Title: FSMA market abuse regime: evaluating the sunset clauses (2011)	**Impact Assessment (IA)**
IA No:	**Date:** 02/12/2011
Lead department or agency: HM Treasury	**Stage:** Final
Other departments or agencies: N/A	**Source of intervention:** Domestic
	Type of measure: Secondary legislation
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Summary: Intervention and Options	**RPC Opinion:** Amber

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£50.4m	£50.4m	£0m	No	N/A

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

In 2001, the UK introduced a domestic regime to tackle market abuse. The European Commission adopted the EU Market Abuse Directive (MAD) in 2003. As the MAD framework did not go as far as the UK regime, the UK's domestic provisions were retained in its implementation of MAD, but subjected to a 3 year sunset clause to assess their continued need. Following previous consultation (see background), it was decided to retain the sunset measures until after the EU completed a review of MAD, and then align with a new EU common standard. However, the EU review has been repeatedly delayed, and the sunset measures are due to expire 31 December 2011. The measures will cease to apply at this time, unless they are renewed.

What are the policy objectives and the intended effects?

The objective is to establish a robust framework for tackling market abuse to ensure high levels of market integrity and investor protection. The intended effect of having a high-quality market abuse regime is to exert a deterrent effect on would-be abusers, give competent authorities broader powers to support their investigative work into market abuse, and ensure the confidence of investors accessing UK markets.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

(1) Retain the existing measures and align with the new EU regime, once negotiations have completed
(2) Allow the sunset measures to expire on 31 December 2011.

The preferred option is Option 1. Following previous consultation, the Government indicated that it would align with the new EU regime following the European Commission's review of the Market Abuse Directive. This impact assessment supports a continuation of the existing policy.

It would be highly disruptive and cause market uncertainty to change the UK regime for a short period ahead of EU negotiations concluding. This argument is all the more compelling considering that the European Commission has made clear it wishes to strengthen the EU Market Abuse framework. To dilute the UK regime only to expand it soon afterwards would be counterproductive.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 09/2014

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: M Hoa Date: 6.12.11

Summary: Analysis & Evidence

Policy Option 1

Description: Retain the existing measures and align with the new EU regime (preferred option)

FULL ECONOMIC ASSESSMENT

Price Base Year 2012	PV Base Year 2012	Time Period Years 3	Net Benefit (Present Value (PV)) (£m)		
			Low: n/a	**High:** n/a	**Best Estimate:** £50.4m

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Cost (Present Value)
Low	n/a	0	n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	£0		£0	**£0**

Description and scale of key monetised costs by 'main affected groups'

There would be no additional costs imposed on the market by retaining the existing sunset measures as proposed under this policy option. This reflects the current situation in the UK and the costs have already been experienced by industry.

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

N/A.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	n/a	0	£0m	**n/a**
High	n/a		£35m	**n/a**
Best Estimate	£0		£18m	**£54m**

Description and scale of key monetised benefits by 'main affected groups'

Using the improvement in the FSA's market cleanliness data as a guide, it is estimated that the sunset provisions provide an annual benefit of around £18 million by way of greater market integrity.

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

Market participants will incur compliance costs aligning with the new EU market abuse regime at the end of the time period. These are likely to be slightly lower under option 1 than option 2 as the Commission is seeking to strengthen the new EU market abuse framework - in part more closely reflecting the UK's regime. Other benefits of retention are continued regulatory certainty and investor confidence.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5%

1. Isolating and quantifying the costs and benefits of the UK regime is very difficult; the calculation provided of the benefit is merely indicative.

2. EU negotiations are shortly due to commence and the outcome is uncertain. On the basis of the Commission's proposal, this option assumes the eventual cost of aligning with the new EU regime is slightly lower. However, this is not assured as the final outcome is unknown.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £0m	**Benefits:** £18m	**Net:** £18m	No	N/A

Summary: Analysis & Evidence

Policy Option 2

Description: Allow the sunset measures to expire in 2011 (baseline scenario)

FULL ECONOMIC ASSESSMENT

Price Base Year 2012	PV Base Year 2012	Time Period Years 3	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** £0m

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Cost (Present Value)
Low	n/a		n/a	**n/a**
High	n/a	1	n/a	**n/a**
Best Estimate	£4m		£0m	**£3.9m**

Description and scale of key monetised costs by 'main affected groups'

A one-off cost would be experienced by firms in removing the measures - redrafting internal guidance, changing procedures relating to market abuse compliance, and communicating the changes to staff. It is unlikely wholesale changes would need to be made to systems and controls as compliance is more about understanding and firms will still need to monitor for market abuse more widely. (It is unclear if firms will make the changes if they believe the EU regime will reintroduce similar provisions.)

