

# **The Investment Exchanges and Clearing Houses Bill**

## **Regulatory Impact Assessment**

### **1. Title of proposal**

The Investment Exchanges and Clearing Houses Bill.

### **2. Purpose and intended effect**

#### Objective

2.1. The purpose of the measure is to amend Part 18 of the Financial Services and Markets Act 2000 (FSMA) to enhance the powers of the Financial Services Authority (FSA) over the rules and other regulatory provision of UK recognised investment exchanges (RIEs) and recognised clearing houses (RCHs). The new powers will enable the FSA to veto changes to the regulatory provisions of RIEs and RCHs where those changes would be disproportionate to the end the provisions are intended to achieve or would not pursue a reasonable regulatory objective. The new powers will not apply to changes to the regulatory provision of overseas investment exchanges and clearing houses recognised under FSMA. The new powers will only apply to future changes in regulatory provision; FSA will not be able to reverse any changes to regulatory provision which a UK RIE or RCH has made before the proposed measure comes into force. The FSA will also have the power to make rules (and, in the first year of operation, to grant waivers) to limit the scope of the new power of veto to significant changes in the regulatory provision of UK RIEs and RCHs.

#### Background

2.2. The UK's regulatory regime for RIEs and RCHs provides for these bodies to be recognised by the FSA if they meet recognition requirements laid down in FSMA and in regulations made by HM Treasury under powers conferred in FSMA.

2.3. Five of the nine UK RIEs and RCHs are subsidiaries of non-UK companies. Foreign ownership can help to bring in investment and innovative ideas to the United Kingdom and openness to foreign investment has been an important part of the success of the City as an international financial centre. The government has no plans to restrict foreign investment in the UK financial services sector.

2.4. Foreign ownership of UK RIEs and RCHs has, however, led to concerns about the interaction of UK and foreign regulation. In particular, there are concerns that foreign regulatory obligations might be imposed on issuers of securities traded on UK markets, or on other users of UK RIEs and RCHs if a foreign regulator sought to exercise jurisdiction over a UK body owned by an entity in that jurisdiction, or a foreign parent company of a UK RIE or

RCH sought to impose obligations on issuers or users in response to a legal or regulatory obligation in its own jurisdiction.

- 2.5. Surveys have indicated that one of the most attractive factors about London as a location for international financial services is the proportionate risk-based regulatory regime operated by the FSA. The Government believes that it is important for market participants to have a degree of certainty that the UK approach to regulation will continue in London.

#### Rationale for Government Intervention

- 2.6. The intended effect of this measure is to give that certainty about the UK regulatory regime. It is not intended to put into question the existing regulatory provisions of UK RIEs and RCHs or to involve the FSA in their day-to-day commercial decisions. The new power for the FSA is intended to be a power of veto over disproportionate rule changes. The new measure is also not intended to make foreign ownership of UK RIEs and RCHs any easier or more difficult than it is at present.

### **3. Consultation**

- 3.1. The Treasury has consulted the FSA.

- 3.2. This is a narrowly focussed measure concerning a matter which is unlikely to be of wide general interest and the Government wishes to take it forward with all reasonable speed. The Treasury decided therefore that it would not be appropriate to undertake a formal public consultation on its proposal. However, the Treasury has shown the proposal informally to UK RIEs and RCHs, relevant trade associations and other key stakeholders. The UK RIEs and RCHs were also shown a draft of this regulatory impact assessment. The proposal has been generally welcomed but the RIEs and RCHs have expressed concerns about the compliance cost associated with the measure, the number of notifications of proposed changes in regulatory provision which they will have to make and about the implications for their operations of any delays to their rule-making processes arising from the need to receive clearance from the FSA of any proposals they have to notify.

- 3.3. The Treasury has sought to reflect these concerns in this revised regulatory impact assessment. However, the Treasury considers that, while the concerns of UK RIEs and RCHs are understandable, they will be addressed substantially by the FSA having the power to restrict the obligation to notify proposed changes in regulatory provision to changes of such descriptions or in such circumstances, as it may specify in rules. The Treasury anticipates that the FSA will use these powers to ensure that various minor or routine changes in regulatory provision which would not raise the kind of concerns this measure seeks to address will not need to be notified. In addition, the Bill includes provision for the FSA to grant waivers to reduce the scope of the notification obligation during the first 12 months of operation. The purpose of this temporary provision is to ensure that

unnecessary notifications need not be made during a period in which the FSA can formulate its permanent rules.

