

Feedback Statement following June 2004 Consultation on UK implementation of EU Market Abuse Directive (2003/6/EC)

The Treasury and FSA consulted in June 2004 on legislative proposals to implement the Market Abuse Directive. We received over thirty responses from a variety of market participants and representative organisations, and are very grateful for the time and effort people put into responding. This feedback statement addresses the main comments in those responses.

Amendments to the Prescribed Markets and Qualifying Investments Order

2. The revisions to this order contained two definitions of a qualifying investment for the purposes of different market abuse offences. One trade association suggested that this was unnecessary and confusing and that the only definition of a qualifying investment should be that in the directive. We have accepted this suggestion.

Amendments to Part 6 of the Financial Services and Markets Act

3. The directive requires that, where persons discharging managerial responsibilities within a share issuer, or others closely connected with those persons, transact in these same shares, such transactions should be publicly disclosed. The consultation asked whether it would be appropriate to rely partly on the definition of a 'connected person' in section 346 of the Companies Act 1985 in implementing this provision. All but one of the respondents who commented on this felt that it was appropriate, largely on the grounds that the definition was familiar and well understood. We have decided to apply the Companies Act definition of a connected person to persons discharging managerial responsibilities.

Amendments to Part 8 of the Financial Services and Markets Act

4. Two main issues were raised in relation to the amendments to this part of FSMA:

- the inclusion of offences which go beyond those in the directive
- the lack of a trading information defence akin to that in schedule 1 to Part 5 of the Criminal Justice Act

5. In the consultation document we proposed that the UK should retain the current boundaries of its market abuse regime. This would involve prohibiting a wider range of behaviours than required under the directive.

6. The responses to this proposal in the consultation document were mixed. Some felt that the boundaries of the existing regime were familiar and could help to provide the UK with a more secure trading environment. But other responses argued that the UK should only prohibit the behaviours it was required to do under the directive. They said that the regime in the directive was comprehensive, that going beyond it would introduce unnecessary complexity making it difficult to explain to those in intermediaries how to

act properly so as to avoid any risk of falling foul of the regime, and that inadequate justification had been given for the proposals.

7. We remain concerned about narrowing the scope of the existing regime, but are also mindful of our commitment to ensuring that the benefits of going beyond the minimum standards in directives exceed the costs. One particular difficulty in assessing the benefits and costs in this area is that the existing regime has only been operational for just over three years.

8. In the light of this we have decided to retain the provisions which maintain the current boundaries of the UK's regime. However, the provisions in the legislation prohibiting a wider range of behaviours than in the directive, namely sections 118(4) and 118(8) of Part 8 of FSMA and certain related provisions, will be subject to a three-year sunset clause. This means that they will automatically lapse three years after they take effect unless new legislation is adopted to allow them to remain in force.

9. Before May 2008, we will conduct a review of the impact of the provisions mentioned above to establish whether the expected benefits of having all or part of these provisions has exceeded the cost. If they have not, then the Treasury will allow all or part of these provisions to expire, leaving in place a regime based on the narrower directive provisions. The review will involve consultation with industry including a formal opportunity to express views.

10. The planned review will be expected to take into account, inter alia, the following factors:

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

Trading Information

11. A number of respondents expressed significant concern that, in the absence of the regular user test for most market abuse offences, the lack of an explicit “trading information” defence in the legislation would significantly disrupt existing business practice. A trading information defence is a defence for market participants who trade whilst in possession of information about actual or potential orders, the identity of those trading or considering trading and details of deals which have been completed but have not been or do not require to be reported to the market.

12. We did not intend that the proposals to implement the directive should force structural change upon securities and futures firms by significantly changing the existing position in relation to trading information. In the directive this issue is dealt with in recitals which clarify that the legitimate business of buying and selling financial instruments and the dutiful execution of client orders by market participants does not constitute market abuse. Likewise in our implementation we were relying on clarification in section 1.3 of the Code of Market Conduct. This reproduced language from the relevant recitals to the directive.

13. In the light of the concerns expressed by respondents we have considered this issue. We remain of the view that this issue is best dealt with in the Code of Market Conduct as it relates to the interpretation of the offences in the directive which are being incorporated into legislation. But are keen to ensure that the industry has the clarity it requires in order to continue its day-to-day business. The FSA will therefore expand the relevant sections of the Code of Market Conduct to make clearer how, in the context of the UK’s markets, the recitals to the directive on trading information should be interpreted.

