@hm-treasury.x.gsi.gov.uk

Telephone: 020 7270 5912

Confidentiality disclosures

1.13 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental information Regulations 2004).

1.14 If you want the information that you provide to be treated as being confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request to disclose the information we will take account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

1.15 HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

2 UK Market Abuse Policy

2.1 The UK has had some form of market abuse regime since 1980. This length of experience with a market abuse regime is relatively unusual. Internationally, market abuse rules are comparatively new – before 1990 only 34 countries had market abuse rules and only nine of these had brought prosecutions.[4]

2.2 Tackling market abuse is a core objective for the FSA. 'Maintaining confidence in the financial markets' is one of the FSA's four statutory objectives contained in the Financial Services and Markets Act. Moreover certain types of market misconduct (i.e. insider dealing and misleading statements and practices) constitute financial crimes, which in the view of Parliament are serious enough to warrant a sentence of up to seven years imprisonment.

2.3 The EU has also recognised market abuse as a key issue. The EU first established powers in this area in the 1989 Insider Dealing Directive, and the 2003 Market Abuse Directive was a key part of the Financial Services Action Plan.

Why it matters

2.4 Market abuse rules are recognised as important in supporting the integrity of a financial centre. Specific benefits from robust market abuse regimes have been shown to include the possibility of greater ownership dispersion, more informative stock prices and greater stock market liquidity.[5] Research has suggested that market abuse increases the cost of equity, as shareholders demand a higher rate of return to compensate for the fact that they find it difficult to analyse firms.[6] Insider trading has also been shown to increase market volatility.[7] An effective market abuse regime is therefore an essential part of a successful capital market.

The FSA's powers to tackle market abuse

2.5 Reflecting the importance of market abuse, the FSA has a range of powers it can use to tackle market abuse. These encompass civil, criminal and regulatory powers. Its civil and criminal powers can be used in relation to any person, but actions for breaches of regulatory requirements, such as the FSA's Principles for Businesses, can only be brought against those the FSA regulates. The superequivalences form part of the civil regime, which is discussed in further detail below. Background information on the other powers that the FSA can use is set out in Annex C.

The civil market abuse regime

2.6 The UK's civil market abuse regime is contained in section 118 FSMA, which describes seven different types of behaviour that amount to market abuse.

2.7 Five of these behaviours reflect the requirements of the Directive. These provisions have been in force since July 2005 and capture insider trading, improper

[4] Bhattacharya, U., Daouk, H., (2002). The World Price of Insider Trading. *Journal of Finance, 57*(1), 75-108

[5] Beny, L.N. (2007). Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate, *Journal of Corporation Law, 32*(2), 237-300

[6] Bhattacharya, U., Daouk, H., (2002). The World Price of Insider Trading. *Journal of Finance, 57*(1), 75-108

[7] Du, J., Wei, S-J., (2004). Does Insider Trading Raise Market Volatility? *Economic Journal 114*(498), 916-942

disclosure, market manipulation through the use of manipulating transactions, market manipulation through the use of manipulating devices (such as a form of deception or contrivance), and behaviour giving rise to a false and misleading impression through dissemination of information.

2.8 The remaining two categories of abusive behaviour, capturing general misuse of information (section 118(4) of FSMA) and behaviour that is likely to give rise to a false or misleading impression or to market distortion (section 118(8) of FSMA), are the superequivalent provisions that are the subject of this Review. These clauses can only be applied where the behaviour does not fall within the terms of the five Directive provisions and the key differences they make to the UK regime are set out below.

2.9 The superequivalent clauses reflect the market abuse regime in place in the UK prior to the implementation of the Directive. The UK reviewed and materially revised its market abuse regime in 2001 to introduce a civil regime. The superequivalences reflect the difference between the 2001 regime and that introduced by the Market Abuse Directive.

2.10 There are five key differences between the UK regime and the MAD regime:

- The Directive provisions, implemented through sections 118(2) and (3) FSMA, rely on the concept of ‘inside information’ whereas section 118(4) relies on the concept of ‘relevant information not generally available’ (‘RINGA’). RINGA is wider in scope than ‘inside information’, which has a prescribed meaning. Accordingly, section 118(4) captures behaviour based on a wider set of information than under the Directive provisions.
- The Directive provisions require some specified positive action (e.g. dealing, effecting trades, disseminating information etc.); the superequivalent provisions focus on ‘behaviour’ that might capture inaction. So, for example, a failure to correct information that gives a false or misleading impression could fall within the scope of section 118(8).
- The Directive provisions in sections 118(2) and (3) require the existence of an ‘insider’, and the term ‘insider’ is defined. Section 118(4) does not require an ‘insider’ so there may be circumstances where, notwithstanding the absence of an identifiable insider, enforcement action may be brought under section 118(4) which could not be brought under sections 118(2) or (3).
- The different definitions of investments to which the provisions apply have the effect of varying the scope of the regime depending on which provisions apply.
- The different market coverage of the two sets of provisions.

2.11 These differences and their potential to deliver enhanced market integrity are described in more detail below.

RINGA

2.12 The definition of ‘inside information’ used in the Directive is narrower than the definition of ‘relevant’ information used in the superequivalent provisions. The primary reason for this is that the relevant part of the Directive is based on the 1989 Insider Dealing Directive (implemented in the UK in Part V of the Criminal Justice Act 1993). Difficulties were experienced in the UK in prosecuting the Part V Criminal Justice Act 1993 offences and the civil market abuse regime introduced by FSMA at N2

(1st December 2001) was in part designed to address these difficulties. The civil regime entails a lower standard of proof. In addition, a deliberate decision was taken at the time of implementation of the civil regime to broaden the type of information covered by the civil regime to use the 'relevant' test, in part due to the difficulties experienced under the criminal regime in proving the 'price sensitivity' of a particular piece of information.

2.13 In practice while the UK has different definitions of 'inside information' for disclosure and market abuse provisions, there is nevertheless a connection between the two. The FSA recognises in the Code of Market Conduct ('the Code') that behaviour based on undisclosed information which is required to be disclosed or announced will be regarded as unacceptable by the regular user and therefore amount to market abuse. This often reverts in effect to whether the disclosure obligations in the Disclosure and Transparency Rules (DTR) apply, which use the Market Abuse Directive 'price sensitive' test. However, this is not an exhaustive or exclusive test, with behaviour based on other 'relevant' information capable of constituting abusive behaviour. In particular, information can be abused for trading purposes before it is precise or certain enough for the issuer to be under an obligation to disclose it. Judging the precise point at which a piece of information becomes 'disclosable' even under DTR is often difficult. The FSA therefore discusses explicitly in the Code that behaviour based on 'relevant information' which is likely to be disclosable in the future is unacceptable, even if it is less clear at that point in time that the information amounts to 'inside information' which is price sensitive and needs to be disclosed.

