BBA RESPONSE TO HM TREASURY CONSULTATION PAPER
FSMA MARKET ABUSE REGIME: ***A review of the sunset clauses***

The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

Summary of Consultation Paper

"The UK currently has a wider definition of market abuse than that established in the 2003 EU 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 HMT 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".

The 2 main areas of superequivalence are:

- 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 behavior based on a wider set of information than under the Directive provisions.

- The MAD provisions require some specified positive action (e.g. dealing, effecting trades, disseminating information etc.); the superequivalent provisions focus on 'behavior' 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).

(Extract from HMT CP)

Regulatory Dialogue:

We welcome the continuation of the valuable dialogue that has been created between HMT and the banking industry in its efforts aimed at preventing market abuse. The prevention of market abuse is vital in ensuring the high levels of investor confidence and integrity remain a firm fixture of the UK financial landscape. The BBA and the industry are in favour of maintaining a robust and effective regime for tackling market abuse and this should be a key component of both the UK and European regulatory framework.

The BBA recognises that it may sometimes be appropriate for the UK, as the EU's largest international banking centre, to maintain superequivalent provisions over the rest of Europe. However, it is essential that all superequivalences are completely justified with robust cost-benefit analysis.

2001 saw the introduction of the Financial Services and Markets Act (FSMA) in the UK after a lengthy period of pre-consultation with the industry. When the UK implemented the Market Abuse Directive (MAD) in 2005, the FSMA definition of market abuse was wider than that of MAD, with certain FSMA provisions overlapping. It was decided that some of these superequivalences would be kept in place in the form of sunset clauses, with an expiry date of June 2008.

The superequivalences in question certainly create extra costs for firms. They also hinder the establishment of an effective single market. UK firms have foregone some of the benefits they would otherwise acquire from the work undertaken by the Committee of European Securities Regulators (CESR) to unify market abuse regimes across Europe. Indeed, HMT estimate that additional work created directly by the superequivalences (such as obtaining extra legal advice) amounts to approximately £4.8 million per year.

Whilst HMT recommend that the sunset clauses should be temporarily extended, the BBA and our membership feel they should be left to fall away on the 30th of June 2008. We do not consider that they present sufficient benefits to outweigh the disadvantages brought by employing a superequivalent market abuse regime.

Lack of Superequivalences Use:

FSA have conceded that there have been no cases of market abuse brought forward under any of the superequivalent provisions since the 2005 implementation of MAD. Furthermore, there has not been a single case of market abuse that could have been launched solely on the superequivalences since N2. Whilst several market abuse cases have been considered under the superequivalent provisions, they were withdrawn for evidential reasons. Although perhaps at one time, the superequivalences did offer the investing community assurances that FSA held a wider range of powers to protect their interests, this comfort is now negligible when considering the lack of use the superequivalences have offered in reducing market abuse. Indeed, the paper notes that "enforcement, or threat of enforcement, of these provisions cannot be shown to have yielded quantifiable benefit to the market over the period in question".

In context of the superequivalences, we would point out the FSA's move towards a 'More Principle Based Regulatory' approach. Recent quasi-market abuse cases have seen the FSA launch enforcement action against firms based on breach of FSA principles. For example, a recent case was based on principles 2 and 3 of PRIN (A "firm failing to conduct its business with due skill, care and diligence", AND "failing to take reasonable care to organize and control its affairs responsibly and effectively and to implement adequate risk management systems", respectively). The renewal of the superequivalences currently held within the UK market abuse regime seems to conflict with the FSA's outlined approach of pursuing a more principles based regime and eliminating unnecessary text from the handbook.

The FSA have recently stated their intention to make greater use of their powers of criminal prosecution. FSA have also strongly publicised their ability to enter into plea bargain agreements where individuals who assist FSA in market abuse cases (i.e. through a supply of information) can potentially be offered immunity from prosecution. FSA have recently also increased staff numbers in their Enforcement division significantly. The BBA support these moves and are engaged in constant dialogue with the FSA in attempts to minimise levels of market abuse. This has been demonstrated by the great deal of time and resource the industry has invested in the area of transaction reporting, through projects such as the BBA/ICMA Transaction Reporting working group. It is through this type of UK market surveillance that sophisticated methods of market abuse are most likely to be detected. Because of this, the rationale behind transaction reporting is both understood, and accepted by the industry. This is in stark contrast to the unused superequivalence provisions which seem to offer very little in terms of detecting/preventing market abuse. We consider that the sunset clauses should be left to expire in 2008 with a transitional arrangement put in place allowing FSA to utilise the superequivalences in any on-going market abuse cases they may currently be in the midst of.