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

Firms will incur a second transition cost aligning with the new EU regime at the end of the period. These will likely be slightly higher under this option if firms have already ceased to comply with the sunset provisions - since the Commission's intention is to strengthen the regime, partly reflecting the UK model. Thus, a slightly greater expansion would be expected under the new EU regime, having previously diluted the UK's regime. Investor protection could also suffer.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low	n/a		n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	£0m		£0m	**£0m**

Description and scale of key monetised benefits by 'main affected groups'

Under policy option 1, the cost of retention is negligible and therefore assumed to be nil. The benefit of their removal, under this option, is therefore also nil as there is no cost-saving associated with their expiry (see evidence base).

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

N/A.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5%

It is difficult to measure the benefits of the UK market abuse provisions subject to a sunset clause and thus the risk of their removal. Their removal could signal to the market that the UK is now less safe or attractive for trading purposes. There is also a risk of regulatory disruption under this option, by changing the familiar UK market abuse regime twice in swift succession (to first remove the provisions, and later align with the new EU regime). This could create market uncertainty.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £4m	**Benefits:** £0m	**Net:** £4m	Yes	IN

Evidence Base

Purpose of reviewing the sunset measures

The prevention of market abuse is essential to ensure clean, safe markets in which investors have the confidence to invest. This ensures that markets maintain their integrity and transparency so those using the market are confident that they are not being disadvantaged by other market participants knowing or acting on information that they are themselves unaware of when trading, thus ensuring a level-playing field.

The UK currently has a slightly wider definition of market abuse than that of the EU Market Abuse Directive 2003 (MAD). This is because the UK's domestic framework for market abuse, which was established in 2001, preceded the European legislation. As the European Commission adopted a minimum harmonisation directive in 2003, the UK made the decision to retain its domestic market abuse provisions when transposing MAD in to UK law in 2005. However, these measures were subject to a 'sunset clause' of three years, so that the need for their continued retention could be reassessed. After three years, the measures subject to the sunset clause would expire, unless the 'sunset clause' was amended to keep them in force.

In February 2008, HM Treasury consulted on the sunset measures and found that the argument in favour of their retention was finely balanced. However, a small majority of respondents felt it was appropriate to extend the UK's regime, pending the outcome of the European Commission's review of MAD which was expected in 2009.

The review of the Market Abuse Directive was repeatedly delayed following the financial crisis. This resulted in the UK's sunset provisions being extended on two occasions – once in 2008 and, again, in 2009 when it became clear that the EU review would be postponed. The measures are currently due to expire on 31 December 2011. The Commission finally adopted a proposal for a new Market Abuse Regulation on 20 October 2011, and a final regime will likely take around 3 years to be negotiated and come into effect across the EU.

The length of the delay in reviewing the MAD, combined with the change in UK Government, led to HM Treasury undertaking an informal consultation in September 2011 to establish current views on the sunset provisions. This sought to evaluate whether there was any reason to recommend departing from the established policy of aligning with the outcome of the MAD review, and to revisit the domestic measures more broadly. The consultation involved a broad array of affected market participants in a roundtable discussion of the measures, including investor groups, financial intermediaries, and the leading UK trading venues.

An informal discussion paper was sent in advance to highlight the subject-matter and points for discussion, and to invite comments on the costs and benefits associated with the UK's market abuse regime.

The following firms were involved in the informal consultation:

- International Securities Lending Association (ISLA)
- International Capital Markets Association (ICMA)
- BATS
- Chi-X
- Association for Financial Markets in Europe (AFME)
- Association of British Insurers (ABI)
- London Stock Exchange Group (LSEG)
- British Banking Association (BBA)
- Investment Management Association (IMA)
- Association of Corporate Treasurers (ACT)
- Association of Investment Companies (AIC)
- International Swaps and Derivatives Association (ISDA)
- Futures & Options Association (FOA)
- Financial Reporting Council (FRC)
- The Association of General Counsel and Company Secretaries of the FTSE (GC100)
- Alternative Investment Management Association (AIMA)
- City of London Law (CLLS)

The UK market abuse framework

The areas of the UK market framework subject to a sunset clause are as follows:

1. The definition of inside information (Section 118(4) of FSMA);
2. The definition of market manipulation (Section 118(8) of FSMA);

Inside information

In the EU Market Abuse Directive, inside information is limited to precise information relating to an issuer of financial instruments. If published, it would have a significant effect on the price of those instruments or related financial instruments. Issuers are required to disclose this information to the market and Member States are required to prohibit the use of such information by trading in the instruments to which it relates.