#### **4. Options**

4.1. There are only two options: to proceed with the measure and not to proceed with the measure (“do nothing”).

##### **Option 1 – Do nothing**

4.2. The measure would not be taken forward. UK RIEs and RCHs would not have to submit any proposed changes to their regulatory provision to the FSA in accordance with the new procedure.

##### **Option 2 – Proceed with the measure**

4.3. The measure proposes a two-stage process for examining proposed changes in RIE and RCH regulatory provision. The RIEs and RCHs must notify the FSA of a proposed change in regulatory provision, unless that change does not need to be notified under the terms of a waiver or as provided in the new FSA rules. The FSA then has 30 days to decide whether to call in the proposal for further examination. If it does not call in a proposal, the RIE or RCH may proceed with the change in its regulatory provision. If the FSA calls in a proposal, it must allow time for representations to be made to it about the proposal and then has a further 30 days to consider whether to veto it. If the FSA approves the proposal, the RIE or RCH may then make the provision. An RIE or RCH may revise a proposal but a revision counts as a new proposal.

4.4. The objective of the measure is to remove risks that foreign owned UK RIEs and RCHs would change their regulatory provisions in such a way as to damage the United Kingdom’s risk-based proportionate approach to the regulation of financial markets, which would ultimately reduce the attractiveness of London as a financial centre and so harm the competitiveness of the UK financial services sector. Not proceeding with the measure would mean that those risks remained but the RIEs and RCHs would not incur additional compliance costs nor would their rule-making processes be subject to any delay, while the FSA would not incur the additional administrative costs. Proceeding with the measure means that these bodies will incur additional costs but that the risks described should be significantly reduced, if not eliminated.

4.5. There is no other option which would achieve the objective without excessive cost or regulatory burden. It would not be possible to rely on voluntary action or agreement of the UK RIEs and RCHs not to make changes to their regulatory provision which were disproportionate to the end to be achieved or which did not meet a reasonable regulatory objective. No such agreement could bind current or potential foreign owners, or foreign regulators, or make it impossible for a UK RIE or RCH to be compelled to comply with instructions given to it by a foreign owner.

- 4.6. The desired result could not be delivered by making changes to the recognition requirements which RIEs and RCHs have to meet<sup>1</sup>. While the recognition requirements often require RIEs and RCHs to have rules (implicitly if not explicitly), the requirement is usually framed in terms of the objective to be achieved or the minimum standards which the RIE or RCH has to meet. It would be difficult to reformulate the recognition requirements in ways which set both minimum and maximum standards without making the recognition requirements much more detailed and specific. This would probably restrict the commercial freedom of RIEs and RCHs to design rulebooks appropriate for the markets they serve and which met the needs of their own customers by more than the effect of the regime now proposed. It could therefore reduce the ability of UK RIEs and RCHs to compete with foreign exchanges and clearing houses, or with UK authorised persons providing similar services, to a greater extent than the new regime.
- 4.7. The FSA also has no power under existing legislation to prevent an RIE or RCH from changing any regulatory provision provided the body continues to meet the recognition requirements. In particular, the FSA could not veto proposed changes to an RIE's or RCH's regulatory provision using its existing FSMA powers.
- 4.8. The objective could be achieved by giving the FSA new more extensive powers over UK RIEs and RCHs and their regulatory provision than are provided in the Bill. However, this would mean that the RIEs and RCHs would incur higher costs in complying with new FSA requirements and that the FSA would incur higher costs in administering the system while the benefits in terms of the objective achieved would be no greater. There would also be a risk that additional regulation would itself make London a less attractive place to do business, and this could damage the competitiveness of the UK financial services sector. This option is not therefore considered further.

## 5. Costs and benefits

### Option I – Do nothing

- 5.1. None – by assumption. This is the base case for the comparison of costs and benefits.

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<sup>1</sup> The recognition requirements are to be found in the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (S.I. 2001/995). These regulations will be substantially revised as part of the implementation of the EC Markets in Financial Instruments Directive (2004/39/EC) (MiFID); draft regulations were published in December 2005 in the Treasury consultation document *UK Implementation of the EU Markets in Financial Instruments Directive (Directive 2004/39/EC)*. FSA guidance on the recognition requirements and more information about the FSA's approach to regulating RIEs and RCHs can be found in the FSA's *Recognised Investment Exchanges and Recognised Clearing Houses Sourcebook (REC)*. This will also be revised in the light of MiFID: see FSA consultation paper CP06/14 *Implementing MiFID for Firms and Markets*.

