

In addition to its statutory functions, NedCo met regularly to receive updates in relation to proposed changes to the regulatory architecture. It considered the implications for the operating structure and efficiency of the FSA and the position of senior executives, including related retention and transition issues.

This section of the Remuneration report is not subject to audit.

Remuneration Committee (RemCo)

RemCo is a committee of NedCo and is chaired by the chair of NedCo. The principal responsibilities are contained in the Terms of Reference, which can be found on the FSA website.

During the year, RemCo met on 14 occasions. The exceptional number of meetings was due largely to the government's proposals for significant restructuring of financial services regulation in the UK, the consequent effects on the future roles of existing FSA senior management and the general uncertainty for all FSA staff. In discharging its role, RemCo paid particular attention to ensuring the FSA Executive was supported in retaining key staff to maintain stability and mitigate risks to the FSA achieving its statutory objectives.

Remuneration strategy:

The FSA's remuneration strategy is to provide a remuneration package that:

- helps to attract, retain and motivate;
- recognises the FSA's role and responsibilities as a public authority;
- is as competitive as possible against the appropriate market;
- encourages and supports a culture aligned to the achievement of the FSA's statutory objectives;
- is fair and transparent; and
- is capable of being applied consistently across the organisation.

Remuneration policy:

To achieve the strategy, the remuneration policy aims to:

- set base salaries at, or around, the median of the relevant market competitive level;
- reward stretching performance; and
- provide an appropriate balance between the need to attract, retain and motivate staff while reflecting the constraints placed on a public authority.

2010 Remuneration Review

The total remuneration package, which is common to all FSA employees comprises:

- basic pensionable salary;

- eligibility for an Individual Incentive Award;
- other benefits of a flexible nature; and
- pension contribution.

Information on the appointment of the chairman and the executive directors can be found in the Report of the Directors and in Table 8.4. The information contained in the remuneration table has been audited by the external auditor. The directors have continuous contracts of employment that provide for between six and 12-months prior notice of termination by either party. The chairman is employed on a fixed-term contract, which began on 20 September 2008 and ends on 19 September 2013.

One of the responsibilities of RemCo is to determine the remuneration of the executive directors. In doing so, RemCo received information on, and assessment of, their individual performance. Performance is measured against the achievement of the FSA's collective FSMA objectives by reference to the Business Plan, the objectives relating to the directors' individual areas of responsibility and assessment of their leadership abilities.

In considering executive remuneration, RemCo had the benefit of advice from the Director, Human Resources, together with market data from Towers Watson, its external consultants.

Basic Pensionable Salary

Salaries are reviewed annually in line with the policy. In addition, in reaching decisions on base salary, RemCo was mindful of the need for public sector organisations to exercise restraint.

Annual Incentive Award

The executive directors are eligible to be considered for a performance-related incentive award up to a maximum of 35% of average base pensionable salary applying during the previous year. The chairman is not eligible to be considered for an individual incentive award. In reaching decisions, RemCo took proper account of all aspects of the FSA's and the individual's performance.

Other benefits

A sum is available for each director, which may be spent against a range of benefits. The sum for the chairman and executive directors is included in 'other emoluments' in Table 8.4. The chairman and executive directors also have access to a car and driver and, where appropriate, the relevant portion of these costs is included in 'other emoluments' in Table 8.4.

Pensions

The FSA Pension Plan (the Plan) has two sections, both of which are non-contributory: a defined benefits section (closed to new entrants and any future accruals) and a defined contribution section. Sally Dewar and Margaret Cole are members of the defined contribution section. Adair Turner, Hector Sants and Jon Pain are not members of the Plan and are entitled to receive a non-pensionable supplement. The sums paid to the chairman and each of the executive directors in respect of each component are shown in Table 8.4.

The Table below has been audited:

Table 8.4

	Board fee £	Salary £	Performance related bonuses £	Other emoluments and benefits £	Pension £	2011 Total £	2010 Total £
Chairman							
Adair, Turner ^{a, b, p}	-	426,000	-	22,076	52,200	500,276	488,557
Executive directors^c							
Margaret Cole ^{* d, e}	-	191,722	28,603	16,030	27,332	263,686	-
Sally Dewar ^{* e, f, p}	-	317,419	85,000	113,723	38,091	554,233	649,498
Jon Pain ^{* b, g}	-	362,500	85,000	28,270	43,500	519,270	599,564
Hector Sants ^{b, h, p}	-	500,000	115,000	131,810	60,000	806,810	773,067
Non-executive directorsⁱ							
Amanda Davidson ^{* j}	32,083	-	-	-	-	32,083	-
Sandra Dawson ^{* j}	32,083	-	-	-	-	32,083	-
Carolyn Fairbairn ^k	43,333	-	-	-	-	43,333	28,000
Brian Flanagan	35,000	-	-	-	-	35,000	28,000
Peter Fisher ^l	-	-	-	-	-	-	-
Karin Forseke ^k	45,167	-	-	-	-	45,167	36,500
Michael McAteer	35,000	-	-	-	-	35,000	11,667
Professor David Miles ^m	-	-	-	-	-	-	9,333
Brian Pomeroy ⁿ	51,667	-	-	-	-	51,667	11,667
Andrew Scott	35,000	-	-	-	-	35,000	11,667
Michael Slack ^m	-	-	-	-	-	-	16,333
Hugh Stevenson ^{* o}	14,833	-	-	-	-	14,833	89,000
James Strachan	35,000	-	-	-	-	35,000	11,667
Paul Tucker ^l	-	-	-	-	-	-	-
	359,167	1,797,642	313,603	311,909	221,122	3,003,443	2,764,519
Remuneration as executives						2,644,276	2,510,685
Fees for service as directors						359,167	253,834
						3,003,443	2,764,519

* Where directors have served for part of the year only, the remuneration figures are shown as pro-rated.

