

UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC)

A consultation document

June 2004



HM TREASURY





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PREFACE

This is a joint consultation document by HM Treasury and the Financial Services Authority (FSA) on proposals to implement the Market Abuse Directive in the UK.

Part 1 introduces the document.

Part 2 explains the provisions of the Market Abuse Directive.

Part 3 explains HM Treasury proposals for legislation to implement the directive and contains the proposed regulations.

Part 4 explains the FSA proposals for changes to its handbook and contains the new handbook text.

EXECUTIVE SUMMARY

1. This consultation document invites comments on draft regulations and draft changes to the FSA's Handbook which give effect to the EU's Market Abuse Directive.

The directive

2. The directive's aim is to promote the integrity of Europe's financial markets. It seeks to do this by introducing a common EU legal framework for preventing and detecting market abuse and for ensuring a proper flow of information to the market.

Draft regulations

3. The directive's provisions are similar but not identical to the UK's existing market abuse regime. Implementation requires changes to ensure that the UK regime meets the minimum standards in the directive. The Government has considered two main approaches to these changes: first, adapting the UK's existing regime to give effect to the directive's provisions but maintaining the current scope of the UK's regime where it is wider than the directive's; second, adapting the UK's existing regime to give effect to the directive's provisions but narrowing its scope so that it aligns with the regime in the directive.

4. The draft regulations take the first approach. The UK's existing regime was extensively consulted on before it was introduced fewer than three years ago. There are behaviours prohibited in the existing UK regime which the Government believes should continue to be prohibited. There are markets covered in the existing regime (Ofex, AIM, LME, IPE and OM London) which the Government and the markets themselves believe should continue to be covered. The resulting regime should be more familiar for market participants.

5. The draft regulations propose extending the FSA's powers to make rules applicable to certain issuers. This will enable the obligations in the directive requiring companies to disclose inside information and keep lists of those with access to inside information to be given effect in disclosure rules made by the FSA. The same approach has been taken to the directive's provisions requiring directors and senior managers (and those 'connected' to them) to report their transactions in the shares of the companies for which they work.

6. The directive requires regulation of those producing and disseminating investment recommendations to ensure they present the recommendations clearly and disclose any conflicts of interests. Consistent with the directive, the Government has decided that existing self-regulation will apply to journalists. This will occur where journalists are subject to certain specified or firm specific self-regulatory codes and the application of these codes is disclosed.

Draft handbook changes

7. Implementing the directive will require amendments to a number of sections in the FSA Handbook including the Code of Market Conduct, the Price Stabilising Rules, the UK Listing Rules and the Conduct of Business Sourcebook. The changes have been drafted with two main policy objectives in mind. First, the commitment to reduce and simplify the content of the handbook. Second, an overall approach to implementing EU directives of relying on directive text and providing additional guidance where this might be helpful.

8. The changes to the Code of Market Conduct encompass a series of detailed changes flowing from revisions to the definition of market abuse in legislation. One general change relates to safe harbours. The term has a narrower and more specific meaning in the directive than currently in the code. This requires that many of the safe harbours

currently in the code – which are descriptions of behaviour that do not fall within the definitions of market abuse in the directive – have to be deleted.

9. The existing price stabilisation rules are being replaced by references to the Commission regulation which details the provisions that have to be followed to benefit from the directive's safe harbour for such transactions.

10. Changes are being proposed to the sections of the Listing Rules dealing with disclosure obligations for companies, purchases of own shares and disclosure of directors' dealings, (they will now include disclosure rules). Use of the directive's definition of inside information should not significantly affect the flow of disclosures by companies. The rules aim at ensuring that only one public notification is made of dealing by directors when the same transaction is covered by a notification under the Companies Act and the new rules.

11. The implementation of the directive's provisions on disclosures concerning investment research will be contained in the Conduct of Business sourcebook. They are broadly similar to domestic proposals consulted on in CP171 and therefore not only implement the directive but also complete the FSA's programme of regulatory change to address investment research conflicts.