## Option 2 – proceed with the measure

5.2. The main sectors and groups affected are: UK RIEs and RCHs, issuers of securities traded on UK markets and investors in those securities, members of UK RIEs and RCHs<sup>2</sup> and other persons who use the facilities of RIEs and RCHs (usually as customers of members) to effect, clear or settle transactions in investments.

5.3. The main benefit of the proposed measure arises from the prevention of the imposition of disproportionate regulatory provision by UK RIEs and RCHs. The effect of such provision by these bodies would be to raise the costs of doing business on financial markets. Higher costs would directly damage the competitiveness and profitability of the UK financial services sector and, to the extent that these higher costs reduced the liquidity of financial markets, adversely affect the wider economy. It is not possible to make any precise estimates of these effects but a previous regulatory impact assessment in this field suggested that a proxy for effects on liquidity might be found in changes in the spread between the best bid and offer prices in equity markets<sup>3</sup>. It is very difficult to assess how much spreads might increase if the proposed measure were not adopted. However, it was estimated that a one basis point increase<sup>4</sup> in the spread in equity markets would increase the cost of trading (based on 2003 market turnover figures) by £150 million and it seems reasonable therefore to conclude that any increase in spreads arising from disproportionate regulatory provision could be significant. The main benefit is likely to be spread widely among the groups and sectors affected; RIEs and RCHs themselves are more likely to benefit indirectly (rather than directly) as they will mainly benefit from higher levels of activity in financial markets generally.

5.4. The main costs of the proposed measure are:

- the compliance costs for UK RIEs and RCHs (a) in deciding whether a proposed change to its regulatory provision needs to be notified to the FSA, (b) arising from waiting for FSA clearance of notified proposals and (c) arising if the FSA decides to call in a proposal for further scrutiny;
- and the additional administrative costs for the FSA in (a) deciding whether to call in a change in regulatory provision proposed by an RIE or RCH for further examination and (b) in examining a called-in proposal and deciding whether to accept the proposed change or to veto it, including considering representations made to it.

The FSA will not have the power to reverse changes to regulatory provisions which RIEs and RCHs have made before the coming into force of the

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<sup>2</sup> “Member” is used to refer to those stockbrokers, banks and other financial services firms which have an arrangement or agreement with an RIE or RCH to use its facilities. It does not mean “shareholder” although members will be shareholders in a member-owned (mutual) RIE or RCH.

<sup>3</sup> See paragraph B.30 of the Regulatory Impact Assessment in the Treasury consultation document *UK Implementation of the EU Market Abuse Directive 2003/6/EC* published in June 2004.

<sup>4</sup> One basis point is one hundredth of a percentage point; an increase of one basis point is an increase from (say) 4.89 per cent to 4.90 per cent.

proposed measure and, therefore, there will be no costs arising to either these bodies or the FSA from a need to review existing regulatory provision.

- 5.5. The UK RIEs and RCHs believe that there could be over 1,000 changes a year to their regulatory provision which will need to be considered for notification. Depending on the FSA rules (or the terms of the waivers), a much smaller number of changes will need to be notified. The FSA anticipate that on average there will be about 25 notifications (which may include more than one proposed change to regulatory provision) a year from UK RIEs and RCHs of which they will call in on average only 1 notification a year for further examination.
- 5.6. The additional compliance costs for an RIE or RCH in deciding whether to notify proposed changes to the FSA, in making notifications to the FSA (and in dealing with FSA queries etc at that stage) are expected to be minimal. This reflects the assumption that UK RIEs and RCHs will consider whether a proposed change to regulatory provision needs to be notified to the FSA as part of the work in formulating the proposal and that it is their current practice to keep the FSA informed of significant regulatory matters. The further compliance costs for an RIE and RCH if a proposed change is called in are expected to be about £6,000 per called-in proposed change.
- 5.7. The additional administrative costs for the FSA in considering whether to call in proposed changes to regulatory provision are also expected to be minimal. The FSA already reviews rule changes by UK RIEs and RCHs as part of its supervision of those bodies. The further administrative costs for the FSA if it calls in a proposal are expected to be about £26,000 per called-in proposed change.
- 5.8. On this basis, the total costs of the measure are expected to be about £32,000 a year once the UK RIEs and RCHs and the FSA have built up experience of operating the new regime. The costs in the first years of operation are likely to be higher as this experience is built up. In addition, the FSA will incur one-off costs in drawing up the new rules and processing waiver applications and the UK RIEs and RCHS will incur one-off costs and in participating in consultations with FSA about the new rules. Some of these one-off costs should be regarded as an investment which will reduce ongoing compliance and administrative costs. (Additional costs which the FSA incurs will be recovered under its normal financing arrangements in the fees it charges to UK RIEs and RCHs.)