Market Understanding

Paragraph 3.9 of the consultation paper states that the "UK market abuse regime has been in place since 2001, and is therefore generally well understood by UK market participants". We would agree that this generally is the case. However, whilst market awareness of the UK superequivalences is high, we do not consider there to be a detailed level of understanding, in both their rationale and operational value.

Our members do not consider the sunset clauses capture a wider scope of abusive behaviour, and instead view them as an unnecessary complication of the UK market abuse regime. There are high levels of industry uncertainty surrounding the superequivalences, whilst they bring only minor and intangible benefits. Members feel the superequivalences hamper EU cross-border harmonisation and certainly increase legal costs. HMT estimates that the additional cost of compliance directly down to the superequivalences is approximately £5 million per year across the industry. Furthermore, as much as 20% of advice purchased by firms [regarding the UK market abuse regime] is spent looking directly at issues and uncertainty surrounding the superequivalences. We would point out that these super equivalent clauses divert internal resource away from other purposes which could bring a larger impact in terms of reducing or detecting market abuse. We would again refer to firms' transaction reporting as a more appropriate and constructive use of firms' internal resource with regards to minimising market abuse.

Therefore, although we agree that the superequivalent provisions neither massively increase the cost of regulation nor significantly reduce market efficiency, they needlessly complicate the UK market abuse regime. They dissipate internal resources without offering any real, tangible benefits in return.

Regular User Test

It is noted in paragraph 2.13 of the consultation paper that there is a connection between the two different UK definitions of 'insider information'; one being applicable to disclosure requirements, and the other market abuse. The FSA Code of Market Conduct ('the Code') recognises that a 'regular user' would class actions (such as the execution of a trade) based on undisclosed information which is actually required to be disclosed or announced as unacceptable. This would therefore be tantamount to market abuse. This question is closely linked to whether or not the disclosure obligations within the Disclosure and Transparency Rules (DTR) apply to the specific piece of information in question.

The FSA rules on Disclosure and Transparency use the Market Abuse Directive 'price sensitive' test. It is noted in the consultation paper that this test is neither an exhaustive or exclusive test, as a market abuse case can also be based on 'relevant information'. The ability to consider RINGA in market abuse investigations is one of the key superequivalent provisions the UK market abuse regime holds over the MAD. It is the view of the Treasury that a piece of information can be abused for trading purposes before it is precise or certain enough for the issuer to come under an obligation to publicly disclose it.

We consider that the application of 'relevant information' (in the form of the RINGA provision) neglects the FSA 'Regular User Test' embedded within the superequivalent provisions. In order for a specific action or behaviour to be classed as market abuse under RINGA, it must be shown that a 'regular user' of the market would regard the behaviour to fall below the standards reasonably expected of a person in their position within the prescribed market. Whether or not a regular user would deem a specific piece of behaviour based on 'relevant information' as unacceptable or not quickly turns to whether or not that piece of 'relevant information' is price sensitive. Price sensitive information is classed as disclosable under FSA 'Disclosure and Transparency Rules', and thus information of this nature would automatically fall within the scope of MAD.

The consultation paper suggests investor groups value the distinction RINGA brings, as without RINGA, individuals would be allowed to trade to their advantage (and ultimately to the disadvantage of others) on the basis of relevant information that is not generally available. For example, when an individual makes a trade based on a major contract negotiation that a firm may be in the midst of. However, it seems logical that information of this nature would be classed as 'price sensitive', and automatically fall within the boundaries of MAD.

Based on these observations, it is hard to see how the RINGA superequivalent provisions would capture a wider body of information than the Market Abuse Directive. We consider it is far from certain whether the FSA could rely exclusively on the RINGA superequivalences in any enforcement proceedings. It is precisely this lack of certainty surrounding the viability and operational use of the RINGA provisions, in addition to their lack of actual application in the markets, which prompts us to request their removal.