The UK has a dual definition of inside information, encompassing information that must be disclosed but also a *wider* horizon of information that should also not be used to inform trading decisions. This is information which is not generally available to those using the market, but which would be regarded (if it was available) as relevant when deciding the terms of a transaction, provided that a reasonable regular market user would regard the behaviour concerned to be unacceptable. Dealing or attempting to deal in qualifying investments on the basis of that information constitutes market abuse in the UK.

The advantage of having a broader provision in this area is that it would capture an unfair trade that was made using any kind of privileged information which a regular market participant would view as relevant. It is not necessarily the case that in every trading situation, for every kind of asset, inside information is necessarily of a "precise" nature and falls within the narrower EU definition. An example might include an employee's knowledge that the Chief Executive Officer of the company had decided to resign but that information had not been announced. If that employee sold shares in the company he may commit market abuse under the broader provision. This behaviour creates an unfair marketplace based on information asymmetry – as the person buying the shares from the employee would be unlikely to purchase them, or to do so at that price, if he was aware about the impending resignation. This behaviour would not *necessarily* be picked up by the EU's Market Abuse Directive definition of inside information as it may not be sufficiently important to be likely to have a significant effect on the share price.

Market manipulation

The UK has a broader definition of market manipulation, covering any 'behaviour', beyond the MAD definition that market manipulation relates to 'transactions' and 'orders to trade'. In effect, this covers attempted market manipulation. The UK's definition also covers manipulation that may 'distort a market in an investment'. This has given the FSA a discretionary power to capture abuse not caught in MAD today: such as abuse committed through derivatives, and via spot commodity markets – both of which are now covered explicitly in the Commission's new proposal for an EU Market Abuse Regulation (further detail below).

Costs & affected participants

The prohibition of market abuse entails a significant amount of compliance on the part of trading venues, issuers, and investment firms (financial intermediaries and asset managers). This involves:

- making relevant disclosures of inside information (issuers);
- having in place adequate systems and controls to detect market abuse (trading venues and investment firms);
- transaction reporting to competent authorities to ensure adequate transparency and integrity (investment firms);
- providing training to staff to ensure their understanding and compliance with the market abuse framework (investment firms); and
- providing information to competent authorities requested as a result of market abuse related enquiries and investigations.

However, all of these activities are required under the wider EU market abuse framework. It is very difficult to isolate the individual or additional cost posed by the UK provisions subject to a sunset clause. Primarily, the domestic

measures provide discretionary powers to the competent authority to investigate and take action against market abuse. For market participants, the domestic measures will comprise part of staff training, and some additional suspicious transaction reports may be made as a result of the UK provisions and dealing with some additional requests from competent authorities.

The FSA estimates that approximately 1,100 firms are affected by the sunset provisions, comprising:

- 940 firms conducting investment business and required to provide transaction reports to the regulator;
- Approximately 30 platforms responsible for ensuring the integrity of their venues;
- An additional 100 asset managers exempt from making transaction reports but still providing staff training and monitoring of market abuse;

In addition, some corporate finance firms and listed issuers would also be impacted by the domestic provisions but to a smaller extent.

However, the cost of the UK's sunset provisions will already have been experienced by firms, since the UK's domestic framework is now long-established having been in place for nearly 10 years. The costs are considered to have been absorbed by firms with the sunset measures forming a small element of routine communications and monitoring of market abuse. If any cost is still imposed on market users, this is expected to be negligible.

This assumption was supported by the informal consultation, which did not find any particular cost associated with the sunset provisions at this time. One consultee indicated that if there was a cost posed to firms, it was correct to recognise that this would already be factored into firms' budget assumptions. This reflects a combination of their long establishment and the existing Government policy to retain these measures until after the MAD review was completed. For this reason, it would be fair – in the context of extending the sunsets for a short period and aligning with the EU review – to consider these as negligible for the very reason that they are in line with firms' existing expectations. By contrast, to make these measures permanent *would* pose an additional level of cost on those affected, as this would not be anticipated by firms.