- a In line with the terms of his contract, Adair Turner was awarded a salary increase to £435,000 with effect from April 2009, on which his benefits are based. However, at that time, he decided to forego the increase and his salary remained at £416,000. With effect from 1 April 2010, he accepted an increase to £426,000.
- b Adair Turner, Hector Sants and Jon Pain are not members of the FSA Pension Plan and received a non-pensionable supplement in lieu of pension contributions.
- c The performance related bonuses for executive directors is the amount approved by RemCo for the period 1 January 2010 to 31 December 2010, pro-rated as appropriate.
- d Margaret Cole was appointed as an executive director from 7 September 2010 at her existing salary.
- e Sally Dewar and Margaret Cole are members of the defined contribution section of the FSA Pension Plan. To allow for direct comparison the 2010 total figure for Sally Dewar has been restated to include £48,000 contribution to the pension scheme.
- f Sally Dewar resigned as an executive director with effect from 9 January 2011 and was paid her contractual entitlement.

- g Jon Pain resigned as an executive director with effect from 31 January 2011 and was paid his contractual entitlement.
 - h The total emoluments of the highest paid director during the year, Hector Sants, were £806,810 (2010: £773,067), which included £60,000 (2010: £53,191) paid during the year as a non-pensionable supplement in lieu of pension contribution, and amounts for car and flexible benefits.
 - i The fee for non-executive directors was set by the independent panel, established with the approval of HMT, at £35,000 per annum with effect from 1 April 2010.
 - j Amanda Davidson and Sandra Dawson were appointed as non-executive directors from 1 May 2010.
 - k An additional fee of £10,000 per annum is paid to any non-executive director who has been appointed to chair a committee of the Board. Carolyn Fairbairn was appointed to chair the Risk Committee from 1 June 2010. Karin Forseke chaired the Audit Committee, throughout the year. Karin Forseke received an overpayment of £167 for the year.
 - l Peter Fisher and Paul Tucker both waived their Board fee in respect of the years concerned.
 - m Professor David Miles and Michael Slack retired on 31 July 2009 and 31 October 2009, respectively.
 - n Brian Pomeroy was appointed to chair the FSA Pension Plan Trustee Ltd from 1 June 2010. The annual fee was set by the independent panel at £20,000 with effect from 1 April 2008. This remained unchanged in 2010/11.
 - o Hugh Stevenson's term as a director and chair of NedCo, chair of the FSA Pension Plan Trustee Ltd and chair of the Risk Committee ended with effect from 31 May 2010.
 - p The 2010 comparisons have been restated due to adjustments in the car benefit for last year. This has resulted in an increase of £6,115 for Adair Turner, £25,265 for Sally Dewar and £31,056 for Hector Sants.
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Non-executive directors

The assessment of fees for non-executive directors is carried out by an Independent Panel, the membership of which comprises the chair of the Practitioner Panel, a nominee of the chair of the Consumer Panel and an external moderator. In May 2010, the Panel reviewed the fees payable to the non-executive directors, deputy chair, chairs of Board committees and the chairman of the Pension Plan Trustee Board. In doing so, the Panel had the benefit of a review, which had considered the levels of time commitment required of non-executive directors and compared fees across a variety of sectors. As a result, increases were made to the fees paid to non-executive directors and to the chairs of Audit and Risk Committees and the changes are shown in the notes to Table 8.4.

Committees of the Board

Audit Committee (AuditCo)

Membership

The composition (including changes to membership in the year) of AuditCo is shown in Table 8.2. For the purposes of the Code, Amanda Davidson, Brian Pomeroy and James Strachan are considered to have 'recent and relevant financial experience'.

Meetings

AuditCo met on four occasions during the year. The chief executive, the chief operating officer, the director of Internal Audit and the lead audit partner from Grant Thornton LLP (May 2010) and the National Audit Office (NAO) (September, December and March), or their alternate, attended each of the scheduled meetings at the request of the AuditCo chair. Private sessions were held with the internal and external auditors during the year without management present. AuditCo also held private sessions on its own without management present.

Role and responsibilities

The role of AuditCo is set out in its terms of reference (which were reviewed during the year) and these terms of reference are available on the FSA website.

To discharge its functions, AuditCo has carried out the following during 2010/11.

Financial reporting

- Monitored the integrity of the financial statements and provided challenge to management on financial performance.
- Reviewed the financial reporting judgements and disclosure issues.
- Reviewed pension plan arrangements.