2.14 The use of different definitions for information that is required to be disclosed and that which is capable of being abused is a feature of the UK regime introduced in 2001 and maintained on the adoption of MAD. This distinction was seen as important by investor groups who feared that omission of this provision would allow people to trade to their advantage and to the disadvantage of others on the basis of information not generally available to investors, for example, information about the state of negotiations over a major contract.

2.15 The lack of a similar split in the Directive has been the subject of some negative comment by the European Securities Markets Experts (ESME) group, which will be considered further by CESR and the European Commission in 2008 (see Chapter 4 for more detail).

Behaviour

2.16 The Directive provisions require some specified positive action whereas the superequivalent provisions simply require 'behaviour'. As a result the superequivalent provisions may capture certain additional types of behaviour. Key examples include the behaviours listed below.

2.17 The Directive, in focussing on transactions or orders to trade, does not extend to tackling 'inaction' where this can have an impact on the market. An example of where inaction can have a misleading effect on the market is where a regulatory disclosure is required and this is not made. While this is likely to constitute a breach of the listing or disclosure rules, in serious cases it may also be regarded as market abuse. Non-disclosure of major shareholdings can also result in the market being misled as to the true composition of the shareholder base of a company and may conceal the intention of a shareholder to accumulate a significant stake.

2.18 The placing of a fixed odds bet on the future share price of a company on the basis of information an individual has received that is not yet public, concerning a takeover approach for that company, is unlikely to fall within the definition of 'dealing'

in the Directive and this behaviour would not be addressed by the Directive's provisions. It would however amount to 'behaviour' in relation to the company's shares and so could be subject to the superequivalent provisions.

2.19 An analyst possesses inside information knowing it will be disclosed the next day when the market opens. He amends his forecasts and prepares an amended research report providing commentary on the information that will take time for the market to digest. As a result he gets a significant 'first mover' advantage since his amended work is published seconds after the information is disclosed. This would be 'behaviour' based on the information, but may not amount to insider dealing as defined by the Directive.

2.20 The Directive provisions may not cover limiting the supply of a physical commodity product in order to squeeze a related commodity futures contract. The futures trades would fall within the scope of the Directive provision, but the squeezing of the physical market, or interfering with the supply/delivery mechanism would not. Aside from the more obvious examples such as withholding supply of physical product from the delivery mechanism or interfering with the grading process to influence the amount of deliverable product, the superequivalent provisions could also cover apparent movements of goods which are being undertaken to give the impression of supply when this is not in fact the case.

2.21 A company director approaching retirement decides to begin selling his sizeable holding in the company's shares to release some capital. He knows the market is fairly illiquid and due to the size of the stake he instructs his broker to begin searching for buyers at the best price he can find. The next day he is called to an emergency board meeting to be told that the company has received a takeover approach from another company at a 20% premium to the current share price. Following the meeting the Director calls his broker, tells him he has changed his mind and will hold onto his shares for the time being. There is no 'dealing' on the basis of the inside information, but the director's actions do constitute 'behaviour' and are arguably unacceptable. This scenario may be hard to detect since it amounts to 'not dealing' based on inside information, but it is the sort of behaviour that may arouse suspicions in the broker's mind, particularly if the bid approach were to be announced days later. In such circumstances the broker may be required under the FSA's rules to provide a Suspicious Transaction Report, which may then lead to further enquiry by the FSA.

Insiders

2.22 It is a requirement under the Directive provisions of sections 118(2) and (3) that the individual be an insider either by virtue of how he obtained the inside information or because he knew or could reasonably be expected to know that the information in his possession was inside information.

2.23 Demonstrating that the information came from an inside source can be a significant hurdle where there are many people involved in the activity e.g. a network of contacts used to pass information to the person ultimately dealing. Some groups of individuals who have access to inside information arrange their affairs in a sophisticated way in an attempt to disguise the nature of the information being passed or the fact of it passing – often referred to as an insider ring. Such systematic abuse is a serious concern but given the evidential hurdles is often extremely difficult to take action against.

2.24 The superequivalent provision of s118 (4) helps to overcome this difficulty, as the provision requires no proof of how the information being abused was obtained.

The FSA need only show that the information was RINGA, i.e. information not generally available that the regular user would be likely to regard it as relevant.

Instruments **2.25** The Directive sets out the scope of the regime both in relation to the markets covered and the specific instruments. Given the pace of innovation and the levels of increasing complexity in the capital markets it is possible that the definitions used in the Directive have become out of date.

2.26 There has been some doubt about whether the Directive covers credit default swaps (CDS), which have become increasingly important instruments in the credit markets. CDSs are not traded on prescribed markets and so behaviour in relation to them does not fall within section 118(1)(a)(i). However, the Directive regime also covers 'related instruments', by section 118(1)(a)(iii). Insider dealing in CDSs will therefore only fall within scope (subsection 118(2)) if they are 'related investments' in relation to qualifying investments.

2.27 Related investment is defined in the legislation as 'an investment whose price or value depends on the price or value of the qualifying investment'. There may be circumstances where the price or value of the CDS depends on the price or value of the underlying security, but there is significant doubt that this will always be the case.

2.28 However, the position is different under the superequivalent provision set out in section 118(4). As well as applying to behaviour that occurs in relation to qualifying investments admitted to trading on a prescribed market, this subsection also applies to behaviour that occurs in relation to investments whose subject matter is the qualifying investments (section 118A(3)).

2.29 Although each case has to be considered individually, it is more likely that a CDS could be shown to have as its subject matter the underlying security than that its price or value depends on that of the underlying. In other words CDSs are much more likely to be caught by the superequivalent provisions. It is difficult to obtain precise figures on the scale of the CDS market in the UK, but this is likely to be a significant proportion of the $45 trillion global market. If the superequivalent provisions were to lapse then trading in these securities, even where based on information closely held by the issuer of the underlying, would very probably be outside the scope of the market abuse regime.

Market Coverage **2.30** The market coverage of the superequivalent provisions also differs from that of the Directive. Both sets of provisions require that the abusive behaviour occurs either within the UK or in relation to qualifying investments traded on a prescribed market situated or operating in the UK (or related investments or investments with such qualifying investments as their subject matter, as described under 'Instruments' above). The markets prescribed for the purposes of the Directive provisions include EU regulated markets as well as UK recognised investment exchanges and PLUS markets. For the superequivalent provisions the prescribed markets are limited to UK recognised investment exchanges and PLUS markets, because they reflect the UK's earlier domestic regime.

Penalties **2.31** The process for investigating and taking enforcement action for a breach of section 118 is the same whether the behaviour falls within the terms of the five Directive provisions or the two superequivalent provisions. The FSA may impose an unlimited fine or a public censure for any behaviour amounting to market abuse within the terms of section 118.