Other Part 8 issues

14. There were several other issues raised in respect of Part 8 including:

- the coverage of markets which are not EU regulated markets
- related investment
- the lack of a definition of commodity derivatives
- the inclusion of accepted market practices in the Code of Market Conduct

15. The consultation document proposed that UK markets which are not regulated markets but covered by the existing market abuse regime should continue to be covered after the directive is implemented. All of the markets concerned agreed with this as did other respondents. The coverage of UK markets will therefore remain unchanged.

16. The consultation document proposed that insider dealing should constitute dealing in a qualifying investment or related investment on the basis of inside information relating

to the qualifying investment. Some consultation responses expressed concern that this would prevent dealing in related investments when an individual is in possession of information that is not inside information in relation to the related investment. We accept that the directive should not prevent such behaviour and have sought to clarify that the prohibition on dealing in related investments only applies where a person has inside information that relates to such an investment.

17. The directive contains a three-part definition of inside information. This provides a separate definition of inside information in relation to commodity derivatives to that applying to other financial instruments. But the directive does not define commodity derivatives. Some respondents said this created uncertainty about the scope of the definition of inside information. We accept that the position is not wholly satisfactory but do not believe it would be helpful to produce a UK-specific definition of a commodity derivative in the context of implementing a European directive.

18. The directive provides for a defence to one of the offences of market manipulation where a person's behaviour was undertaken for legitimate reasons and in accordance with accepted market practices. Accepted market practices are to be determined in the UK by the Financial Services Authority following consultation procedures. The consultation document proposed that accepted market practices as determined by the FSA should be published in the Code of Market Conduct.

19. Some respondents were concerned that providing for publication of accepted market practices in the Code created inflexibility. Allowing for publication in the Code is designed to fulfil the requirement that the FSA publish accepted market practices. This does not prevent the FSA from considering new and emerging market practices to decide whether they too should become accepted market practices.

Investment Recommendation (Media) Regulations

20. There were three main points made about the Investment Recommendation regulations:

- there was a lack of clarity about the coverage of the regulations;
- there was a lack of clarity about the geographical scope of the regulations;
- there was no exemption for self-regulation where this occurs in line with codes of individual countries.

21. The intention was that the regulations should apply to media organisations who produce and disseminate investment recommendations but are not subject to regulation by the FSA for advising on investments. Regulations 3(1) and 3(2) of the regulations now makes clear that they are intended to cover the production and dissemination of investment recommendations by someone whose profession or business is in the media.

22. The proposals in the consultation document did not say anything about the geographical scope of the regulations. In the light of the responses to the consultation

document it has been decided to include provisions, at regulation 12, on geographical scope. These mean that the regulations will apply where a person producing investment recommendations or disseminating recommendations produced by a third party is based in the UK. This is intended to help avoid potential overlapping jurisdiction with the regimes in other member states.

23. We accept that there should be a provision that allows firms with their own self-regulatory codes to apply these to their activities rather than be subject to the substantive provisions of the regulations. A provision to this effect has now been included in regulations 3 (4) and (5) .

Other issues

24. There was one other main issue raised in relation to the Treasury's implementation of the directive. This was suspicious transactions reports, which intermediaries are required to make under the directive. Respondents had two concerns in relation to these:

- that there should be a legislative provision protecting from liability those who make such reports in good faith
- that potential overlap with suspicious transactions reporting under the Proceeds of Crime Act should be minimised.

25. A provision has been included in Part 8 of FSMA, which is similar to that in section 337 of the Proceeds of Crime Act 2002, providing protection from liability for those making suspicious transactions reports in good faith in accordance with FSA rules which implement the relevant provisions of the directive.

26. Some of the suspicious transactions reports required under FSA rules implementing the directive will relate to circumstances which will require a suspicious transactions report under the Proceeds of Crime Act. The former reports are required to go to the FSA, the latter to the NCIS. Both organisations need to receive the information without delay for the different purposes for which they are required to receive it. It would be contrary to the internationally agreed Financial Action Task Force principles on which the relevant sections of the Proceeds of Crime Act are based for the reports to be sent only to the FSA.

HM TREASURY
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