## **6. Small Firms Impact Test**

- 6.1. None of the UK RIEs and RCHs would be regarded as a small firm. Small financial services firms which are members of these bodies, or use their facilities are unlikely to benefit more or less than in proportion to their size.
- 6.2. Maintaining levels of liquidity in primary security markets could make it easier for smaller companies to raise capital by issuing securities. But in

practice, it is unlikely that any company using a placing of its securities on a UK RIE to raise capital would be a genuinely small firm.

## **7. Competition assessment**

7.1. The main practical effect of the measure will be to slow up changes in regulatory provision by UK RIEs and RCHs (since such changes could only be made when the FSA has said that it does not intend to call in the proposed change or to veto it). It is unlikely, therefore, to affect competition between UK RIEs and RCHs.

7.2. The measure will reduce the flexibility with which a UK RIE or RCH could respond to competitive moves by foreign exchanges and clearing houses or by UK authorised persons which provided competing services because of the need to notify a relatively small number of proposed changes to the FSA and wait for clearance. The FSA will be able to decide quickly in appropriate case to announce that it is not calling in a proposed change in regulatory provision while clearly any change called in by the FSA (and even more so, a change vetoed by the FSA) is likely to be a change which would adversely affect the competitiveness of the RIE or RCH concerned. It seems unlikely therefore that the new regime would adversely affect competition. More generally, by safeguarding the United Kingdom's proportionate risk-based approach to financial market regulation, the measure will help to maintain competition in financial markets and between financial services providers.

## **8. Enforcement, sanctions and monitoring**

8.1. UK RIEs and RCHs will not be able to make any proposed change to their regulatory provision before the end of the periods in which the FSA has to consider the proposals or before the FSA confirms that it will not call in the proposal or, if it has called in the proposal, that it intends to take no action. If an RIE or RCH makes the regulatory provision before that time, it will not be able to enforce the regulatory provision in court.

8.2. The FSA will also have new powers to make rules concerning the notification of proposed changes in regulatory provision. It will be able to enforce these rules, if necessary, in the same way as it can enforce other FSMA requirements on RIEs and RCHs using its existing powers.

## **9. Implementation and delivery plan**

The proposal will be implemented through amendments to the FSMA made in the Bill. FSA will be responsible for delivering the policy through its existing machinery for recognising and supervising RIEs and RCHs.

## **10. Post-implementation review**

The effectiveness of the proposal will be demonstrated by the continued attractiveness of London as an international financial centre and the competitiveness of the UK financial services sector. In practice, these will be

difficult to observe and measure but the Treasury will be able to keep the effectiveness of the policy under review through its ongoing dialogue with stakeholders in the City and other parts of the UK financial services sector.

## 11. Summary and recommendation

There are two options: to introduce (option 2) and not to introduce (option 1) the proposed measure. Option 1 would mean that the benefits in terms of the prevention of excessive regulation of UK markets would not be gained although there would no additional compliance costs for RIEs and RCHs and no additional administrative costs for the FSA. The benefits cannot be quantified but it is thought that excessive regulation could reduce liquidity in UK markets and the resulting increase in bid-offer spreads would impose a resource cost which would be significantly greater than the expected additional costs of the measure. The recommendation is therefore to proceed with Option 2.

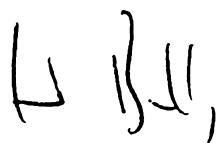
### Summary costs and benefits table

| Option | Total benefit per annum:  | Total cost per annum:-   |
|--------|---|--|
| 1      | None (base case)  | None (base case)   |
| 2      | Benefits in terms of greater liquidity and lower bid-offer spreads in UK markets. | Compliance costs for UK RIEs and RCHs - £6,000 a year in the longer term.<br>Administrative costs for FSA - £26,000 a year in the longer term.<br>TOTAL costs - £32,000 a year in the longer term.<br>Initial costs are likely to be higher as both UK RIEs and RCHs and the FSA gain experience of the new regime, apply for and process waiver applications and engage in the process of making new rules. |

## 12. Declaration and publication

*I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs*

Signed



Ed Balls, Economic Secretary to the Treasury

13 November 2006

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