Additionally, the FSA has confirmed that the measures do not pose an additional cost on its own resources by retaining the sunset provisions.

Cost of removal

There are also costs associated with the *removal* of the provisions operating under sunset clause. A transitional cost would be experienced by firms having to prepare themselves for their removal. Furthermore, as the European Commission's review of the Market Abuse Directive is resulting in a more robust regime, closer to the UK's current standard, there would also be a slightly higher cost associated with later aligning with the EU review if the sunset provisions were first removed.

Additional costs

A cost is also associated with removing the measures for investors, and with respect to wider market integrity. Removing the domestic measures will leave the market with a narrower definition of market abuse. Arguably, this could impact investor certainty and confidence, sending an unwelcome signal to the market that the UK is diluting its standards.

The subsequent impact on market confidence is impossible to monetise, but could practically impact on the attractiveness of the UK as a marketplace, which in turn could impair the market's liquidity. One consultee suggested that the willingness of stock lenders to participate in the market could be compromised by the UK being seen to dilute its regime by removing the sunset provisions. Lenders are not obliged to lend and many are highly risk averse, as this activity entails both reputational risk and credit risk. The structure of the UK market is such that lenders are comfortable with the current legal basis and the risk controls. Whilst the income obtained from lending is welcome, it was suggested that this was by no means so important that it could not be sacrificed if there was concern, or the suggestion or incidence of market abuse increased. Wholesale withdrawals of stock from lending pools would weaken market liquidity considerably.

Additionally, the UK's domestic provisions have contributed to the perception that the UK is rigorous in tackling market abuse, thus helping to exert a deterrent effect on would-be abusers, which could be compromised.

The implication is that the removal of the sunset measures would therefore be to the detriment largely of investor groups and ordinary investors. In responding to the informal consultation, investor groups indicated that the UK regime reflects the standards of probity that institutional shareholders in UK-listed companies expect from the companies in which they invest. They argued that market and regulatory developments since the sunset provisions were last reviewed in 2008 did not make their utility less appropriate – in the context of a financial crisis and much higher levels of market volatility, they argued that their value had in fact been strengthened.

It is also hard to see how industry would appreciate the removal of the sunset provisions now with the likely reintroduction of similar provisions as part of the EU's Market Abuse Regulation. It is likely to be considered an unnecessary and unimportant distraction from their focus on the key European legislative changes over the next 2-3 years, which will significantly impact the markets. This was confirmed by the consultation exercise, where a number of market participants – venues, financial intermediaries and other market participants – argued that there was a pragmatic case for maintaining the status quo at this time.

Benefits

Assessing the precise benefit of the UK's domestic measures is highly challenging and, arguably, the practical value of the measures has been limited to date. The FSA has previously indicated that while the broader UK provisions were used as the basis of enforcement actions prior to MAD, they have not been used since its implementation in 2005. This raises a question over the value of these provisions and whether, in the context of the broader EU regime, they are still required.

However, as the costs to investor groups and the wider market serve to indicate (above), the provisions have resulted in greater confidence that the FSA has the powers needed to investigate market abuse and safeguard investors' interests. This must also be considered in the context of the UK's broader regime not imposing any new costs on those affected.

The FSA has also argued that the fact the broader UK provisions have been used sparingly does not mean they do not have a value and would not be used in the future. This is credible in the context of the increasing number of enforcement actions being brought in the UK against market abuse. The FSA has given a strong public emphasis on enforcement in recent years[1], including in 2010/11:

- five criminal convictions for insider dealing, with sentences ranging from 12 months to over three years;
- 15 penalties levied for market abuse, totalling £8,342,804;
- 13 defendants currently awaiting trial for insider-dealing offences with trial dates fixed for November 2011, February 2012 and April 2012; and
- Additionally, the FSA noted that there has been considerable improvement in UK market cleanliness in recent years, which it measures in its Annual Report. While it is difficult to establish the extent to which the sunset measures or indeed the market abuse framework as a whole is responsible, this is highly welcome.