Financial policies

- Reviewed the FSA's financial policies.

FSA chairman's expenses

- Reviewed the chairman's expenses.

Internal controls and risk management

- Reviewed and challenged the identification of internal risks, including financial management risks, information systems risk and people risks (as reflected in the consolidated risk report) and management's mitigation of these risks.
- Reviewed compliance by FSA staff with key internal policies and procedures.

Potential implications of legal action

- Reviewed potential and actual litigation against the FSA.

Internal audit

- Reviewed the adequacy and effectiveness of the internal audit function.
- Reviewed and approved the audit universe (i.e. the internal audit framework) and the annual audit plan for internal audit.
- Monitored and challenged management on its responsiveness to internal audit findings.
- Reviewed the quarterly reports from internal audit.

External audit

- Reviewed the independence and effectiveness of the external auditor. The FSA aims to protect the external auditor's independence through its policy, which requires that fees for non-audit services are limited to the charge for performing the audit of the FSA's annual accounts. Information on fees paid to the auditor is provided on page 154. Moreover, there are no relationships between the NAO or its staff and the FSA that bear on the NAO's objectivity and independence.
- Has not made any recommendation to change the FSA's external auditors from the NAO who were appointed with effect from 1 July 2010.
- Considered the external auditor's audit strategy for the financial year.

Risk Committee (RiskCo)

RiskCo's purpose is to assist the Board in reviewing external risks to its statutory objectives. It does not review internal risks, which are the responsibility of AuditCo, nor does it review individual firms.

RiskCo's terms of reference and information on its membership can be found on the FSA website. Information on RiskCo members' attendance at meetings can be found in Table 8.2.

During the year, RiskCo has undertaken a review of its effectiveness and its role. Through discussions with each of the committee members, the chairman discussed RiskCo's role in relation to oversight of risks to the FSA's statutory objectives, including clarification of the split of risks between risk and audit committees, the structure of meetings and the way feedback was provided to the Board.

The FSA executive's risk management and reporting framework records all risks identified and reviewed by local business areas. The risks are further reviewed and appropriate mitigation strategies put in place by the FSA executive. RiskCo has responsibility for review and oversight of the risks to the FSA's statutory objectives, the FSA executive's appetite for such risks, and the management and mitigation strategies and systems used to control these risks. In discharging that responsibility, RiskCo has made use of the FSA executive's risk management and reporting framework.

RiskCo has sought assurance from the FSA executive through debate and challenge in the following areas: whether the major risks to the FSA's statutory objectives and its reputation, arising within the environment that the FSA regulates, have been identified and prioritised appropriately by the FSA executive; whether the actions taken to address and mitigate the risks were effective; and whether the timescales for mitigation were appropriate. RiskCo has also considered whether there are other risks that should be reviewed.

RiskCo reports to the Board on its consideration of the risk areas and provides feedback into the risk management framework as required.

Over the year, RiskCo has considered a number of forward-looking risk scenarios and a diverse range of risks and mitigation strategies, including:

- the implications of a change in the base rate and a low or rising interest rate environment on regulation and regulated firms;
- the FSA's approach to stress testing for firms and the development of new tools and IS systems to assist in tailoring stresses;
- the implications of a long period of low growth and deflation on regulated firms and regulation;
- progress on the strategy for developing funding plans and improving liquidity within regulated firms;

- the risks relating to the execution of the transition of the FSA into the new regulatory bodies, including the impact on the FSA's capability to deliver against its current FSMA obligations;
- the reprioritisation of ARROW assessments in order to make capacity for the changes to the regulatory structure;
- conduct risks and the FSA's strategy to address these;
- the FSA's risk tolerance and how this translated into supervision practice and project management, particularly in terms of resource allocation; and
- issues of sovereign risk and their impact on firms and regulation.

Internal controls

The Board and NedCo (the latter under FSMA) have responsibility for ensuring the FSA has a sound system of internal controls and risk management (internal risks being overseen by AuditCo and external regulatory risks by RiskCo). AuditCo reported at least quarterly to the Board on internal controls and internal risk management. AuditCo received regular reports from management on financial, operational and compliance controls and the risk management systems. In addition it received and reviewed reports from the director of Internal Audit, summarising work undertaken, findings and actions by management.

The system was designed to provide reasonable, but not absolute, assurance against material misstatement or loss and to manage rather than eliminate risks to the FSA's statutory objectives. The Board's policy on internal controls and risk management includes established processes and procedures for identifying, evaluating and managing significant risks.

The FSA's internal control processes have been in place throughout the year and have been under review up until the date of approval of the report and accounts.

Key features of the FSA's internal control system include the following.

- Risk reporting, which highlights the key internal (and regulatory) risks faced. This facilitates discussion on the best course of action to mitigate the key risks and assists senior management in taking decisions on priorities and resource allocation. This is regularly reviewed by the Operations Committee and the Executive Committee and formally reported to AuditCo on a quarterly basis through the consolidated risk report.
- A review of the framework of controls to mitigate the key internal (and regulatory) risks faced.
- Internal Audit's provision of independent assurance to the FSA Board and management on the effectiveness of risk management and controls over all of the FSA's activities.
- The Audit Universe, which contains all the FSA's processes, systems, projects and programmes. Each unit within the universe has been assessed in order to

appropriately prioritise review by Internal Audit and these priorities are revised periodically. Factors considered include risk, business criticality and materiality.

