

Regulatory environment

Introduction

1. Paragraphs 2.30 to 2.35 of the final report summarize the relevant regulatory environment for this inquiry, both in the UK and in the EU. This appendix sets out further details of the regulatory environment.

The UK regulatory environment

2. In the UK, the FSMA establishes the regulatory framework for the financial services sector, including exchanges and clearing houses.

Regulated activities

3. A key provision of the FSMA is the general prohibition against any person carrying on a regulated activity in the UK unless they are either authorized or exempt.¹
4. Regulated activities include dealing in investments as principal or as agent, and safeguarding and administering investments. Investments include equities, bonds, futures and options, and contracts for differences. Firms carrying out trading or investment activities in the UK need to be authorized by the UK regulator. ATs must also seek authorization.
5. FSA oversight of exchanges in the UK may either be through the Recognized Investment Exchange (RIE) regime, whereby an exchange is exempt from the requirement to seek authorization from the FSA provided that it meets certain conditions, or alternatively under the Authorized Firm Regime. A similar exempt Recognized Clearing House (RCH) regime operates for clearing houses. There are two avenues by which exchanges not located in the UK may offer services in the UK. First, exchanges based in another EU member state and operating as an EU regulated market can place access facilities in other member states without requiring further authorization from these states. Second, a non-EU exchange can operate in the UK by seeking Recognized Overseas Investment Exchange (ROIE) status from the FSA for its existing overseas exchange.

The regulator

6. The FSA has four statutory objectives, as set out in sections 3 to 6 of the FSMA. They are:
 - to maintain confidence in the financial system;
 - to promote public understanding of the financial system;
 - to secure the appropriate degree of protection for consumers; and

¹Section 19 FSMA.

- to reduce the extent to which it is possible for a business carried on, by a regulated person or in contravention of the general prohibition, to be used for a purpose connected with financial crime.
7. In discharging its functions, the FSA has regard to the principles of good regulation, set out in section 2 of the FSMA. These, for example, encourage the FSA to be efficient in the use of resources and proportionate in its dealings with firms and other regulated entities. The principles of good regulation also require the FSA to have regard to the need to minimize any adverse effects on competition arising from regulation and the desirability of facilitating competition, and to facilitate innovation. Finally, they recognize the international character of markets and the UK's competitive position.

United Kingdom Listing Authority

8. The FSMA also covers the official listing of securities.² The FSA in its capacity as the competent authority makes the rules ('listing rules') for the admission of securities to a market operated by an RIE for listed securities (eg the LSE Main Market, 'the official list') and is responsible for:
- admitting securities to listing;
 - regulating sponsors (firms that act as advisers to issuers during and after listing);
 - other applications; and
 - imposing and enforcing ongoing obligations on issuers and suspending and cancelling listing.³

A requirement of admission of securities to the official list is that they are also admitted to trading on an RIE.

LSE sets the eligibility requirements for securities to be admitted to trading on its Main Market and AIM. A requirement for securities to be admitted to the Main Market is that issuers should be on the official list (maintained by the UKLA). Issuers admitted to trading on AIM do not need to be on the official list.

Recognized Investment Exchanges

9. To qualify as an RIE, an exchange must satisfy the requirements specified by HM Treasury (the Recognition Requirements) and be formally recognized by the FSA.⁴ The requirements specified by HM Treasury cover the areas of: financial resources, suitability, system and controls, safeguards for investors, disclosure by issuers of securities, promotion and maintenance of standards, procedures for making and amending rules, arrangements for monitoring and enforcing compliance with its rules, arrangements for investigation and resolution of complaints, and rules for defaults in respect of market contracts.

²Part VI of the FSMA.

³See the FSA's web site.

⁴FSMA (*Recognition Requirements for Investment Exchanges and Clearing Houses*) Regulations 2001 (2001/995) made under section 286 (1) of the FSMA.