Overall **2.32** The issues addressed by the superequivalences cover behaviour that could

impact on market integrity and which market participants would be unlikely to deem desirable or acceptable. The most notable elements are probably the potential ability to control abuse in relation to 'relevant' information and behaviour in the CDS market, which is of significant value.

2.33 Were the superequivalences to fall away the FSA would still be able to bring an action for breach of its principles for these matters against authorised firms and approved persons. However, these powers do not cover all people that might carry out such abuses.

2.34 While there is clear theoretical benefit to the superequivalences, it is nevertheless important also to look at what practical benefit they have delivered and at what cost. The evidence gathered to date on the impact of the superequivalences over the past two and a half years since their introduction is discussed in the following section.

Q1: Do you consider that the superequivalences increase the effectiveness of our regime and have an effect on market integrity?

Q2: Which of the identified differences do you see as most important and why?

3 EVIDENCE ON THE OPERATION OF THE SUPEREQUIVALENCES

3.1 Alongside the theoretical benefit of retaining the superequivalences, it is also necessary to consider evidence of their practical operation over the past two and a half years. The feedback statement covering the 2005 implementation of the Market Abuse Directive set out a number of issues that would be considered in reviewing the impact of the superequivalences.[8]

- Enforcement: the types of enforcement case brought under the Directive market abuse regime.
- Market understanding: how well, and easily, financial market participants understand the scope of the UK's market abuse regime.
- Costs and competitive impact: the impact of going beyond the minimum requirements in the Directive on the costs of compliance of financial market participants and on the conduct of cross-border business either out of or into the UK.
- Foreign rules and implementation: how the Directive has been implemented and enforced in other EU member states and how the operation of the UK's market abuse regime compares with that in the United States.

3.2 This evidence will form part of the cost benefit analysis in the impact assessment but is set out here separately for clarity.

Enforcement

3.3 Between July 2005 and December 2007 no cases have been brought under the superequivalent provisions. In that period the FSA has brought three cases under the civil market abuse regime and brought one criminal case under section 397 FSMA, for misleading statements. Between implementation of the UK regime in 2001 and that of MAD in 2005, eight cases could have been brought under what are now the MAD provisions but two cases may have included (although not solely relied upon) adverse findings against what are now the superequivalent provisions.

3.4 The fact that the FSA has not brought successful enforcement action under the superequivalent provisions since the implementation of the Directive can be attributed to a number of different causes. It could be seen as evidence that the Directive provisions cover all possible types of abusive behaviour, as the FSA can only bring a case under the superequivalent provisions if it cannot use one of the MAD provisions. This explanation is unlikely, however, as cases have been considered in that time in relation to both the superequivalent provisions but not brought forward for evidential reasons. Further, there are current investigations that rely on the superequivalent provisions.

3.5 In this context it is significant that market abuse cases are usually lengthy and evidentially complex, and so the number of market abuse cases in general is low. The absence of concluded cases relying on the superequivalent provisions in the past two and a half years is therefore not definitive proof that the provisions are not important.

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[8] http://www.hm-treasury.gov.uk/media/C/E/MAD_feedback240205.pdf

The FSA has highlighted that it will be making more use of its Enforcement powers to combat insider dealing and market abuse, so it is therefore possible that there might be an increased use of the superequivalent provisions in future – certainly they feature in ongoing current investigations.

3.6 Regardless of whether actual cases have been brought under the superequivalent provisions, the existence of the regime may have dissuaded market participants from engaging in undesirable behaviour. The strength of this effect is hard to assess. Research has shown that it is the *enforcement* of a market abuse regime that matters rather than the existence of a market abuse regime.[9] However, whether this effect is also true for particular types of market abuse rather than the regime as a whole is unclear.

3.7 It has also been shown that low levels of enforcement may be optimal if fines are very high,[10] but it is not clear whether UK fines are sufficiently high to achieve this. The largest fine that the FSA has imposed against an individual is £750,000[11]. The FSA has, however, stated that it intends to increase the fines imposed under the market abuse regime.[12]

3.8 Overall therefore the enforcement, or threat of enforcement, of these provisions cannot be shown to have yielded quantifiable benefit to the market over the period in question. But it is possible that this would alter in the future if they were retained.

Market understanding

3.9 The UK's market abuse regime has been in place since 2001 and is therefore generally well understood by UK market participants. The FSA does not report high levels of queries regarding the scope of the superequivalences. Market awareness of the existence of the superequivalences is reasonably high amongst the investing community and considerable comfort is taken from the existence of a tighter regime.

3.10 While the regime may be broadly well understood, there is a considerable level of scepticism among the trading community as to the amount of actual behaviours that would uniquely be captured by the superequivalences.

3.11 Moreover the need to explain the superequivalences does impact on legal costs and training regimes. In addition to potential cost consequences (which are discussed in the following section) this can impact on the clarity of the regime's objectives. Firms report that explanation of the superequivalences does not require additional training sessions but does consume a material share of the allocated time for internal training on market abuse. This may mean that the key messages on market abuse are less effectively transmitted.

3.12 However, it is not clear to what extent the removal of the superequivalences would improve the quality of training and hence understanding of market abuse. Firms would be likely to continue to explain the prior regime and the remaining training would not necessarily be sufficiently improved to have a marked benefit on standards of market integrity.

[9] Bhattacharya, U., Daouk, H., (2002). The World Price of Insider Trading. *Journal of Finance, 57*(1), 75-108

[10] Polinsky, A.M., Shavell, S., (2000). The Economic Theory of Public Enforcement of Law. *Journal of Economic Literature, 38*(1), 45-76

[11] http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/077.shtml

[12] http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0118_mc.shtml

3.13 Overall therefore it appears that while market awareness is high, market understanding is mixed and the existence of the superequivalences adds some complexity to the training process.

Costs and competitive impact

3.14 The costs to the FSA of retaining the superequivalent provisions are negligible – specific staff are not allocated to enforcing the superequivalent provisions and the additional cost of training is not seen as significant. Removal of the superequivalences would therefore neither reduce the FSA's costs nor enable it to increase resources spent on other enforcement matters.

3.15 Firms concede that the additional costs of compliance are not overly large. However legal costs for advice on market abuse issues are higher as a result of the superequivalences. This was estimated as around £3million in 2004 – or around an average of two hours a year per firm. Training costs do not appear to be affected.

3.16 Legal firms report that firms do not generally seek out separate advice on the superequivalences. Nevertheless when providing advice on the UK market abuse regime, explanation of the superequivalences does account for a material share of the advice. One estimate suggests the superequivalences could account for as much as 20% of the advice.