Upcoming EU review of MAD

It seems the main rationale behind HMT's recommendation to renew the sunset clauses stems from this year's impending European Commission review of the Market Abuse Directive. The FSA consider the MAD definition of 'inside information' should be amended, so as to run along the lines of the UK regime, i.e. to include a distinction between RINGA and insider information. HMT have used the MAD review as an opportunity to highlight the advantages of the UK superequivalence regime, and in particular, the RINGA provisions. It is a possibility that there will be post-review changes to the definition of 'inside information' to accommodate a RINGA-type distinction. For this reason HMT recommended an extension to the sunset clauses until 2010. Without this extension, it is a risk both the industry and the FSA could experience a transitional burden by experiencing two sets of regulatory changes within only a short period of time (i.e. removing the superequivalences only to have them re-introduced shortly thereafter).

The BBA and our membership do not believe the superequivalences in question produce any tangible benefits, and as such, do not consider the provisions should be incorporated into the Market Abuse Directive. Furthermore, we are unconvinced that the Commission actually possesses the appetite to include a RINGA-type distinction in the pan-European market abuse regime. HMT have cited concerns expressed by the European Securities Markets Experts group (ESME). However, it should be noted that the ESME report praises the current MAD regime and its definition of inside information. They comment that "the definition of 'inside information' works well as a test for when a person in possession of such information should refrain from trading or encouraging trading in relevant financial instruments". Despite this, the ESME report does outline how practical difficulties can arise from MAD using the same definition of inside information for both the market abuse regime and firms' disclosure requirements. It therefore seems likely that any potential change at EU level is likely to come in the form of changing the issuer's disclosure obligations, rather than an expansion of the market abuse regime through the use of a RINGA-type provision.

We have previously highlighted the practical issues we see arising from the operational use of RINGA. The 'regular user test' effectively means that the superequivalences cover the same scope for market abuse as MAD. It seems unlikely that the EU review would lead to a widening of MAD (through the adoption of a RINGA-type distinction), only to then limit this by adopting the UK 'regular user test'. There would be very significant implications if a distinction between 'inside information' and RINGA was introduced into MAD, unless it were accompanied by some sort of 'regular user test'. This would represent a huge expansion to the current

EU / UK market abuse regimes. It would imply that anyone person who reasonably ought to be aware that they possess ‘relevant information that is not generally available’ is prohibited from dealing, regardless of whether or not the specific piece of information is disclosable to the market, or price-sensitive in nature.

There is also a concern that if the EU review includes the UK market abuse superequivalences in MAD, the door is effectively opened for the superequivalences of other European countries to be incorporated. We believe it a genuine danger that other European regulators could potentially see this as a ‘green light’ to lobby for their specific market abuse ‘superequivalences’ on a European level. This would only serve to negate the benefits received from a unified European market abuse regime, and hamper cross-boarder harmonisation.

It seems the principle reason behind the Treasury’s request for a temporary extension to the sunset clauses is they would not want firms to experience two sets of regulatory changes within a short period of time. However, firms’ market abuse training manuals do not go into extensive depth regarding the UK superequivalences. Thus, if there were to be 2 changes to the UK regime in quick succession, training manuals would not need to be heavily re-written. We believe this means any transitional costs are significantly lowered. Furthermore, there is a strong case to say that it should be an individual firm’s choice as to whether they should undertake this two-change risk and amend their manuals or alternatively, continue including them in their internal market abuse prevention frameworks.

Examples of Superequivalent Applications in Practice

The HMT consultation paper sets out some brief examples which are intended to demonstrate how exactly the superequivalent provisions cover significant abusive behaviours which are not covered by the UK provisions directly implementing the provisions of the Market Abuse Directive. However, we have some reservations as to the arguments made in these sections of the consultation paper, which we have highlighted below.