- The effectiveness of the Internal Audit function was reviewed internally during the year. There is an external review every third year.
- Clear reporting lines and delegated authorities, which are reviewed on a regular basis.
- The external audit including interim and final audit, which provided assurance to the Board and senior management in relation to financial controls. The independence and effectiveness of the external auditor is reviewed by AuditCo and reported to the Board on an annual basis.
- Clear segregation of the regulatory aspects of the FSA's supervisory operations and those of the internal treasury function. In addition a third party is used to decide, from a list of approved counterparties, where best to place our deposits for the optimum return. This enables the FSA to adopt a robust 'Chinese Wall' arrangement in line with good market practice.
- Ensuring appropriate policies and procedures are contained within the staff handbook (which is available on the FSA website).
- The performance management framework which includes the setting of objectives on an annual basis and a formal appraisal process.
- Directors' and senior management's commitment to maintaining an appropriate control culture across the FSA which is regularly communicated to all staff.

Regulatory Decisions Committee (RDC)

The RDC decides whether the FSA should give the statutory and other notices described as within its scope by the Handbook, any regulatory guide or legislation. Members of the RDC are appointed by the Board. The Board receives quarterly reports from the RDC chairman, who also attends Board meetings twice a year to discuss significant matters in those reports. More details on the role and membership of the RDC can be found on the FSA website.

Listing Authority committees

The Board has two listing committees made up of external practitioners to advise the Board and review elements of the FSA's function as the competent authority for listing in the UK. The Listing Authority Advisory Committee (LAAC) met three times during the year, with a number of smaller sub-groups also meeting during the year to consider particular issues. The chairman provided reports to the Board on relevant issues.

The Listing Authority Review Committee, whose role is as a technical appeal committee, has not been called during the year. More details on membership of the committees can be found on the FSA website.

Independent auditor's report to the members of the FSA

I have audited the financial statements of the FSA for the period ended 31 March 2011, which comprise the Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Financial Position, Statement of Cash Flows and the related notes. The financial reporting framework that has been applied in their preparation is applicable under law and International Financial Reporting Standards as adopted by the European Union. I have also audited the information in the directors' remuneration report that is described in that report as having been audited.

Respective responsibilities of directors and auditors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practice Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition I read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my report.

Opinion on financial statements

In my opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 March 2011 and of its surplus for the period then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
- have been prepared in accordance with the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In my opinion:

- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the part of the directors' remuneration report described as having been audited has been prepared in accordance with the requirements of the Companies Act 2006, that would have applied if the FSA were a UK incorporated quoted company.

Matters on which I am required to report by exception

I have nothing to report in respect of the following matters where the Companies Act 2006 requires me to report to you if, in my opinion:

- adequate accounting records have not been kept, or returns adequate for my audit have not been received from branches not visited by my staff; or
- the financial statements or the part of the directors' remuneration report that is described as having been audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- I have not received all the information and explanations I require for my audit.

Bryan Ingleby (Senior Statutory Auditor)

26 May 2011

for and on behalf of the
Comptroller and Auditor General (Statutory Auditor)

157-197 Buckingham Palace Road
Victoria,
London
SW1W 9SP

Financial statements for the year ended 31 March 2011

Statement of comprehensive income for the year ended 31 March 2011

	Notes	Continuing Operations 2011 £m	Operations* transferred 2011 £m	Total 2011 £m	Continuing Operations 2010 £m	Operations* transferred 2010 £m	Total 2010 £m
Administrative costs		(475.9)	(0.7)	(476.6)	(401.2)	(21.1)	(422.3)
Interest on bank deposits		1.6	-	1.6	0.3	-	0.3
Other net finance (cost)/income	15	(3.0)	-	(3.0)	(6.4)	-	(6.4)
Other revenue	7	44.1	-	44.1	44.0	0.1	44.1
Net costs for year		(433.2)	(0.7)	(433.9)	(363.3)	(21.0)	(384.3)
Fee revenue		462.9	1.3	464.2	413.8	21.7	435.5
Surplus before taxation	5	29.7	0.6	30.3	50.5	0.7	51.2
Taxation	8	(0.4)	-	(0.4)	(0.1)	-	(0.1)
Surplus after taxation		29.3	0.6	29.9	50.4	0.7	51.1
Actuarial losses for the year in respect of the defined benefit pension scheme	15	(13.3)	-	(13.3)	(38.3)	-	(38.3)
Total comprehensive income for the year		16.0	0.6	16.6	12.1	0.7	12.8

* Operations transferred to Money Advice Service 26 April 2010.