The FSA also indicated that while the sunset provisions have not acted as the *sole* basis in enforcement actions since 2005, they nonetheless provide a secondary legal basis and as such nearly all market abuse investigations initiated by the FSA into insider trading will be conducted under both sections 118(2) (which reflects MAD), and 118(4) (which is one of the two UK sunset provisions). This enhances the confidence of the regulator to proceed in the preliminary stages of an investigation ahead of this escalating to full-scale enforcement. It should be noted that there is also a practical difficulty with undertaking Enforcement investigations solely under sunset provisions. The FSA has indicated that most of its insider dealing investigations and prosecutions take 2-3 years to progress to a public outcome. As a matter of practicality and overall case prioritisation, it would not be sensible to build a long-running insider dealing case around a provision that has a risk of expiring in the near future – thus potentially appearing to an administrative tribunal and the public that resources had been wasted. Nonetheless, the capacity of the sunsets to strengthen enforcement and act as a *contributory* legal basis was considered very helpful by the regulator.

[1] See for example: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0622_mc.shtml

This may also beg the question of why not to make the UK regime permanent. This is academic considering the new EU Market Abuse Regulation will be directly applicable (and in fact the Commission's proposal reflects in large part the UK's own framework). Even if it were possible, this may be unwelcome considering the regulatory certainty that has previously been provided to industry that the UK will maintain its existing regime and align with the new EU standard. Furthermore, there is a clear benefit of ultimately having a single, stronger EU framework in place, which the review of the Market Abuse Directive will provide.

Policy options

(1) Retain the existing measures and align with the new EU regime, once negotiations have completed

(2) Allow the sunset measures to expire on 31 December 2011

Assessing each policy option: the costs & benefits

Option 1: Retaining the existing measures and aligning with the new EU regime

Costs

In this scenario, there would be no departure from the stated UK intention of waiting until the EU review of market abuse had completed. Therefore, no transitional cost would be experienced by firms in modifying the UK regime at this time. Additionally, the costs associated with retention (as above) are considered to be negligible and therefore treated as nil. This reflects firms' familiarity with the existing regime, their existing compliance with the measures, and budget forecasts ahead of outlining with the outcome of the EU review.

A transitional cost would, however, be incurred by firms in adjusting to the new regime following the outcome of the Commission's review.

In view of the Commission's intentions to make the EU market abuse regime more robust, we envisage that the review will result in a stronger framework which will in part reflect the UK's existing regime. In particular, the Commission's proposal, which forms the basis of the EU negotiation, seeks to partially reflect the UK definition of inside information and tightens the definition of market manipulation making it more similar to the UK standard.

The transition cost of aligning with the new EU framework is expected therefore to be slightly lower under this option than under the second option (where firms will have diluted the UK regime to then comply with a stronger EU standard). Until a final text is agreed in negotiation it is, however, impossible to provide a meaningful estimate of the time and cost involved in complying with a new EU regulatory regime.

Benefits

As the UK provisions have not been used as the basis for recent enforcement actions, it is difficult to monetise their benefit. The non-monetised benefits encompass: ensuring high levels of investor confidence; exerting a deterrent effect on would-be abusers; providing the market with a consistent and familiar regulatory regime in the near-term; and ensuring the optimum transition cost to the new EU regime.

However, in response to the informal consultation, investor groups suggested that calculating the benefits ought to involve the European Commission's estimate of the total cost of market abuse in the EU. Using this figure, it would be possible to estimate the UK's share of the market, and assess the value of the sunset measures with respect to UK market cleanliness data. A high-level estimate of the value is therefore provided below:

> The European Commission has estimated that the annual cost of market abuse is €13.3 billion per year across the EU. This figure is concentrated only on equities, which suggests it is highly conservative. However, it is also a helpful measure as most enforcement takes place with respect to equities trading.
>
> Data by Thompson Reuters shows that approximately 40% of trading takes place in the UK – which as a proportion of the €13.3bn figure is €5.3bn or **£4.6bn**[2].
>
> Working from FSA 2010/2011 data, from its annual report, the UK has witnessed around a 25% improvement in market cleanliness since the financial crisis in 2008 (and the time of the HM Treasury consultation on the sunset measures). If the **£4.6bn** were 25% higher (i.e. in the absence of the UK market improving in this

[2] Conversion provided by currency conversion site www.xe.com – 17 October 2011.

period), this figure would be **£1.15bn** higher, or **£5.75bn**. The 25% improvement witnessed in UK market cleanliness relates to the level of abnormal, pre-announcement price movements made with respect to takeovers – a highly sensitive time for trading in UK companies, where there may be considerable scope for market abuse to be committed.