12. There is some overlap between the directive's requirements for those arranging transactions to report suspicious transactions and requirements in the Proceeds of Crime Act. Efforts will be made to explore whether where the obligations overlap, a single report can be made.

Timing 13. The Treasury and FSA are aiming to finalise the necessary legislative and handbook changes by the end of November. There will then be a period of three months before the changes come into force.

INTRODUCTION

Why is a Market Abuse Directive Needed?

1.1 On 28 January 2003 the European Parliament and the Council of the European Union adopted the Directive on Insider Dealing and Market Manipulation¹ (market abuse). Subsequently implementing measures relating to the directive have been made under the Lamfalussy process².

1.2 The Commission proposed a Market Abuse Directive as part of the Financial Services Action Plan (the framework for identifying a series of actions that were needed in order to complete the single market for financial services)³ because it considered the Insider Dealing Directive⁴, adopted more than a decade ago, out of date and incomplete (it did not deal with market manipulation). Furthermore, the current approaches in member states to tackling market abuse are very diverse with different systems and powers existing across the EU. Criteria such as the definition of infringements, imposition of sanctions and persons subject to the market abuse regime varies among the different jurisdictions. Also the range of criminal sanctions varies and many jurisdictions have few administrative (civil) sanctions available in this area.

1.3 The Commission believed that these differences had led to competitive distortions in European financial markets. Financial intermediaries and other economic actors were often uncertain over concepts, definitions and enforcement in each market. Moreover, the Commission believed that new developments had added to these difficulties. New products and technologies have been developed; increasing numbers of new participants have entered the markets; cross-border trading has increased; and European financial markets have begun to link across borders far more than in the past.

Aim of Market Abuse Directive

1.4 To counter these problems the aim of the directive is to bring convergence among the different national regimes, by establishing a basic framework for the prevention of market abuse and so achieve greater confidence in the integrity of the financial system.

1.5 To meet this objective, the directive introduces a common EU legal framework to seek to prevent, detect, investigate and sanction both insider dealing and market manipulation. It also provides a common framework for the disclosure of information to the market. And it provides for powers and obligations, to enforce the directive, to be conferred on a single competent authority in each member state.

1.6 The Market Abuse Directive is the first directive to go through under the new “Lamfalussy”⁵ process for financial services legislation in the EU. This process introduced new legislative techniques based on a four level approach, namely framework principles, implementing measures, regulatory co-operation and enforcement. The Market Abuse Directive is a framework directive (“the level 1 text”) with further detail provided in implementing measures (“level 2 texts” or “comitology measures”). The implementing measures are legal texts in the form of directives or

¹ Directive 2003/6/EC (OJ L 96, 12.4.2003, p.16.)

² Commission Directive 2003/124/EC (OJ L 339, 24.12.2003, p.70); Directive 2003/125/EC (OJ L339, 24.12.2003, p.73), Directive 2004/72/EC (OJ L162, 30.4.2004, p.70) and Commission Regulation (EC) No 2273/2003 (OJ L336, 23.12.2003, p.33). All found on the website at www.europa.eu.int/eur-lex/en/index.html

³ COM (1999) 232

⁴ Directive 1989/592/EEC

⁵ Baron Lamfalussy chaired a Committee of wise men who in February 2001 delivered a report on ‘The Regulation of European Securities Markets’

regulations adopted by the Commission following advice from the Committee of European Securities Regulators (CESR), and with the assistance of the European Securities Committee (ESC) which is composed of representatives from EU Finance Ministries.

Implementation of the directive

1.7 Implementation of the directive requires action by the Treasury and the Financial Services Authority (FSA). The Treasury proposes to legislate through regulations made under section 2(2) of the European Communities Act 1972, making the relevant amendments to primary and secondary legislation and enacting such free standing secondary provisions as are necessary. The Financial Services Authority needs to make amendments to its handbook, principally in the Code of Market Conduct and the Listing Rules.

Delivering the FSAP in the UK

1.8 In May the Treasury, the FSA and the Bank of England published a paper about the implementation of EU Financial Services Action Plan directives in the UK⁶. This set out the UK's approach to implementing the FSAP in three key areas: internal arrangements within the public authorities, working with business and cooperation with authorities in other member states.