Statement of changes in equity for the year ended 31 March 2011

	£m
At 1 April 2009	(123.1)
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Total comprehensive income for the year	12.8
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At 31 March 2010	(110.3)
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Total comprehensive income for the year	16.6
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At 31 March 2011	(93.7)
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Statement of financial position as at 31 March 2011**Company number: 1920623**

	Notes	2011 £m	2010 £m	2009 £m
Non current assets				
Intangible assets	9	77.2	55.3	39.8
Property, plant and equipment	10	77.3	62.6	57.0
		154.5	117.9	96.8
Current assets				
Trade and other receivables	11	14.4	13.6	17.5
Cash and cash deposits	11	100.1	31.0	0.2
		114.5	44.6	17.7
Total assets		269.0	162.5	114.5
Current liabilities				
Trade and other payables	12	(232.0)	(144.6)	(131.5)
Current tax liabilities	12	(0.2)	-	(0.5)
Provisions	12	-	(0.8)	-
Borrowings	13	-	-	(2.0)
		(232.2)	(145.4)	(134.0)
Total assets less current liabilities		36.8	17.1	(19.5)
Non current liabilities				
Trade and other payables	12	(16.0)	(14.6)	(14.6)
Long term provisions	14	-	(0.1)	(0.1)
Net asset/(liabilities) excluding retirement benefit obligation		20.8	2.4	(34.2)
Retirement benefit obligation	15	(114.5)	(112.7)	(88.9)
Net liabilities, including retirement benefit obligation		(93.7)	(110.3)	(123.1)
Accumulated deficit		(93.7)	(110.3)	(123.1)

The financial statements were approved and authorised for issue by the Board on 26 May 2011, and were signed on its behalf by:

Adair Turner..... Chairman

Hector Sants..... Chief Executive Officer

Statement of cash flows for the year ended 31 March 2011

	Notes	2011 £m	2010 £m	2009 £m
Net cash generated from operations	20	132.6	72.3	12.8
Corporation tax paid		(0.2)	(0.5)	(1.3)
Net cash from operating activities		132.4	71.8	11.5
Investing activities				
Interest received on bank deposits		1.6	0.3	3.2
Expenditure on software development	9	(36.3)	(22.7)	(14.8)
Purchases of property, plant and equipment	10	(28.6)	(16.6)	(26.5)
Net cash used in investing activities		(63.3)	(39.0)	(38.1)
Returns on investment and servicing of finance				
(Repayment)/Proceeds from borrowings		-	(2.0)	2.0
Net increase/(decrease) in cash and cash equivalents		69.1	30.8	(24.6)
Cash and cash equivalents at the start of the year		31.0	0.2	24.8
Cash and cash equivalents at the end of the year		100.1	31.0	0.2

Notes to the financial statements

1. General information

The FSA is a company incorporated in the UK under the Companies Act 2006. The FSA is a company limited by guarantee with no share capital. The members of the company have agreed to contribute £1 each to the assets of the company in the event of it being wound up. The address of the registered office is given on page 2. The nature of the FSA operations and its principal activities are set out on page 120.

These financial statements are presented in pounds sterling because that is the currency of the primary economic environment in which the FSA operates.

The financial statements are presented in accordance with International Accounting Standards (IAS) 1, Presentation of Financial Statements (Revised 2007). These financial statements include the disclosure requirements of International Financial Reporting Standards (IFRS) 8 Operating Segments.

In line with last year, we continue to disclose three comparative periods for the statement of financial position and the statement of changes in equity. This year we are also disclosing three comparative periods for the statement of cash flows.

At the date of the approval of these financial statements, the following relevant and applicable standards and interpretations, which have been applied in these financial statements, were in issue but not yet effective:

- IFRS 9 Financial Instruments (effective 1 January 2013); and
- IAS 24 (Revised 2009) Related Party Disclosures (effective 1 January 2011).

2. Significant accounting policies

The financial statements have been prepared on an historical cost basis, except for financial assets, which are held at fair value. The financial statements have been prepared on a going concern basis. The financial statements have been prepared in accordance with IFRS. The financial statements separately disclose the Money Advice Service as an operation that has been transferred following government approval to transfer this operation to a separate legal entity.

The principal accounting policies adopted are set out below:

a. Statement of comprehensive income

The format of the statement of comprehensive income on page 140 has been designed to show net costs before fees levied to cover those costs. It is considered that this format best represents the nature of the activities of the FSA, which involves carrying out statutory functions and levying fees to meet the net cost of those functions.

b. Revenue recognition

All fee revenue is receivable under the Financial Services and Markets Act 2000 (FSMA), is measured at fair value and represents the fees to which the FSA was entitled for the financial year.

Sundry income is recognised when it is received for services we provide, which includes fees for applications, publications and training services and recovery of professional fees.

Any surplus revenue from Transaction Reporting System, scope change and United Kingdom Listing Authority is held in reserves until such time that it is used to pay for future expenditure.

Interest received on bank deposits is accrued on a time basis by reference to the principal outstanding and the effective interest rate applicable.

c. Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated impairment losses.

Depreciation is calculated to write off the cost less estimated residual value on a straight-line basis over the expected useful economic lives. The principal useful economic lives used for this purpose are:

Leasehold improvements	Ten years
Computer equipment (excluding software)	Up to five years
Furniture and equipment	Ten years
Motor vehicles	Four years

If events or changes in circumstances indicate the carrying value may not be recoverable, then the carrying values of property, plant and equipment are reviewed for impairment.