Any figure derived from this analysis is necessarily indicative in the absence of hard data. It is also difficult to pinpoint why market cleanliness has improved, which could be down to a number of factors not necessarily associated with the FSA's market abuse strategy. However, the reassurance that the FSA has the powers available to investigate market abuse and a wide legal regime may be a contributing factor – but further analysis is required by the FSA before such conclusions can firmly be drawn from this statistic.

Taking a conservative estimate, the annual contribution to market cleanliness provided by the sunset measures could be estimated as exerting an effect of anything from 0% to 3% on market cleanliness. The higher figure (3% annually, or 9% over the 3-year time horizon of this impact assessment), seeks to provide a conservative view of the issues raised in consultation over the sunset , in short the perception that the UK has a more robust regime and willingness to investigate market abuse, that the wider provisions of the sunset measures may provide a deterrence effect to would-be abusers, and that changes to the regime could be destabilising for the markets and signal that the UK regime had been weakened. This in turn could affect confidence and liquidity.

- 1 % of 1.15bn = £0m
- 3 % 1.15bn = £35m
- Best estimate (mid-point) = c.**£18m**

Option 2: Allow the sunset measures expire on 31 December 2011 (baseline scenario)

Costs

To continue with the current situation, which would result in the sunset provisions expiring at the end of December 2011, would mean firms experience two sets of costs. A transitional cost would first be experienced by firms revisiting the provisions subject to a sunset clause, redrafting training and guidance, and communicating this to staff. A second cost would be experienced in aligning with the outcome of the EU review.

As part of the informal consultation, HM Treasury suggested that the cost of removing the sunset measures would require 1 day of a Compliance Officer (at a rate of £600/day), and 2 hours of more senior-rated time. This comprises a small amount of external legal advice advising and checking the work of the Compliance Officer, as well as firm's internal senior management. A rate of £770/hour was applied, updated from the 2008 consultation to reflect earnings inflation in the services industry.

Feedback from those consulted was very limited in terms of quantifiable costs and benefits. However, it was suggested that the time may have been underestimated by HM Treasury and that, in particular, updating guidance and communicating this to staff, may take longer.

Consequently, this has been updated to 2 days of Compliance Officer time, and 3 hours of senior-rated time.

The transition cost of removing the sunset measures is therefore:

- 2 days of Compliance Officer time: £1,200
- 3 hours of senior management / legal counsel: £2,310
- Approximately 1,100 firms would be affected by the changes, resulting in a total cost of £3.86m, or c. £4m. In reality this figure is likely to be considerably higher as it is impossible to capture the training of front office staff, which may involve hundreds of traders. This could significantly increase the cost from £4m, which we consider to be a highly conservative estimate.

The second transitional cost – of aligning with the new EU regime – is also estimated as slightly higher under this scenario as firms will have first diluted the UK regime to then comply with a stronger EU standard. Until a final text is agreed in negotiation it is, however, impossible to provide a meaningful estimate of the time and cost involved in complying with a new EU regulatory regime.

Benefits

As market participants are familiar with the current regime and have already experienced the cost of introducing the sunset provisions, it is not believed that there is any cost-saving associated with their removal.

The risk of their removal is the impact this could have on market behaviour, should confidence in the reputation and integrity of the UK market be compromised, which in turn could affect liquidity. Market cleanliness, as calculated in option 1, may also be compromised. However, this 'loss' is not included under option 2, as the £18m figure is clearly indicative of the possible benefit exerted by the UK's broader definition of market abuse.

Context of the EU review

The Commission has stated clearly that it intends to increase harmonisation and establish a stronger European legislative framework to tackle market abuse. In so doing, the EU regime proposed by the Commission in its draft text for negotiation, adopted on 20 October 2011, more closely reflects that of the UK.

The Commission has taken on board the utility of differentiating between inside information that must be disclosed and information that should not be used for trading purposes (thus moving toward the current UK standard of having a dual definition to tackle insider dealing).