1.9 This consultation document has been produced in a manner consistent with the approach above. There has been a joint Treasury/FSA steering group which has met regularly and worked on the production of this consultation document. This work has included consideration of different options for implementation which are set out in the Treasury's Regulatory Impact Assessment (annex B).

1.10 There have been frequent contacts with industry including two roundtables held in July 2003 and January 2004. In addition there have been frequent bilateral contacts between industry contacts and the Treasury and FSA.

1.11 To ensure consistent implementation of directives, the UK has encouraged the Commission to hold transposition meetings, starting with the Market Abuse Directive, with member states. Representatives from the Treasury and FSA have attended three transposition meetings (one hosted by the Committee of European Securities Regulators) to discuss the implementation of the directive with representatives of other member states and the Commission. The UK has kept market participants informed of the main points of these discussions. And there have been bilateral contacts with other member states on specific issues.

Next steps

1.12 This joint HM Treasury/FSA consultation document seeks comments on the proposed regulations and FSA Handbook changes to achieve implementation. Comments on the proposals generally or on any particular aspect of them would be welcomed.

1.13 Member states are required to implement the directive by 12 October 2004. The Treasury and FSA are aiming to finalise the legislative and rule changes required by the

⁶ The EU Financial Services Action Plan: Delivering the FSAP in the UK. It is available at www.hm-treasury.gov.uk and www.fsa.gov.uk

end of November 2004. And once they are finalised, industry will be given approximately three months to adapt to the changes before they are enforced.

1.14 HM Treasury invites comments on Part 3 of this consultation document. Please send your comments in writing to Jacqueline Latter by 10 September to:

HM Treasury, Capital Markets & Governance Team, 4/22, 1 Horse Guards Road,
London SW1A 2HQ

Email: jacqueline.latter@hm-treasury.x.gsi.gov.uk

The Financial Services Authority invites comments on Part 4 of this consultation document. Please send your comments in writing to Fionnuala O'Brien by 10 September to:

Financial Services Authority, 25 The North Colonnade, Canary Wharf, London
E14 5HS

Email: marketabusedirective@fsa.gov.uk

It is government policy to make all responses to formal consultation documents available for public inspection unless the respondent requests otherwise. Any responses or parts of responses which you do not wish published should be clearly marked as confidential.

This document can be accessed via the Treasury's website (www.hm.treasury.gov.uk). To obtain further information about publication of this document, please contact:

HM Treasury, Correspondence and Enquiry Unit, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ.

If you consider your comments to be relevant to both Parts of the Consultation Document please send or email them to both the Treasury and the FSA.

2

THE MARKET ABUSE DIRECTIVE

2.1 This chapter explains the main provisions of the directive and its implementing measures.

Market abuse (Articles 1-5)

What is market abuse

2.2 Market abuse, which consists of insider dealing and market manipulation, arises in circumstances where investors have been unreasonably disadvantaged by others. It prevents full and proper market transparency and undermines market integrity and investor confidence. Articles 1-5 of the directive prohibit two broad descriptions of behaviour that might bring about these circumstances:

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

Insider Dealing

2.3 The directive prohibits anyone in possession of inside information from dealing (or attempting to deal) in relevant securities, encouraging others to deal and disclosing the information¹. The directive sets out three categories of inside information²:

- ⚡ In respect of financial instruments that are not commodity derivatives, it is defined as information in relation to financial instruments or issuers that is precise, not in the public domain and which, if it were made public, would be likely to have a significant effect on the prices of those instruments or on the price of related derivative instruments. Information that would be likely to have a significant effect on prices is information a reasonable investor would be likely to use as part of the basis for his investment decision.
- ⚡ In respect of commodity derivatives, inside information is defined as information of a precise nature which has not been made public and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practice on those markets.
- ⚡ In respect of intermediaries executing client orders, it is precise information about pending orders which, if made public, would have a significant effect on prices of financial instruments or related derivative financial instruments.