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in the statement of comprehensive income.

d. Intangible assets

In accordance with IAS 38: Intangible Assets, costs associated with the development of software for internal use are capitalised only where: the FSA can demonstrate the technical feasibility of completing the software; the FSA has adequate technical, financial and other resources available to it, as well as the intent to complete its development; and the FSA also has the ability to use it on completion. In addition,

costs are only capitalised if the asset can be separately identified, it is probable that the asset will generate future economic benefits, and that the development cost of the asset can be measured reliably. Expenditure on research activities is recognised as an expense in the period in which it is incurred.

Only costs that are directly attributable to bringing the asset to working condition for its intended use are included in its measurement. These costs include all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in a manner intended by management.

Intangible assets are amortised on a straight-line basis over their expected useful lives, generally between three and seven years, with the expense reported as an administration expense in the statement of comprehensive income. Subsequent expenditure is only capitalised when it increases the future economic benefits embodied in the specific asset to which it relates.

Where no intangible asset can be recognised, development expenditure is charged to the statement of comprehensive income when incurred.

e. Impairment of property, plant and equipment, and intangible assets

At each financial year end, the FSA reviews the carrying value of its property, plant and equipment and intangible assets to determine whether there is any indication that those assets have suffered impairment loss. If any such indication exists, the recoverable amount of the asset is estimated to determine the extent of the impairment loss.

The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and risks to the specific asset for which the estimates of future cash flows have not been adjusted. If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately.

When an impairment loss subsequently reverses, the carrying amount is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. A reversal of an impairment loss is recognised as income immediately.

f. Recognition of enforcement expenses

All costs incurred to the end of the year are included in the financial statements, but no provision is made for the costs of completing current work unless there is a present obligation.

In the course of its enforcement activities, the FSA gives indemnities to certain provisional liquidators and trustees. Provision is made in the accounts for costs incurred by such liquidators and trustees based on the amounts estimated to be recoverable from the FSA under such indemnities. The amount provided is discounted to present value.

g. Financial penalties received

Under FSMA, the FSA has the power to levy financial penalties and it is required to apply those penalties for the 'benefit of its fee-payers', which means that although the penalty payments are collected by the FSA, it has no rights to recognise these amounts as revenue. If the FSA were to cease activities, then penalties held at that time would be payable to fee-payers. Accordingly, any remaining balance is included in current liabilities: trade and other payables. The FSA is required to apply penalties received in each financial year to reduce the amount invoiced to fee-payers in the following financial year.

h. Financial instruments

Trade receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method. Appropriate allowances for estimated irrecoverable amounts are recognised in the statement of comprehensive income when there is objective evidence that the asset is impaired. The allowance recognised is measured as the difference between the asset's carrying value and the estimated future cash-flows deriving from the continued use of that asset, discounted if the effect is material.

Trade payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

Cash and cash equivalents comprise cash in hand, demand deposits and other short-term liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

Financial guarantee contracts are initially recognised at fair value. Subsequently, they are measured at the higher of an amount determined in accordance with IAS 37 Provisions, contingent liabilities and contingent assets, and the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue.

The company's financial risk-management policy is disclosed in Section 7 on page 112.

i. Leasing

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are treated as operating leases.

The FSA has no finance leases in place.

Rentals payable under operating leases are charged to the statement of comprehensive income on a straight-line basis over the term of the lease. Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight line basis over the lease term.

j. Provisions

Provisions are recognised when the FSA has a present obligation as a result of a past event and it is probable that the FSA will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date and are discounted to present value where the effect is material.

Legal challenges – On occasion, legal proceedings are threatened or initiated against the FSA. The FSA provides for the estimated full cost of any such challenges where at the end of the year it is more likely than not that there is an obligation to be settled. The amount provided is discounted to present value.

k. Taxation

The tax expense represents the sum of tax currently payable. The FSA is only liable to pay corporation tax on investment income.

l. Retirement benefit costs

The company operates an occupational pension scheme, the FSA Pension Plan, for its employees. There are two sections in the Plan: the Final Salary Section (a defined benefit arrangement which is closed to new members) and the Money Purchase Section (a defined contribution arrangement for new entrants).

With effect from 1 April 2010, members of the defined benefit final salary scheme ceased to accrue further future benefits.

- Defined benefit scheme – the charge to the statement of comprehensive income is the past service and interest costs of the scheme liabilities, less the expected return on the scheme's assets.
- Defined contribution scheme – payments to the defined contribution scheme are recognised as an expense in the statement of comprehensive income, as they fall due.

The obligation for the defined benefit pension scheme represents the present value of future benefits owed to employees in return for their service in prior periods. The discount rate used to calculate present value of those liabilities is the market rate at the balance sheet date of high quality corporate bonds having maturity dates approximating to the terms of those liabilities. The calculation is performed by a qualified actuary using the projected unit credit method at each balance sheet date.

Past service cost is recognised immediately, to the extent that the benefits are vested and otherwise amortised on a straight-line basis over the average period until the benefits become vested.