3.17 The impact on firms' cross border operations will depend on their structure. As a rule firms will seek to apply the same level of internal standards rather than have separate internal enforcement regimes. While this means that the training and compliance costs are minimised, it can result in an uneven playing field in overseas markets. UK firms have reported that foreign firms were able to do things on overseas markets that they were less clear would be acceptable under the UK regime, but there is no evidence as to the extent of this or that it is welfare-creating business.

3.18 Importantly the superequivalent clauses are not reported to be so onerous to have damaged market efficiency. Research has shown that overly stringent market abuse rules can reduce market liquidity.[13] There is no suggestion that the superequivalences have imposed this level of costs.

3.19 Similarly there was no available evidence suggesting that UK firms were booking business overseas to avoid compliance with the superequivalent regime. And there was no evidence of any welfare-creating business that is prevented by the existence of the superequivalent regime in the UK.

3.20 Overall therefore the superequivalences impose negligible additional costs on firms.

Foreign rules and implementation

3.21 Implementation of the Directive has not been entirely harmonised and important differences remain in EU approaches to market abuse – most notably in the potential penalties. It is also the case that in some EU countries market abuse regimes remain relatively new – e.g. Germany introduced rules for insider dealing in 1994 and

[13] Kabir, R., Vermaelen, T, (1996). Insider Trading Restrictions and the stock market: Evidence from the Amsterdam Stock Exchange. *European Economic Review, 40*(8), 1591-1603

market manipulation in 2002 and Italy introduced rules for insider dealing in 1991 and market manipulation in 1998.[14]

3.22 CESR has undertaken considerable work to provide guidance on common approaches to implementation of the Directive in an effort to drive forwards harmonisation. In addition, in order to develop a common understanding amongst its members, CESR-Pol has a substantial programme planned of 'further market-facing work that may merit further guidance to achieve a harmonized application of the Directive'.[15]

3.23 There has been very limited quantitative evidence on the impact of the MAD abroad. Research from Netherlands suggests that the introduction of MAD has resulted in a significant decline in suspicious behaviour for small cap firms and the technology firms. There has, however, been little impact for midsize and large firms. The research concluded that there were significant indicators of insider trading but that it was impossible to quantify the extent of the problem.[16] While it is helpful that other countries are considering the quantitative benefits of the MAD regime, the existing UK and Dutch regimes were different (for example the introduction of MAD in the Netherlands resulted in an increase in the range of activities deemed market manipulation[17], whereas it would have been a reduction for the UK) and therefore this does not provide clear evidence either way as to the strength of the current MAD regime.

3.24 Qualitative research from the Global Competitiveness Report suggests that the UK prior to the introduction of MAD was perceived as having the cleanest markets of the surveyed countries.[18] It is impossible to deduce whether this was associated with the precautionary impact of the recently introduced (and now superequivalent) market abuse regime or simply a longer track record of a market abuse regime and the FSA's reputation. Given that the questions were directed to corporate officers at multinationals rather than financial firms it seems likely that it is the overall perception of the FSA rather than the specific legislative regime that is important. We have been unable to find similar updated figures post the introduction of MAD, and acknowledge this perception may have changed – some other European countries were also highly ranked in the 2002-2003 report.

3.25 The US is widely seen as having the most comprehensive market abuse regime. Nevertheless the MAD may have a greater reach than the US regime in certain areas.[19] However, the key difference with the US probably relates to enforcement. Enforcement in the US is far more visible. Since 2001 the FSA has brought 13 cases for market abuse under the civil regime (three of which have resulted in adverse findings against both the individual and the firm involved) and one criminal prosecution for misleading

[14] Enriques, L., Volpin, P., (2007). Corporate Governance Reforms in Continental Europe Journal of Economic Perspectives 21(1) 117-140

[15] CESR-Pol's Work Programme concerning Level 3 of the Market Abuse Directive (July 2007) www.cesr-eu.org

[16] AFM, (2007). Report: The effects of a change in market abuse regulation on stock prices and volumes: Evidence from the Amsterdam stock market

[17] ibid.

[18] Cornelius, P.K., (2002-03). Global Competitiveness Report, 610

[19] For example Greene suggests that prohibition for insiders of trading on inside information may be more stringent than rule 10b-5 in the US, which requires evidence of misappropriation or a breach of fiduciary duty. Greene, E.F., (2007). Resolving regulatory conflicts between the capital markets of the United States and Europe *Capital Markets Law Journal* 2(1) 5-40

statements to successful conclusion compared to over 18 brought by the SEC in just one year.[20]

3.26 Overall therefore the increased efforts to deliver harmonisation of the EU regime are only offering limited benefits to UK firms. The lessons from the US regime are mixed. There is a higher level of enforcement but it has not been demonstrated that this results from a wider range of possible offences.

Summary

3.27 The evidence supporting the retention of the superequivalences is finely balanced. The costs do not appear to be significant. And while the proven benefits are hard to quantify, proposed changes in the FSA's approach to enforcement might increase the use of and hence the demonstrable benefit of the superequivalences. Change is also proposed at the EU level – were elements of our regime to be adopted at the EU level this would remove or reduce the additional costs associated with them.

> Q3: Do you have any further evidence on the practical operation of the superequivalences since the introduction of MAD?

[20] Chronology – Major insider trading cases this year (28.8.2007). *Reuters*

4 POLICY PROPOSALS

INTRODUCTION

4.1 In considering the appropriate scope of the UK's market abuse regime, the key objectives (as discussed earlier) are the importance of ensuring adequate powers for delivering market integrity and maintaining confidence in London's financial markets; the support of innovation, competition and efficiency in the financial system; and the principles of 'Better Regulation'.

4.2 Chapter 2 highlighted the additional powers that the superequivalent provisions might offer to the FSA in delivering market integrity and maintaining confidence in London's financial markets. Chapter 3 considered the preliminary evidence on the costs of the superequivalences and whether they were impacting on the competition and efficiency of UK firms.

4.3 The principles of better regulation are applied to all rule making proposals.[21] However, there is also specific advice on the implementation of EU directives contained in the Davidson Review: Implementation of EU legislation.[22]

4.4 Lord Davidson QC, commissioned to review the way in which the UK implemented EU legislation, counsels that:

> '…creating obligations additional to the minimum EU requirements – where it cannot be demonstrated that the benefits exceed the costs – can hamper UK productivity, innovation and competitiveness'.
>
> *Lord Davidson QC, 28 November 2006*

4.5 HM Treasury remains committed to the Davidson Review's list of recommendations for the best-practice implementation of European legislation – 'Higher national standards should only be retained if it can be demonstrated, after consultation with stakeholders, that the benefits of doing so justify the costs.[23]

4.6 We have taken all these objectives into consideration in the choice of policy options and our recommended policy proposal.