2.4 The directive defines three ways in which the market could be manipulated³.

- ⚡ Firstly where transactions or orders to trade could give false or misleading signals as to the demand or supply of a price or where the price was

¹ Articles 2 to 4 of Directive 2003/6/EC

² Article 1.1 of Directive 2003/6/EC. Further detail on inside information in respect of financial instruments which are not commodity derivatives is provided in Article 1 of Directive 2003/124/EC, and further detail on inside information in respect of commodity derivatives is provided in Article 4 of Directive 2004/72/EC

³ Article 1.2 of Directive 2003/6/EC

deliberately fixed at an abnormal or artificial level, unless it was for legitimate reasons and it conformed to accepted market practice.

- ⚡ Secondly transactions or orders to trade where some form of deception is used.
- ⚡ Thirdly the dissemination of information via the media or any other means eg internet that gives misleading signals, news or rumours about financial instruments by persons who knew or ought to have known that it was false or misleading.

Defences 2.5 The prohibitions in the directive are not absolute. There are qualifications and defences that narrow the scope of the prohibitions. For example, in respect of the first category above of market manipulation, if someone can establish that there are legitimate reasons for their behaviour and it conforms to accepted market practice on the market concerned (which is a practice that the competent authority regards as acceptable) then the behaviour will not be regarded as market abuse.

Safe Harbours 2.6 Having set out the parameters of what is and what is not market abuse, the directive goes on to recognise that in particular circumstances and for economic reasons, exemptions (so called “safe harbours”) will need to be allowed⁴. Activities falling within such safe harbours do not amount to market abuse. There are two sets of circumstances provided for in the directive where safe harbours exist: trading in own shares in “buy-back” programmes and stabilisation of a financial instrument. To qualify for this safe harbour status, buy-back programmes and stabilisation activities have to conform to the requirements set out in an implementing measure⁵.

Disclosure of information (Article 6)

Market Integrity 2.7 As well as prohibiting market abuse, the directive also seeks to ensure the market gets a proper flow of information. Article 6 seeks to improve the quality of information disclosed to the market in several ways:

- ⚡ ensuring that issuers inform the public of inside information as soon as possible;⁶
- ⚡ requiring members of the management of issuers (and persons closely associated with them) of shares to disclose their dealings in the shares (or other instruments linked to the shares) of the issuer;⁷
- ⚡ requiring those producing or disseminating research or other information recommending or suggesting investment strategy to present the information fairly and to disclose any interests or conflicts of interest;⁸
- ⚡ requiring those arranging transactions to notify the competent authority of any suspicious transaction.⁹

⁴ Articles 7 and 8 of Directive 2003/6/EC

⁵ Regulation (EC) No 2273/2003

⁶ Articles 6.1 & 6.2 of Directive 2003/6/EC

⁷ Article 6.3 of Directive 2003/6/EC

⁸ Article 6.5 of Directive 2003/6/EC

⁹ Article 6.9 of Directive 2003/6/EC

Disclosure 2.8 Issuers are required to ensure in disclosing inside information that the disclosure to all investors is made promptly and in as synchronised a fashion as possible¹⁰. This is to prevent some investors gaining an advantage over others by having earlier access. In addition, issuers must not combine the disclosure of inside information with the marketing of their activities in a manner that is likely to be misleading,¹¹ and any significant changes to publicly disclosed information must also be promptly disclosed¹². Disclosure of inside information can, however, be delayed by issuers to protect their legitimate interests (such as during the course of negotiations), provided that the confidentiality of the information can be ensured during the delay and provided that such delay would not be likely to mislead the public¹³. More detailed provisions on how to disclose inside information are being set by the Transparency Obligations Directive. The disclosure of information requirements do not apply to issuers who have not requested or approved admission of their financial instruments to trading on a regulated market in a member state.

Investment research 2.9 In respect of investment recommendations, member states can choose¹⁴ the most appropriate form of regulation they use to ensure compliance with these provisions; this can include self-regulatory mechanisms. Such an approach was considered necessary because the scope of the provisions extends beyond investment firms and banks. They can also apply to, for example, journalists making direct investment recommendations. However, those making recommendations who work in independent analysts, investment firms, banks and others whose main business is to produce investment recommendations are subject to additional obligations in respect of fair presentation and disclosure of conflicts of interest.