Fixed Odds Betting

Paragraph 2.18 of the consultation document states that the placing of a ‘fixed odds’ bet on the value of a firm’s future share price is unlikely to fall within MAD’s definition of ‘dealing’. It suggests that, under MAD it would not be classed as market abuse if a person profited from a fixed odd bet made on a company’s share price, when the bet was based on information not yet public concerning a takeover approach for that company. The consultation document indicates that the superequivalent provisions would enable the FSA to take enforcement action in a case such as this, as it amounts to ‘behaviour’ in relation to the company’s shares. However, the UK provisions implementing MAD go beyond the minimum requirements of the Directive in that they define a related investment to cover any ‘investment’ whose price or value depends on the price or value of the qualifying investment (section 130A(3)).
Under section 130A(2) and section 22 FSMA ‘investment’ (for these purposes) include any asset, right or interest. Since sections 334 and 335 of the Gambling Act

2005 came into force in September 2007, fixed odds betting contracts of this kind are fully enforceable contracts and would thus appear to be ‘investments’ within the context of FSMA. Moreover, a fixed odds bet on a listed share would appear to be a related investment, as its value depends on the price of the qualifying investment. Thus, a fixed-odd bet based on inside information does seem to constitute ‘dealing’ for the purposes of the UK provisions implementing the directive.

Pre-Briefing of Analysts

It is suggested within paragraph 2.19 of the consultation paper that it is unacceptable behaviour for an analyst to amend his forecast and prepare a revised research report based on inside information that is due for disclosure the following day. This is because the analyst is then able to publish his report literally seconds after the announcement is made which takes the information public. The consultation document suggests that the analyst’s behaviour would amount to market abuse under the superequivalent provisions because he would have achieved a significant ‘first mover’ advantage over others in the market.

FSA MarketWatch issue no. 4 (April 2002) discussed the issue of bringing research and sales analysts ‘over the Chinese wall’. Whilst it was made clear that these analysts are still firmly bound by obligations (and thus unable to deal on, or disclose the inside information pre-announcement), FSA observe that “pre-briefings were widely regarded as normal, long-standing and legitimate functions for corporate 'house' brokers which can aid market efficiency and speed assimilation of the 'news'”. Further more, FSA explicitly stated that this kind of behaviour meets the standards expected of participants by the ‘regular user’. Ultimately, we fail to see how the pre-briefing of analysts could be classed as a form of market abuse, and there was certainly no indication within the FSA’s thinking to suggest otherwise. There has been no indication to the industry that the FSA’s thinking on this subject is otherwise, and we would consider it inappropriate to signal a change of this magnitude through a HMT consultation document reviewing the market abuse sunset clauses.

Underlying Commodities

It is suggested in paragraph 2.20 of the consultation document that, while transactions in a commodity futures contract would fall within the scope of the provisions implementing the Directive, transactions in the underlying commodity would not. For example, let us say someone has taken a specific position in a commodity futures contract. This transaction would fall in the scope of MAD. However, the consultation indicates it would not fall within the scope of MAD if that same individual interfered in the physical commodity market (by limiting supply of the physical commodity) in order to squeeze the related commodity futures contract they hold. However, it seems very likely that the provisions of the Market Abuse Directive relating to market manipulation apply both to transactions in the instrument admitted to trading on the regulated market (the commodity future) and the underlying commodity, if the interference has the specified effect on the regulated market in question. Unlike the provisions on insider dealing, the relevant provisions are not expressly restricted to dealings in the specified kinds of financial instrument, but merely refer to "transactions or orders to trade" without qualification. (Compare article 1(2) (a) and article 2(1) of MAD).

In addition, the EU regulation dealing with the stabilisation safe harbour assumes that stabilising transactions in the instruments underlying a qualifying investment (as well as derivatives on that investment) require a safe harbour, which would not be the case if the prohibition in the Directive itself were restricted to transactions in qualifying investments only (see the definition of associated investment in article 2(8) of Commission regulation (EC) No. 2273/2003).

Non-Dealing off 'Inside Information'

Paragraph 2.21 of the consultation paper looks at the case of a company director in the process of selling his shares in the firm he works for, when his firm simultaneously receives an unexpected takeover approach at a 20% share price premium. It is suggested that the director should continue with his initial plans and sell his shares at the current market price.