Policy options

4.7 The nature of the sunset clauses is that unless new legislation is brought forward then the superequivalent provisions will automatically fall away. There are therefore three options: to allow the sunset clauses to naturally expire, meaning that the superequivalent provisions are removed at the end of June 2008; to make the superequivalent provisions permanent or to temporarily extend them.

4.8 We remain committed to ensuring the FSA has adequate powers to deliver high standards of market integrity but it is difficult to prove with certainty that removal of these clauses would have a material affect on the standards of market cleanliness in the

[21] Better Regulation Principles require that regulation should be: necessary, suitable and proportionate, transparent, consistent and flexible and risk sensitive.

[22] Davidson Review of the Implementation of EU legislation (2006). 90, http://www.hm-treasury.gov.uk/media/E/F/davidson_review281106.pdf

[23] ibid.

UK. The differences over and above the Market Abuse Directive are necessarily small, as the Market Abuse Directive was designed to provide a robust coverage of market abuse offences.

4.9 We are therefore unable at present to demonstrate with certainty that the benefits of having all or part of these provisions has exceeded the cost. However, the evidence is finely balanced, and the costs are negligible.

4.10 The European Commission will be undertaking a review of the Market Abuse Directive and its implementation during 2008. This may well result in changes to the European market abuse regime. Davidson counsels against pre-emptive UK legislation when EU legislation is expected. Our aim is that the EU review should deliver an outcome that we consider fully satisfactory in combating market abuse. Therefore the Government considers a short extension to the current superequivalences beneficial, until the outcome of the EU review is known.

4.11 A temporary extension until the outcome of the EU review is clear will avoid excessive transitional burdens to both industry and the FSA from two sets of changes in close proximity.

4.12 We will be taking the opportunity presented by the EU review to highlight the strengths of our current regime. It is already possible that the Commission - either in the Directive or in the implementing Regulations, will amend the definition of inside information in the Directive. Such a change could distinguish between something similar to RINGA and inside information. It would be unfortunate to remove a UK requirement only to see it re-introduced.

4.13 The Commission is likely to consider the definition of 'inside information' because of concerns raised by representatives of EU industry. The European Securities Markets Experts group (ESME) have produced a report identifying practical difficulties that arise from the Directive using the same definition of inside information for the market abuse regime and for a company's disclosure obligations.[24] In particular, ESME has suggested that the current requirements result in issuers having to disclose information too early and it would be preferable if the dates at which information becomes 'abusable' and 'disclosable' were separated. The problem identified by ESME could be addressed by having two definitions of inside information, as indeed the UK currently has (and had prior to MAD), or a different interpretation of 'precise' such that the time the information could be abusable and the time the information becomes disclosable could be different.

4.14 Consideration of this issue is already underway in the Committee of European Securities Regulators (CESR) Market Abuse Directive drafting group. This may lead to CESR producing Level 3 guidance on the issue or making suggestions to the European Commission regarding possible changes to the Directive.

4.15 The European Commission is also considering commodity markets and what regulatory issues arise in connection with these markets. It is possible, but more uncertain, that this consultation could raise issues related to capturing behaviours specific to the commodity market. The UK's wider definition of behaviour is felt to have

[24] http://www.ec.europa.eu/internal_market/securities/docs/esme/mad_070706_en.pdf

particular relevance for the commodities markets. The UK has issued a separate Discussion Paper seeking views on this issue. [25]

4.16 Regardless of whether the outcome of the European Commission review of the Directive is to introduce something identical to the current UK requirements, it could cause undesirable upheaval and costs both to industry and the FSA to have the existing market abuse regime change this summer, on the expiry of the superequivalent clauses, when further significant changes are already anticipated. We are also conscious that firms have been keen to have a regulatory pause in light of the significant implementation projects (such as MiFID) that have only recently been completed. We therefore would welcome views as to the benefits of delaying change till the EU review is complete.

Q4: Do you agree that we should extend the sunset clauses for a limited period until the results of the EU review are known?

Q5: Do you agree that an extension until 2010 would allow sufficient time to assess the outcome of the EU review?

Q6: Do you have any initial views on the EU Review and what the UK priorities for change should be?

Other initiatives

4.17 The policy focus of this paper is on the retention or otherwise of the superequivalent provisions of the civil market abuse regime. However, we are interested in any views that respondees might have on other elements of the current market abuse regime. In particular, in considering the other powers under which FSA can bring market abuse cases, it is notable that the 1993 Criminal Justice Act has not been updated for some time. It may be necessary in due course to consider whether the range of markets and instruments covered by this legislation remains adequate.

Q7: Do you have any views on the need to update the 1993 Criminal Justice Act?

[25] The UK discussion paper on the Commission's review of the financial regulatory framework for commodity and exotic derivatives (December 2007) can be found at: http://www.hm-treasury.gov.uk/consultations_and_legislation

5 Impact Assessment

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of the extension of the sunset clauses in the FSMA Market Abuse regime for a limited period	
Stage: Consultation	**Version:** 1	**Date:** 7 February 2008
Related Publications: UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC) – a consultation document (June 2004).		

Available to view or download at:

http://www.www.hm-treasury.gov.uk

Contact for enquiries: Sarah Parkinson **Telephone:** 020 7270 5912

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

This paper considers whether the UK's superequivalent market abuse regime should be extended for a short while until the outcome of the EU Review is known. Sunset clauses contained in the UK's market abuse legislation mean that if no action is taken by 30 June 2008 the superequivalent provisions will cease to have effect. HMT committed in 2005 to review the superequivalent provisions by May 2008. Government intervention is necessary because the framework is established in primary legislation (the Financial Services and Markets Act 2000) and so can only be altered by the Government.

What are the policy objectives and the intended effects?

The policy objective is to ensure high standards of market integrity balanced against our commitment to the principles of better regulation. Extending the life of the sunset clauses will avoid unnecessary short-term changes to the regulatory framework and avoid possible pre-emptive UK legislation when change to the EU regime is expected.

What policy options have been considered? Please justify any preferred option.

Option 1: Retaining the current UK superequivalent offences for a further limited period.

Option 2: Allowing the current superequivalent offences to lapse.

Option 3: Making the current UK superequivalent offences permanent.

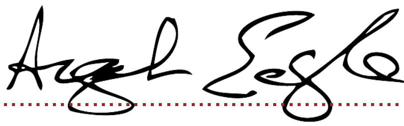
The preferred option is to retain the current UK superequivalences for a further limited period until the outcome of the EU review is known – i.e. option 1

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? 2014.

Ministerial Sign-off For consultation stage Impact Assessments:

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

Signed by the responsible Minister:



.... Date: 31/01/2008

Summary: Analysis & Evidence

Policy Option: 1	Description: Retaining the current UK superequivalent offences for a further limited period.