With respect to market manipulation, the Commission also intends to provide a more robust definition. The framework will be widened to cover *attempts* to manipulate the market, manipulative actions committed through derivative instruments, and the interaction between spot commodity markets and financial instruments. The UK's wider definition already gives the FSA the ability to investigate market abuse committed through derivatives, as well as activity that may 'distort' a market. This latter definition means that the FSA already monitors to some extent the interaction between physical spot commodity markets and financial instruments.

In its response to the Commission's June 2010 public consultation on market abuse, HM Treasury and the FSA were also highly supportive of the Commission's intentions to establish a more robust framework for tackling market abuse across the EU. The Government's response to the Commission's consultation highlighted the advantages of the UK's regime, and the synergy between the UK's existing framework and the outcomes sought by the Commission. The case for extending the UK's existing regime has therefore been, on balance, strengthened by the Commission's stated objectives and on the basis of the text it has published for EU negotiation.

Impact on small firms and microbusinesses

The UK market abuse framework, including the sunset measures, is designed to create a strong framework to prevent anyone using the markets from engaging in insider dealing or market manipulation. In this respect, these measures would also extend to small firms and microbusinesses. In terms of *practical* impact, the vast majority of small firms and microbusinesses would not be affected by the measures, however, and would not need to have in place the internal controls, or provide transaction reports, relating to these measures.

Those conducting relevant investment management and securities business would be affected. However, as this impact assessment has demonstrated, the cost of compliance is negligible. New, unforeseen costs would only be experienced by removing the sunset provisions, as this would impose two sets of changes on the market (removing the sunset measures, and then making further changes to align with the outcome of the EU review). Removing these measures 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.

Risks, assumptions & the wider impact

The UK measures subject to a sunset clause are so well-established in the UK that it is very challenging to establish the costs and benefits connected with them. The £18 million benefit figure provided in this impact assessment is highly uncertain – the benefit would likely be argued as nil or negligible by certain industry groups, and significantly understated by others. Similarly, the cost of transitioning to the new EU regime and the cost under each option will not be clear until the EU negotiation has ended and a final text been agreed.

The difficulty of quantifying the costs and benefits reflects the fact that, in the absence of compelling data, the value of the sunset measures has resulted in strongly divided opinion within industry. As the sunset measures have not been used to undertake enforcement actions since 2005, a superficial reading of their merit would conclude that they do not add value over and above the existing EU market abuse framework. Trading venues and financial intermediaries are not particularly persuaded of their value, in the absence of hard data as to their merit. Yet, by contrast, investor groups are strongly in favour of these provisions and believe they are integral to market confidence, befitting the UK's position as a leading financial centre. They argued in 2008, and reiterated their position strongly for this informal consultation, that the EU must 'level up' to the UK's standard to improve market integrity across the Union.

Realistically, it may only be possible – and potentially highly undesirable – to quantify the merit of the sunset measures by removing these provisions and measuring the impact. If the sunset measures exert the discipline and confidence championed by investor groups this would be highly unwelcome and risky. The wider market impact could be significant, were their removal to result in a less certain trading environment and signal to the market that the UK's standards had been reduced. This would undermine the perception that the UK takes market abuse seriously which, ultimately, could result in greater incidences of abuse and impair liquidity.

This is set against the fact that the cost posed by the UK's broader measures is believed to be negligible – and this was not challenged by the consultation process. The potential benefit (cost-saving) of their removal at this time is therefore nil. Their removal may in fact result in greater information asymmetry, where the groups affected most by their removal are ordinary investors and the fund managers that represent them. These changes would also fall at a time of severe financial stress, in the context of the wider Eurozone discussions currently underway.

Notably, the UK's informal consultation elicited *greater* support than in February 2008 for the continued extension of the sunset measures. This reflected the fact that the EU review was shortly about to commence, and also the context of the Commission's position and overall objectives (which in 2008 were unknown).

Trading venues and financial intermediaries largely stressed the burden of letting the sunset measures expire in 2011 as one of regulatory uncertainty – in short, reducing the UK regime today to later align with the outcome of the EU review was unwelcome, particularly at a time when the financial services industry is facing a demanding legislative agenda following the financial crisis. Of the 17 organisations involved in the consultation, only 2 were actively opposed to a further extension of the measures. This was on the grounds that it was difficult to quantify clearly the benefit of the UK provisions, and that they did not wish to prejudice the outcome of the EU review (which will not be known until the negotiations are completed, and still remains far from certain).