2.10 An example of this is that investment firms and banks making recommendations are required to disclose on a quarterly basis the proportion of all recommendations that are “buy”, “hold”, “sell” or equivalent terms, as well as the proportion of issuers corresponding to each of these categories to which they have supplied material investment banking services over the previous 12 months¹⁵.

2.11 In respect of interests and conflicts of interest which could impair the objectivity of the recommendation, any interests or conflicts of interest that are accessible or reasonably expected to be accessible to the persons involved in the preparation of the recommendation must be disclosed. So to the extent that interests and conflicts of interest are handled through such procedures as Chinese walls, they are not required to be disclosed.

Notification of suspicious transactions 2.12 The directive requires that those arranging financial transactions must notify the competent authority of any suspicious transactions which might constitute market abuse. Those making the reports will not attract liability if the report is made in good faith¹⁶.

¹⁰ Article 2(1) and (4) of Directive 2003/124/EC

¹¹ Article 2(1), third indent, of Directive 2003/124/EC

¹² Article 2(3) of Directive 2003/124/EC

¹³ Article 6(2) of Directive 2003/6/EC and Article 3 of Directive 2003/124/EC

¹⁴ Recital 22 of Directive 2003/6/EC

¹⁵ Article 6(4) of Directive 2003/125/EC

¹⁶ Article 11 of Directive 2004/72/EC

Scope (Articles 9 and 10)

2.13 The directive applies¹⁷ to any financial instrument admitted to trading (or where a request for admission to trading has been made) on a regulated market in at least one member state. The directive applies to all transactions concerning those instruments, whether those transactions are undertaken on regulated markets or elsewhere. This is to avoid markets which are not regulated markets from being used for abusive purposes concerning those financial instruments. The insider dealing provisions also apply to financial instruments not admitted to trading on a regulated market, but whose value depends on such a financial instrument.

2.14 For the benefit of market participants, the directive provides a list¹⁸ of the sorts of instruments covered. This is as follows:

- ⚡ shares in companies and securities equivalent to shares in companies;
- ⚡ bonds and other forms of securitised debt;
- ⚡ any other securities giving the right to acquire shares or bonds;
- ⚡ derivatives on commodities;
- ⚡ units in collective investment undertakings;
- ⚡ money-market instruments;
- ⚡ financial futures contracts;
- ⚡ forward interest rate agreements;
- ⚡ options;
- ⚡ interest rate, currency and equity swaps.

2.15 Each member state is required to apply the prohibitions in the directive¹⁹ to actions carried out on its territory concerning financial instruments admitted to trading on any regulated market in the EEA (or for which a request for admission to trading on such a market has been made). They also have to apply the prohibitions to actions carried out overseas concerning financial instruments that are admitted to trading (or for which a request for admission to trading has been made) on a market situated or operating within their territory. This wide geographical scope is designed to avoid loopholes in the framework of market abuse legislation.

Enforcement of the directive (Articles 11-16)

A single regulatory and supervisory body in each Member State

2.16 Article 11 lays down that each Member State should designate a single competent authority to ensure compliance with the directive. In the UK this will be the FSA. The requirement for a single competent authority is to avoid confusion that might arise from having several authorities involved in enforcement.

¹⁷ Article 9 of Directive 2003/6/EC

¹⁸ Article 1.3 of Directive 2003/6/EC

¹⁹ Article 10 of Directive 2003/6/EC

2.17 Whilst, a competent authority can delegate some powers to other authorities such as exchanges, ultimate responsibility for enforcing the provisions implementing the directive would still rest with the single competent authority.

2.18 The idea of a single competent authority is particularly intended to improve the efficiency of cross-border exchanges of information and investigations in the face of increased cross-border trading. Of particular significance here is the requirement in Article 12 of the directive that competent authorities should be given a range of powers to enable them to enforce the prohibitions and requirements provided for in the directive.