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Using the existing UK regime as the baseline, there would be no additional costs during 2008 and 2009 as this option reflects the current situation. There would be a cost of implementing the outcome of the EU review. We have used a variety of ranges and probabilities to arrive at this £10.6 million best estimate, reflecting the cost of between 2-8 hours work depending on the magnitude of the review and its similarity to existing UK requirements.
£ 10,600,000	1	
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 9,895,100**

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

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'.
One-off	**Yrs**	Using the existing UK regime as the baseline, there would be no additional benefits during 2008 and 2009 as this option reflects the current situation. The benefits of moving towards to a harmonised regime on completion of the EU review would be £4.8m (as we are only considering a limited time frame this appears here as a one-off benefit). This benefit would arise from lower legal and compliance costs.
£ 4,800,000 *	1	
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ 4,480,800**

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

We have not included any benefits of implementing the EU Review.

Key Assumptions/Sensitivities/Risks
The annual costs of maintaining the superequivalences are not included as they are not additional to the status quo. The scale of the EU Review is as yet unclear – we have therefore had to estimate a wide range of possible costs of transitioning to that regime and the probability of the regime including something similar to parts of our current superequivalent regime. The benefits assume the EU review delivers a satisfactory outcome.

Price Base Year 2008	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£ - 5,414,300**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			Continuing	
Which organisation(s) will enforce the policy?			FSA	
What is the total annual cost of enforcement for these organisations?			£0	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			Yes	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease £	**Net Impact £**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Summary: Analysis & Evidence

Policy Option: 2	Description: Allowing the sunset clauses to expire, thereby removing the superequivalences

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	This option involves two sets of transitional costs. Firstly, there would be a transitional cost of £4.8m estimated at two hours work in 2008 as firms adjusted their regimes to remove the superequivalences. Then, in 2010, as firms changed their regimes there would be a further transitional cost of £13.35m estimated at between 3 and 8 hours work depending on the outcome of the EU review.
£18,150,000	2	
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 17,262,225**

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

Removal of the superequivalences could lead to lower standards of market integrity and consequently market confidence which may lead to economic costs through higher costs of capital. These costs are harder to quantify and indeed are disputed. We have therefore not sought to quantify them but they could be material. In 2005 an estimate of the benefit of a robust market abuse regime was as high as £150 million, based on using spread (the difference between the best bid and offer prices in the market place) as a measure of liquidity. A calculation on the weighted average spread for FTSE 100 shares at a point on 16 June was 19 basis points. Based on total turnover in UK equities in 2003 of £1,540 billion, the spread cost was £2.9 billion. A one basis point increase in the spread using these figures would increase costs to the market of trading by £150 million.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	The benefit, or cost saving is calculated as £4.8m per year. This is the amount saved largely on legal costs. As we would be adjusting the regime mid 2008 the benefits this year would be halved. Spread over three years, this averages out to an annual benefit of £4 million a year.
£		
Average Annual Benefit (excluding one-off)		
£ 4,000,000		**Total Benefit** (PV) **£ 11,518,560**

Other **key non-monetised benefits** by 'main affected groups' The greater the degree of harmonisation in Europe in terms of market abuse rules, supervisory practice and enforcement, the closer we will be in creating a single European market for financial services.

Key Assumptions/Sensitivities/Risks. Key assumptions are the time taken to implement changes resulting from EU review. A key sensitivity is the exclusion of quantified costs from removal of the superequivalences – in scale these could significantly outweigh the benefits.

Price Base Year 2008	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£ - 5,743,665**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			30 June 2008	
Which organisation(s) will enforce the policy?			FSA	
What is the total annual cost of enforcement for these organisations?			£0	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Decrease £ **Net Impact £**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Summary: Analysis & Evidence

Policy Option: 3	Description: Making the current UK superequivalent offences permanent.

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Using the existing UK regime as the baseline, there would be no additional costs during 2008 and 2009 as this option reflects the current situation. There would be a cost of implementing the outcome of the EU review. We have used a variety of ranges and probabilities to arrive at this £10.6 million best estimate, reflecting the cost of between 2-8 hours work depending on the magnitude of the review and its similarity to existing UK requirements.
£ 10,600,000		
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 9,895,100**

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

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ 0**

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

We have not included any benefits of implementing the EU Review.

Key Assumptions/Sensitivities/Risks The scale of the EU review is as yet unclear – we have therefore had to estimate the possible costs of implementation.

Price Base Year 2008	Time Period Years 3	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£ - 9.895,100**

What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	Continuing
Which organisation(s) will enforce the policy?	FSA
What is the total annual cost of enforcement for these organisations?	£0

Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			Yes	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of £	Decrease £	**Net Impact**	**£**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

EVIDENCE BASE: FOR SUMMARY SHEETS

Background

5.1 The purpose of this assessment is to review sections 118(4) and 118(8) contained in Part 8 of the Financial Services and Markets Act 2000 (FSMA). These are legislative provisions, which prohibit a wider range of behaviours than the Market Abuse Directive. The aforementioned provisions are subject to a three-year sunset clause, which means that they will automatically lapse on 30th June 2008 unless new legislation is adopted to allow them to remain in force.

5.2 The objective of the Review is to establish whether the expected benefits of having all or part of these superequivalent provisions has exceeded the cost. The Review should take into account the enforcement of the regime, market understanding, costs & competitive impact and foreign rules and implementation.

5.3 The EU Market Abuse Directive was implemented in the UK on 1 July 2005 through the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005 and through changes in the FSA's rules. 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, and through providing a proper flow of information to the market. The Directive covers insider dealing, market manipulation and a framework for proper disclosure to the market. MAD is one of the key directives implemented as part of the Financial Services Action Plan (FSAP) that seeks to deliver an effective single market in financial services in the European Union.

5.4 During the consultations on implementing MAD there were mixed views as to the benefits of maintaining the superequivalent provisions. Those in favour of keeping the superequivalent provisions felt that the boundaries of the regime were familiar and were relevant in providing the UK with a more secure trading environment. Others argued that the UK should only prohibit behaviours defined by the Directive, as this was sufficient.

5.5 Given the range of views on which approach the UK should be taking, it was decided to maintain the original UK definitions of market abuse for a limited period. The underlying rationale for this was to gather more evidence and allow time to conduct a comprehensive review of these provisions.[26] The sunset clauses were inserted into the legislation so that the provisions would expire unless new legislation was introduced.

5.6 This policy and impact assessment is informed by dialogue between HM Treasury, FSA, relevant trade associations and industry.