The net liabilities of the defined benefit scheme are calculated by deducting the fair value of the scheme's assets from the present value of its obligations and disclosed as a non-current liability on the balance sheet.

Actuarial gains and losses arising in the defined benefit scheme (for example, the difference between actual and expected return on assets, effects of changes in assumptions and experience losses arising on scheme liabilities) are recognised in full in the statement of comprehensive income in the period in which they are incurred.

3. Critical accounting judgements and key sources of estimation uncertainty

Critical judgements in applying the FSA's significant accounting policies

In the process of applying the FSA's significant accounting policies as described in note 2, management has made the following judgement that has the most significant effect on the amounts recognised in the financial statements (apart from those involving estimations, which are dealt with below).

- Intangible assets – under IAS 38, internal software development costs of £36.3m (2010: £22.7m, 2009: £14.8m) have been capitalised as additions during the year. Internally developed software is designed to help the FSA carry out its various statutory functions, such as holding details relating to regulated firms, for example their Part IV permissions under the FSMA, and to their senior management; facilitating the collection and collation of regulatory data from those firms, and assisting our staff in the supervision of those firms by generating reports and alerts, and operating the ARROW II methodology for regulating authorised firms. These functions are particular to the FSA, so this internally developed software generally has no market value. Management judgement has been applied in quantifying the benefit expected to accrue to the FSA over the useful life of the relevant assets. Those expected benefits relate to the fact that such software allows us to carry out our functions more efficiently than by using alternative approaches (for example, manual processing). If the benefits expected do not accrue to the FSA (for example, if some aspect of our approach to discharging our statutory functions changes, perhaps due to the impact of implementing a European Directive), then the carrying value of the asset would require adjustment.

Key sources of estimation uncertainty

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, which have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities in the next financial year, are discussed below.

- Pension deficit – the quantification of the pension deficit is based on assumptions made by the directors (as listed in note 15) relating to the discount rate, the expected return on the Plan's assets, retail price inflation, future pension increases and life expectancy.
- The assumptions regarding returns on assets are based on market observables for cash (Bank of England's base rate), corporate bonds (yield on iBoxx Non-Gilt over 15 years index), gilts (yield on FTSE UK Gilts over 15 years index), equities (gilt yield with an assumed equity risk premium of 3.0% per annum) and property (gilt yield with an assumed equity risk premium of 2.0% per annum), all adjusted for investment fees.
- The discount rate was determined with reference to the market rate of a selection of high-quality corporate bonds at the year end, allowing for the anticipated maturity of the Plan's projected benefit cash-flow profile. The change in discount rate assumption from 5.7% to 5.6% has increased the pension liability by £9.7m.

- The assumption for long-term retail price inflation (RPI) is based on market implied inflation, based on the Bank of England's implied inflation yield curve and allowing for the Plan's expected future cash flows, reduced by 0.2% per annum to allow for other data sources, such as the Bank of England's long-term inflation target and other long-term consensus indicators. While the RPI assumption remained the same at 3.5% per annum, the change in pension increase assumptions for some elements of the benefits has reduced the pension liability by £3.3m.
- Generally, the level of annual pension increases awarded by the Plan for pensions in payment is the annual increase in RPI, or 5.0% per annum if lower, although some of the pension rights transferred in from the FSA's predecessor organisations receive different level of pension increases.
- The 31 March 2011 calculations make no allowance for any potential implications of the recent change in inflation index used for legislative pension indexation from RPI to Consumer Prices Index (CPI). The impact of the change on the FSA Pension Plan is currently subject to legal review.
- A new actuarial valuation for funding purposes was carried out as at 31 March 2010 and was finalised in March 2011. For this funding valuation, a new mortality assumption has been adopted. The mortality table used is 100% of SAPS Light, with CMI 2009 projections and a 1.25% floor. This change has also been reflected in these disclosures and resulted in a reduction of £9.4m in the Defined Benefit Obligation (DBO).

4. Business and geographical analysis

Business units

As of 26 April 2010, the Consumer Financial Education Body – renamed Money Advice Service on 12 April 2011 – was separated out from the FSA.

The FSA is organised with the aim of aligning its internal structure with its core functions of identifying risk, mitigating risk through policy initiatives or supervision and ensuring these are applied through supervisor and enforcement actions.

Prudential Business Unit (PBU) and Conduct Business Unit (CBU)

From 4 April 2011, the FSA has realigned its internal management structure to the PBU and the CBU to effect a smooth transition to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). However, the 2010/11 financials have been set out using our structure in existence during that year, which is comparable to the prior year.

Supervision – This division supervises all relationship managed and small firms (except Markets); provides advice and guidance on regulatory matters to regulated firms and consumers; manages regulatory data, applications for authorisation and ongoing changes to firms' regulated status; and ensures the quality of supervision.

The Supervision Division has five key aims to deliver fair outcomes for consumers:

- challenging firms to be well governed and financially sound;
- ensuring firms adhere to conduct principles and treat customers fairly;
- acting to prevent and deter financial crime;
- applying a risk and more outcome-focused regulatory approach; and
- promoting and maintaining efficient, orderly and clean financial markets through effective and proportionate risk-based supervision.