The EU regulatory framework

10. Most countries regulate the issuance and trading of securities by laws and regulations. Overall, the laws and regulations governing listing, trading, and settlement of securities have the objectives of reducing systemic risk, creating a climate of legal certainty, maintaining the integrity of the market and ensuring equality of treatment and opportunity for all participants. This in turn facilitates access to capital for issuers and supports a wide participation of investors and traders in the capital markets.
11. In Europe, EU directives provide the framework for the regulation of the issuance and trading of securities. The directives set core standards which are then implemented in each member state through a combination of national laws and regulations. Historically, EU directives have permitted member states to impose additional standards, as long as these conditions apply equally to all equivalent issuers/trading platforms/intermediaries.
12. The EU regulatory framework for financial services is being overhauled to further the integration of financial markets in the EU. This will increase the harmonization of regulations between member states.
13. The document setting the objectives of the new framework and the measures to be implemented is the EU Financial Services Action Plan (FSAP). It was endorsed by the Lisbon European Council in March 2000 and consists of a set of measures intended to fill gaps and remove barriers to create a legal and regulatory environment supporting the integration of EU financial markets by 2005.
14. The legislative phase of the FSAP is now almost complete. Some FSAP measures take the form of EC regulations, which apply directly in all member states, whilst others take the form of EC directives, which have to be transposed into the law of each member state.
15. The measures covered in the FSAP for the wholesale market relate to: securities issuance; trading and settlement; accounts and corporate restructuring. Of the five key directives which form part of the FSAP, two have already been implemented in the UK—the Market Abuse Directive and the Prospectus Directive:
 - The Market Abuse Directive (MAD) harmonizes offences in relation to insider dealing and market manipulation in instruments admitted to trading on regulated markets and related disclosure obligations on issuers.
 - The Prospectus Directive (PD) is designed to provide a ‘single passport’ for issuers of equity and debt securities so that, once an issue of securities meets prospectus requirements in one country, the securities can be sold across the EU.

The other directives, yet to be implemented in the UK, that are relevant to this inquiry due to their impact on securities issuance and trading can be summarized as follows:⁵

⁵Source: *The EU Financial Services Plan: A Guide*; HM Treasury, the Financial Services Authority and the Bank of England, 31 July 2003.

- The *Markets in Financial Instruments Directive (MiFID)* is due to replace the 1993 ISD which regulates the authorization, organization and conduct of business of investment firms and markets, including exchanges.
 - The *Transparency Directive* is set to impose common core obligations on issuers to meet continuing disclosure requirements after issue.
 - The *Takeover Directive* proposes a minimum framework for the national approval of takeovers, including applicable law, protection of shareholders and disclosure.
16. We discuss the five directives identified in paragraph 15, which each form a key part of the FSAP, in more detail in the following paragraphs.

Market Abuse Directive

17. The MAD has, at EU level, replaced the former Insider Dealing Directive, expanding the proscribed offence to include both insider dealing and market manipulation. Implementation of the MAD required changes to the UK's existing market abuse regime as set out in Part V111 of FSMA, but the provisions of the Criminal Justice Act 1993 in relation to insider dealing remain in force.
18. The MAD's definition of market abuse falls into three categories:
- the use of information that is not publicly available for the benefits of certain persons;
 - transactions to trade, or orders to trade that distort market conditions; and
 - the creation of false or misleading signals through the dissemination of information in the media that is likely to affect the supply, demand or price of financial instruments.
19. The MAD contains a series of preventative measures aimed at reducing the incidence of market abuse, including:
- measures relating to the disclosure and handling of inside information by issuers and the obligation of issuers and their advisers to maintain insiders' lists;
 - requirements for directors and senior management to disclose dealings in their own company's shares to the market; and
 - obligation on firms to report suspicious transactions to the competent authority.

Prospectus Directive

20. The PD replaces the Public Offer of Securities Directive (POSD) and some parts of the Consolidated Admission and Reporting Directive (CARD).⁶ The PD harmonizes the laws in relation to the drawing up and the publication of prospectuses when securities are offered to the public and/or admitted to trading on a regulated market in the EU. Member states may not require disclosure provisions in addition to those

⁶The CARD sets out the requirements for public offers of non-listed securities and for listing and ongoing obligations respectively.

required by the PD.⁷ By regulating the way prospectuses are drawn up and published, the PD aims to lower the cost of raising capital, provide easy access to capital and protect investors.

21. The PD applies to public offers of securities and admission of securities to trading on a regulated market.⁸ Issuers making a public offer of securities or seeking an admission to trading on other markets are exempt from the obligation to produce a prospectus in certain limited circumstances.
22. The PD sets a 'passport' regime for prospectuses: a prospectus published in one member state is valid for the public offer or the admission to trading in another member state provided the competent authority in the host member state is notified.