Legislative proposals and options

5.7 The first option is to retain the current UK regime for a further limited period until the outcome of the EU review is known. The Commission are themselves reviewing the MAD in 2008 and we will take this opportunity to work for an outcome that delivers a satisfactory EU regime and to promote wider discussion of some of the

[26] For further information on the rationale behind our policy please refer to the February 2005 HMT feedback statement http://www.hm-treasury.gov.uk/media/C/E/MAD_feedback240205.pdf

elements of our superequivalences. Indeed one element of the superequivalences is already on the EU agenda for possible changes to the MAD.

5.8 The European Commission are likely to be influenced by the European Securities Markets Experts group (ESME) report that identified practical difficulties that arise from having the same definition of inside information for both market abuse and the disclosure obligation. In particular they think that the current requirements result in issuers having to disclose information too early and it would be preferable if the dates at which information becomes 'abusable' or 'disclosable' were separated. The UK already has such a distinction because of the superequivalences. The changes to MAD could result in new regulations from Europe that more closely resemble our rules.

5.9 Whatever the outcome of the EU review, allowing the superequivalent provisions to lapse in June 2008 and then implementing the EU's changes will subject the industry and FSA to two sets of changes in short succession. This would have cost implications and also a potentially negative impact on market understanding.

5.10 The second option is to align the UK regime with the EU Market Abuse Directive requirements now. Removing the superequivalences would simply require us to let the sunset clauses expire, as they would do as a matter of course, on 30 June 2008. No new legislation would be required. This will deliver some efficiency savings for financial firms and help maintain UK competitiveness by aligning our regime with that of our European counterparts. However, as noted above, it is possible that some legislation would have to be re-introduced following the outcome of the EU review and some of the superequivalent provisions could be re-established.

5.11 The third option is to make the superequivalences permanent. This would provide reassurance to the investing community that the widest range possible of market abuse offences were captured by the UK legislative framework but we would in any event have to implement any changes arising from the EU's review.

BENEFITS

Option 1

5.12 Retaining the super-equivalent provisions for a limited period could maintain high standards of market integrity and consequently market confidence. These benefits are ongoing and hence not new. It would also allow wider discussion of the benefits of the superequivalences. Eventual closer harmonisation with the revised EU regime would bring the benefits of European harmonisation, simplification for those firms operating on a pan-European basis and lower compliance costs.

5.13 The costs of the superequivalences – and hence the size of possible benefits from their eventual removal - were estimated at around £ 3 million in 2004 or an average of around 2 hours work per firm. This has been updated to around £5 million. This reflects an increase in the number of firms and of staff costs. 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). In our 2004 consultation, we updated this to £610 an hour on the basis of increases in average earnings of those working on financial intermediation. We have updated this cost again to £690 per hour, stressing that this is the result of the combined cost of internal project work and the cost of seeking internal and external legal advice.

Option 2

5.14 The main benefits associated with immediately removing the superequivalences would be the earlier harmonisation of our rules with MAD. A greater degree of harmonisation would be beneficial for a variety of reasons. For example, it would remove complexities for those firms operating on a pan-European basis. This is likely to mean lower compliance costs for firms (through alignment of training and control processes and reduced numbers of suspicious transaction reports). These cost savings are not likely to be large. There are also likely to be lower ongoing legal costs for firms. As discussed above, these were estimated as around £3 million in 2004 and we have updated this to savings of £4.8million in 2009 and 2010 with a saving of £2.4 million during 2008, as the new regime would start midway through the year.

5.15 There is no evidence to suggest that any welfare-creating business might be possible if the superequivalent provisions were allowed to lapse and so there are probably no benefits in terms of business creation from this option.

Option 3

5.16 Making the superequivalences permanent would provide continued higher standards of market integrity and consequently market confidence, which may lead to economic benefits through lower costs of capital. These benefits, to the extent that they arise, would be ongoing and hence are not additional.

5.17 Whether benefits arise in practice depends on whether the superequivalent provisions actually deter abuse. In turn, deterrence will depend on the expectation of market participants that the provisions will result in successful enforcement. Since the implementation of MAD in 2005 no action based on the superequivalent provisions has been taken, suggesting at first glance no additional incremental benefits. However, if there is increased enforcement of these superequivalent provisions in the future there should be incremental economic benefits.

COSTS

Option 1

5.18 The costs of temporarily retaining the superequivalences are the additional legal costs and compliance costs resulting from the superequivalent UK regime, as against a regime aligned with the Directive. These costs would be ongoing and are not new. The cost of implementing the EU review is estimated at £10.6 million. We have used a variety of ranges and probabilities to arrive at this £10.6 million best estimate, reflecting the cost of between 2-8 hours work depending on the magnitude of the review and its similarity to existing UK requirements.

Option 2

5.19 Removing the superequivalences will involve costs. The one-off costs of adjustment will vary from firm to firm but we have estimated an average two hours at a consolidated cost of £690 an hour. This means a one-off cost of £4.8 million to remove the sunset clauses. The costs to the industry would largely be related to changing training programmes as well as adjusting procedures and manuals.

5.20 Removing the superequivalences would also entail costs to the FSA arising from changes to the handbook training materials and some retraining of staff. There may also

be additional queries to the FSA arising from change to the regime. These costs are not believed to be significant.

5.21 There is potential for costs to arise to the extent that removal of the super-equivalent provisions leads to lower market confidence and to the extent that this manifests itself in a higher cost of capital for firms.

5.22 There would be further costs under this option resulting from implementing the European review of MAD. This cost will depend on the amount of changes to the regime. Therefore under this option firms would bear the costs of changing their processes now and further costs in the future if the Directive requirements are further altered. Firms may of course opt not to update their internal systems pending the outcome of the EU review. This could lead to considerable confusion in the market. We have assumed that firms would remove the superequivalences given the uncertainty about the precise timing and outcome of the EU review. The cost of implementing the outcome of the Review is estimated at £13.35 million.

Option 3

5.23 The costs of permanently retaining the superequivalences are the additional legal costs and compliance costs resulting from the more complex UK regime, as against a regime aligned with the Directive. These costs would be ongoing and are not new. Firms would also face the costs of implementing the outcome of the European Commission's review. This is estimated as £10.6 million.

COMPETITION ASSESSMENT

5.24 There is no evidence to suggest that any of these proposals has an impact on competition.

SMALL FIRMS IMPACT TEST

5.25 All firms authorised to conduct investment management and securities business in the UK currently have to work within the market abuse regime. Removing the superequivalences may impose additional burdens on smaller firms as they may be less well placed to cope with two sets of regulatory change in short order.

> Q8: Do you agree with the analysis of the costs and benefits for the different implementation options, including the impact on competition and small firms?
>
> Q9: Are there any alternative options, or combinations of the proposed options, that should be considered?
>
> Q10: Do you agree with our policy proposal? If not, please specify your reasons.