While this is a fair consideration, in the absence of the sunset measures posing a compliance cost on firms, their retention at this time is appropriate. Additionally, in the context of the EU review, the various industry groups will be able to make representations as they see fit to the European Commission and international counterparts. The debate is better served in the European context, assessing what is needed for the EU as a whole in the creation of a single framework for tackling market abuse. Increased harmonisation should also, over time, significantly reduce the complexity for firms currently complying with various different national regimes across the EU – the result of MAD being a minimum harmonisation directive and failing to keep up with market developments.

Superequivalence policy

The guiding principle for Government on implementing EU policy and on superequivalence states that UK businesses should not be put at a competitive disadvantage compared with their European counterparts in the transposition of EU legislation. Consequently, the Government will not go beyond the minimum requirements set out in European directives unless the circumstances are clearly justified, based on cost-benefit analysis and consultation with relevant stakeholders.

In this instance, the short extension to the sunset measures, in order to align with the new EU regime, is justified and compatible with these objectives. Consultation with stakeholders showed strong support for their retention at this time and in the context of the wider EU review. The reasons for that support differed. A clear majority felt this was pragmatic considering the timing and direction of travel of the EU review. They believed that dispensing with the measures at this time would introduce uncertainty. Additionally, in terms of cost-benefit analysis, it was noted that the cost of compliance (until the outcome of the EU review) has already been experienced by firms. By contrast, to dispense with the sunset measures at this time would introduce cost, by firms experiencing a cost today in their removal as well as the cost they will shortly be faced with in aligning with a new EU common standard, which looks set to reflect in part the UK's current regime.

Additionally, there was strong support from investor groups for the sunset measures in their own right, arguing that this was important to investor confidence in the UK market (and thus indirectly beneficial to UK competitiveness, and reflecting the size and reputation of UK financial services). They argued that the UK's market abuse regime exerts a strong deterrence effect and that change at this time, while markets remain fragile, would send an unwelcome signal to the market.

Extending the sunset measures for a short period is therefore substantiated by the consultation, and the recognition of the cost and disruption posed by changing the UK market abuse regime at this time. Respondents did note, however, the importance of recognising that, on a permanent basis, the UK having a different regime for complying with market abuse provisions would pose a cost to industry (whereas compliance with the sunset measures until aligning with the EU standard has already been factored in by industry). Permanently having in place a different compliance regime – which has not been contemplated in this impact assessment and would have been a substantial shift in policy from aligning until the outcome of the EU review – would mean businesses would fail to benefit fully from the synergy in compliance costs brought about through the creation of a common EU standard. There is therefore no departure from the existing policy of retaining a wider definition of market abuse until the outcome of the EU review, when the UK can align with the new EU definitions. This is further supported by the fact that the new EU regime will be underpinned by a directly applicable Regulation (in place of the minimum harmonisation Market Abuse Directive), where Member States will no longer be able to extend the definitions of market abuse.

Conclusion

In the context of the EU review, and the preference of the majority of those consulted to retain the existing measures until its outcome, it is appropriate to retain the sunset provisions. Unnecessary regulatory change poses a cost and disruption to business and the market and, considering the negligible cost of retention, it makes sense to maintain the existing policy. The argument in favour has in fact been strengthened since previous consultation, reflecting a better understanding of the European Commission's objectives and the fragility of the markets themselves.

Under both options, there is a transitional cost (and eventual long-term benefit) of aligning with a single EU regime. This cost will be better managed by avoiding regulatory uncertainty today, and may be lower if the final text agreed in negotiation is similar to the Commission's proposal, which reflects in part the UK's regime today.

Implementation

No change will be made to the substance of the UK market abuse regime. The existing FSMA regulations will simply require a change to reflect a new date for the expiry of the sunset measures.

It is not possible, legally, to specify that the sunset measures will expire on the establishment of the new EU Market Abuse Regulation. A precise date is required to provide legal certainty. The regulations will therefore be updated so that the sunset measures expire after a further 3 years (31 December 2014). This represents a best estimate of the time it will take for the EU negotiation to conclude and the new Regulation to come into effect across the EU. This allows a seamless transition from one regime to the next for UK market participants. (Moreover if the new EU regime is in place before this time, the measures will be automatically repealed.)

n.b. For this reason, this cost-benefit assessment is calculated over a three-year time horizon, representing the time that the sunset measures will be extended ahead of the introduction of the new EU framework.