MiFID

23. The MiFID substantially revises the existing Investment Services Directive⁹ and is sometimes known as ISD2; it will replace the ISD and will govern most investment services and the activities of exchanges across the EU. It will result in changes to rules on matters such as best execution, order handling, conflicts of interest, and information disclosure, among others.
24. It will also remove the ISD provision known as 'the concentration rule' which permitted member states to require that all trading by domestic investors take place on a regulated market in that member state. The MiFID introduces the new concepts of systematic internalizers and multilateral trading facilities (MTFs).
25. The MiFID widens the scope of investment services requiring authorization by member states and the range of investments falling within the ambit of regulation. In relation to the regulated investment services and activities, the MiFID, as the ISD, provides a 'passport' for investment firms enabling them to conduct cross-border activities across Europe, where they have received prior authorization from their home state regulator. Because the MiFID covers a wider range of services and instruments than the ISD,¹⁰ it will offer greater opportunities than the ISD for passporting activities.
26. The MiFID divides investment services into two categories: investment services and ancillary services. All activities that fall under the first category will be subject to the MiFID, including for example investment advice and operating an MTF.
27. The MiFID does not cover settlement and clearing in any detail, although it does contain provisions that are intended to promote the access of investment firms to clearing and settlement systems.

⁷As a piece of framework legislation, the PD does not specify the detailed form and contents of a prospectus. Instead this is achieved by an EU regulation, EC/809/2004 (PD Regulation) which is directly applicable in all member states.

⁸The PD only applies to transferable securities, defined by reference to MiFID. Securities are classified either as equity or non-equity. Equity securities are defined as shares or securities which may be converted into the shares of the issuer. In addition, non-equity securities are classified according to their denomination. A number of issuers are outside the scope of the Directive, including sovereigns and their local authorities, as are issuers who offer securities with a total consideration of less than €2.5 million within a period of 12 months.

⁹The Investment Service Directive (ISD) set the legislative framework for investment firms and securities markets creating a European Economic Area (EEA)-wide authorization for investment services, known as the 'single passport'. The passport enabled investment firms incorporated and authorized in one member state to conduct investment services throughout the EEA without separate authorization by the member state in which they conduct business.

¹⁰MiFID, Annex 1 Section C.

28. The most relevant areas of the MiFID for our investigation relate to the new provisions on market transparency for both on- and off-book trading. We discuss these further in the following paragraphs.

Best execution

29. The MiFID envisages that investment firms should provide the investor with an order execution policy that allows clients to obtain for their orders the best possible result in the circumstances. The policy must cover, at a minimum, the execution venues that allow the firm to obtain, on a consistent basis, best results for the client. Firms must also monitor the effectiveness of their order execution policy and address any shortcomings.

MTFs

30. MTFs will be subject to a number of specific regulatory requirements, including the establishment of transparent and non-discretionary trading rules and obligations to monitor the compliance of users with its rules, disorderly trading and market abuse. In addition, MTFs will be subject to pre- and post-trade transparency obligations which will bring them more into line with the obligations of regulated markets. In 2003, the FSA implemented a regime specifically recognizing and regulating ATs in the UK, implementing rules similar to those being introduced by the MiFID.

Systematic internalizers

31. The MiFID contains pre-trade disclosure obligations for investment firms conducting internalized trades on a systematic basis (systematic internalizers). Any such investment firm authorized to deal on its own account that is a systematic internalizer will be required to make a continuous public quote in shares in which it is an internalizer. The firm will be required to trade at those prices for any qualifying order it executes up to a specified size.

Post-trade disclosure

32. There will be an obligation on investment firms dealing in equities to disclose the volume, price and time of the transactions, whether the transaction is executed on a regulated market, an MTF or through a firm's own systems.¹¹

Transparency Directive

33. The TD replaces and updates parts of the existing CARD. The TD aims to enhance transparency on EU capital markets by establishing minimum requirements on periodic financial reporting and on the disclosure of major shareholdings for issuers whose securities are admitted to trading on a regulated market in the EU. Member states may choose to impose additional requirements where they deem it appropriate to do so.
34. All issuers, who have securities admitted to trading on a regulated market situated or operating within the EU, will be covered by the TD. The TD will require these issuers to disclose periodic and ongoing information for investors on a pan-European basis.

¹¹Specific rules for block trades and the mechanics of publication are to be established when devising implementation measures. Such trades are not to be exempted from post-trade disclosure, but some delays are allowed. (Source: FSA.)

It will also require investors to disclose major shareholdings in relation to those issuers.

The Takeover Directive

35. The EU's attempts to create common rules on takeovers form a long-standing part of the EU's ambition to create a single capital market. The Takeover Directive is a first attempt to create a level playing field for bids in the EU, although it does not achieve harmonization in many areas. It is a minimum standard directive and member states will be allowed to impose their own additional or more stringent takeover rules.
36. The Takeover Directive only applies to takeover bids (ie public offers) for the securities of a company governed by the law of a member state if those securities are admitted to trading on a regulated market in one or more member states.