Specific Impact Tests: Checklist

Type of testing undertaken	*Results in Evidence Base?*	*Results annexed?*
Competition Assessment	Yes/No	No
Small Firms Impact Test	Yes/No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

A DRAFT REGULATIONS

STATUTORY INSTRUMENTS

2008 No.

FINANCIAL SERVICES AND MARKETS

The Financial Services and Markets Act 2000 (Market Abuse) Regulations 2008

Made - - - - ***

Laid before Parliament ***

Coming into force - - ***

The Treasury are a government department designated([a]) for the purposes of section 2(2) of the European Communities Act 1972([b]) in relation to insider dealing and market manipulation;

In exercise of the powers conferred upon them by section 2(2) of that Act, the Treasury hereby make the following Regulations:

Citation and commencement

—1) These Regulations may be cited as the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2008.

These regulations shall come into force on 31 January 2010.

Interpretation

In these Regulations—

"the 2000 Act" means the Financial Services and Markets Act 2000([c]).

Amendment of Part VIII of the 2000 Act

-(1) The 2000 Act is amended as follows.

(2) In subsection (9) of section 118 (Market abuse)([d]) of the 2000 Act, for "30 June 2008" substitute "31 January 2010".

([a]) S.I. 2004/2642

([b]) 1972 c.68; by virtue of the amendment of section 1(2) made by section 1 of the European Economic Area Act 1993 (c. 51) regulations may be made under section 2(2) to implement obligations of the United Kingdom created or arising under the Agreement on the European Economic Area signed at Oporto on 2nd May 1992 (Cm 2073) and the Protocol adjusting that Agreement signed at Brussels on 17th March 1993 (Cm 2183).

([c]) 2000 c.8.

(3) In subsection (6) of section 118A (Supplementary provision about certain behaviour)([e]) of the 2000 Act, for "30 June 2008" substitute "31 January 2010".

xxxx
yyyy
Date Two of the Lords Commissioners
of Her Majesty's Treasury

([d]) Substituted, together with ss118A-118C, for original s118 by the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005, SI 2005/381, reg 5, Sch 2, para 1 as from 1 July 2005.

([e]) Substituted as noted to s118.

B
Consolidated List of Questions

Q1: Do you consider that the superequivalences increase the effectiveness of our regime and have an effect on market integrity?

Q2: Which of the identified differences do you see as most important and why?

Q3: Do you have any further evidence on the practical operation of the superequivalences since the introduction of MAD?

Q4: Do you agree that we should extend the sunset clauses for a limited period until the results of the EU review are known?

Q5: Do you agree that an extension until 2010 would allow sufficient time to assess the outcome of the EU review?

Q6: Do you have any initial views on the EU Review and what the UK priorities for change should be?

Q7: Do you have any views on the need to update the 1993 Criminal Justice Act?

Q8: Do you agree with the analysis of the costs and benefits for the different implementation options, including the impact on competition and small firms?

Q9: Are there any alternative options, or combinations of the proposed options, that should be considered?

Q10: Do you agree with our policy proposal? If not, please specify your reasons.

C Background on additional FSA powers

The criminal regime

C.1 The FSA can bring criminal prosecutions under Part V of the Criminal Justice Act 1993 (insider dealing) and section 397 FSMA (misleading statements and practices). Although there is some overlap between the criminal offences and the section 118 market abuse contraventions, the criminal offences have different elements and scope to the civil regime, there are different defences, and the criminal standard of proof is required.

C.2 The FSA will consider various factors when deciding whether to prosecute or to bring a civil action, including for example the seriousness of the misconduct, whether victims have suffered loss and its nature and extent, and the effect on the market. The maximum penalty for insider dealing is 7 years imprisonment and an unlimited fine.

Regulatory action

C.3 The FSA may also bring an action for breach of its rules, including the Principles for Business (PRIN), which apply to authorised firms, or the Statement of Principles for Approved Persons (APER), which apply to approved individuals. These rules specifically require authorised firms and approved persons to observe proper standards of market conduct (PRIN 5, APER 3). In some circumstances, behaviour amounting to market abuse might breach other rules, for example the requirements to act with integrity and with skill, care and diligence (PRIN 1, 2; APER 1, 2).

C.4 If there is a breach of the rules, then the FSA may impose a fine or a public censure, or take steps to prevent a firm or individual from engaging in regulated activities by cancelling permissions (firms) or approvals (individuals) or imposing a prohibition order (individuals).

C.5 Breach of the rules covers a broader spectrum of misconduct than either the criminal or civil market abuse provisions. However, they apply to authorised firms or approved persons only, and so action for breach of them can only be brought against the regulated community.

Additional civil powers

C.6 In addition the FSA has the power under section 381 FSMA to seek an injunction to prevent market abuse, where there is a reasonable likelihood that a person will engage in it or will continue to do so, or to remedy it if there is a reasonable likelihood that he is or has engaged in market abuse.

C.7 The FSA has an identical power under section 380 FSMA to seek an injunction where there is a reasonable likelihood that a person will or will continue to breach a requirement imposed under FSMA or under another Act where the contravention constitutes an offence which the FSA has power to prosecute. This power may be appropriate in market misconduct cases that fall outside the scope of section 118.

C.8 The FSA may also apply for a restitution order under section 382 FSMA, or require restitution under its discretionary power under section 384 FSMA, where a person has breached a relevant requirement and either profited by doing so or caused a

loss to another as a result. Restitution orders may also be obtained in market abuse cases under section 383 FSMA.

D WRITTEN CONSULTATION CODE OF PRACTICE

About the consultation process – the consultation criteria

Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.

It should be clear who is being consulted, about what questions, in what timescale and for what purpose.

A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.

Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.

Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.

Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reason for decisions finally taken.

Departments should monitor and evaluate consultation, designating a consultation co-ordinator who will ensure the lessons are disseminated.

Further information on the Code of Practice on Consultation is available from the Cabinet office website:

www.cabinetoffice.gov.uk/regulation/Consultation/Code.htm

This document has been produced to conform to these criteria.

Complaints

If you have any complaints about any element of the consultation process leading from the issue of this document, please contact:

Better Regulation Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ
Phone: 020 7147 2382

E CONSULTATION LIST

This consultation document has been made available to the general public via the Treasury public website and has in addition been sent to a large number of organisations including the following bodies:

Abbey National

ABN AMRO Bank NV

Allen & Overy

Association of British Insurers

Association of Corporate Treasurers

Barclays

Bear Stearns International Ltd

BNP Paribas

British Bankers' Association

Citibank NA

Clifford Chance LLP

Credit Suisse

Deutsche Bank AG

Financial Services Authority

Freshfields

Goldman Sachs

HBOS plc

HSBC Investment Bank plc

International Capital Market Association

Investment Management Association

JP Morgan Chase

Lawrence Graham LLP

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