It seems unlikely that a successful market abuse case could be brought based on non dealing off 'inside information' in these circumstances. Not only would this type of market abuse be very hard to prove, it also goes against the standard advice that is given to directors of companies that are experiencing a take-over attempt. Directors in the outlined position are advised to refrain from dealing. In fact, the model code prohibits directors from dealing, unless they obtain special consent. This consent is granted only in very exceptional circumstances, and it is very unlikely that the director outlined in paragraph 2.21's example would have sufficient grounds to be granted special consent. Therefore, the suggestion that the director in the outlined example is committing market abuse by terminating his broker's mandate is both unhelpful and unrealistic. However, he should obviously not disclose the reasons behind this termination to the broker.

The Source of the 'Inside Information'

Paragraph 2.23 states that FSA can experience difficulties in demonstrating that 'inside information' did in fact come from an 'insider', or an inside source. Reasons for this may be that the information has been passed through a sophisticated chain or network of individuals, referred to as an 'insider ring'. This in turn creates difficulties for the FSA in bringing forward enforcement proceedings.

MAD dictates that a person is an insider if they obtain the specific piece of 'insider information' during the course of their employment. It is irrelevant whether or not this employment is directly connected to the issuer (article 2(1)(c)), and so it is sufficient to show that all those within the chain knew, or "ought to have known" that the information came from a party that obtained it during the course of their employment (article 4).
Neither we nor our members consider this a demanding standard for FSA to achieve. Besides, in such a case the FSA is also likely to have to demonstrate facts similar in nature when establishing if someone has received information in their private

capacity, that would also be deemed unacceptable behaviour by the ‘regular user test’.

Credit Default Swaps

It is outlined in paragraph 2.26 of the consultation document that there is a doubt as to whether Credit Default Swaps (CDS) are within scope of MAD. The most commonly used forms of CDS contracts provide that on the occurrence of a credit event, the credit protection buyer can choose to deliver a publicly traded security or can receive a cash difference which is arrived at by reference to the price of such a security. It is therefore apparent that the payout of the CDS will be closely correlated to the price of the security of the issuer. Since the introduction of MAD in the UK it has been standard industry practice to assume that MAD provisions do apply to typical Credit Default Swaps that include publicly traded securities as deliverable obligations (or as reference obligations).

If you would like to discuss these points in further detail please contact myself, Ross Barrett or Ruari Ewing.

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ANNEX I:

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

No. We do not consider that the superequivalences in question increase the effectiveness of UK market abuse regime. Nor do we consider them to have any real effect on market integrity. We would refer to our paper for a full explanation of our position. Whilst we are fully supportive of any useful and appropriate moves to minimise market abuse, we do not consider the superequivalences produce any meaningful or tangible benefits. They do, however, dissipate internal resources that could otherwise be directed towards more useful methods of detecting and preventing market abuse. Our argument focuses on the lack of the superequivalent's use and possible reasons behind this. It also specifically discusses problems of compatibility with the FSA's 'Regular User Test', levels of market understanding and the upcoming EU review of the Market Abuse Directive.

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

We consider that all of the sunset clauses in question should be left to expire on the 30th of June 2008. It is our opinion the superequivalences in question do not increase the effectiveness of UK market abuse regime, and nor do we consider them to have any significant effect on market integrity. As such, we do not feel it appropriate to distinguish differences between the individual sunset clauses. Please refer to all sections of our paper for the reasons behind our recommendation to allow the sunset clauses to expire.

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

Yes. We have supplied several pieces of further evidence regarding the practical operation of the superequivalences since the introduction of MAD. The Treasury consultation document sets out some brief examples which are intended to demonstrate exactly where the superequivalent provisions cover significant abusive behaviours that are not covered by the UK provisions directly implementing the provisions of the Market Abuse Directive. We have some reservations as to the arguments made in these sections of the consultation paper. We would specifically refer you to the sections of our paper which discuss: Fixed Odds Betting; Pre-Briefing of Analysts; Underlying Commodities; Non-Dealing off Insider Information; The Source of Insider Information and Credit Default Swaps.

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

No. We do not agree that HMT should extend the sunset clauses for a limited period of time until the results of the EU review are known. For the reasons outlined within our paper we feel they should be left to expire on the 30th of June 2008.

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

We do not consider that the superequivalences should be extended. We believe they should be left to expire on the 30th of June 2008.