Risk – This division identifies and mitigates sectoral and market-wide risk; provides specialist risk and policy support to supervisors; offers expertise on policy formulation – covering prudential, conduct, and market policy – and oversees the FSA’s overall risk-management processes.

Additional responsibilities include supervising exchanges, clearing houses and other infrastructure providers, providing market surveillance and transaction monitoring, and exercising the listing function.

Operations – This division improves our business capability and effectiveness. The aims of this division are to ensure that we have the right people to deliver our regulatory strategy, and that they are equipped with the correct tools needed to do their job to the best of their ability. Operations focuses on attracting, motivating, developing and retaining talented people, as well as running our operational policies and processes smoothly, economically, efficiently and effectively. The Operations division keeps the office building and systems running, manages the finances and looks after staff interests.

Other Direct Reports – This division represents all divisions reporting directly to the chairman and chief executive. The aims of this division are to ensure that the Chairman and the Board are able to fulfil their stewardship and corporate governance responsibilities; and to provide support to the Supervision and Risk divisions in carrying out end-to-end intensive supervision and delivering our credible deterrence strategy. These divisions are managed collectively so competences and relationships are optimised.

Enforcement & Financial Crime – These divisions form part of Direct Reports. The aims of these divisions are to conduct forensic investigations into suspected misconduct and compliance failures, and to help the FSA deliver its statutory objective to reduce financial crime.

Segmental information about the FSA's operations is presented below:

Year ended 31 March 2011

	Risk £m	Supervision £m	Operations £m	Direct Reports Enforcement £m	Other £m	Total for continuing operations £m	Operations to be transferred*	Total for 2011 £m
Revenue								
Fees	-	-	462.9	-	-	462.9	1.3	464.2
Sundry income	22.3	6.4	12.5	1.3	1.6	44.1	-	44.1
Expenses	(155.3)	(143.3)	(56.8)	(67.0)	(50.5)	(475.9)	(0.7)	(476.6)
Segmental surplus/ (deficit)	(133.0)	(139.9)	418.6	(65.7)	(48.9)	31.1	0.6	31.7
Investment income	-	-	1.6	-	-	1.6	-	1.6
Other net finance income	-	-	(3.0)	-	-	(3.0)	-	(3.0)
Surplus/(deficit) before tax	(133.0)	(139.9)	417.2	(65.7)	(48.9)	29.7	0.6	30.3
Income tax expense	-	-	(0.4)	-	-	(0.4)	-	(0.4)
Surplus/(deficit) for year	(133.0)	(139.9)	416.8	(65.7)	(48.9)	29.3	0.6	29.9
Other information								
Capital additions:								
Property, plant & equipment	-	-	28.6	-	-	28.6	-	28.6
Intangible	-	-	36.3	-	-	36.3	-	36.3
Depreciation	-	-	(13.9)	-	-	(13.9)	-	(13.9)
Amortisation	-	-	(10.7)	-	-	(10.7)	-	(10.7)
Trade receivables impairment losses recognised	-	-	1.2	-	-	1.2	-	1.2

* Operations transferred to Money Advice Service 26 April 2010.

**Year ended 31 March 2010
(Restated)***

	Risk £m	Supervision £m	Operations £m	Direct Reports Enforcement £m	Other £m	Total for continuing operations £m	Operations to be transferred** £m	Total for 2010 £m
Revenue								
Fees	-	-	413.8	-	-	413.8	21.7	435.5
Sundry income	10.7	7.2	19.8	4.1	2.2	44.0	0.1	44.1
Expenses	(112.0)	(140.7)	(37.7)	(67.4)	(43.2)	(401.2)	(21.1)	(422.3)
Segmental surplus/(deficit)	(101.5)	(133.5)	395.9	(63.3)	(41.0)	56.6	0.7	57.3
Investment income	-	-	0.3	-	-	0.3	-	0.3
Other net finance income	-	-	(6.4)	-	-	(6.4)	-	(6.4)
Surplus/(deficit) before tax	(101.5)	(133.5)	389.8	(63.3)	(41.0)	50.5	0.7	51.2
Income tax expense	-	-	(0.1)	-	-	(0.1)	-	(0.1)
Surplus/(deficit) for year	(101.5)	(133.5)	389.7	(63.3)	(41.0)	50.4	0.7	51.1
Other information								
Capital additions:								
Property, plant & equipment	-	-	16.6	-	-	16.6	-	16.6
Intangible	-	-	22.7	-	-	22.7	-	22.7
Depreciation	-	-	(11.0)	-	-	(11.0)	-	(11.0)
Amortisation	-	-	(7.2)	-	-	(7.2)	-	(7.2)
Trade receivables impairment losses recognised	-	-	1.1	-	-	1.1	-	1.1
Current and past pension service costs	(1.3)	(3.6)	(1.2)	(0.6)	(0.8)	(7.5)	(0.2)	(7.7)

* The activities within the business units were reorganised during the year.

** Operations transferred to Money Advice Service 26 April 2010.

Statement of financial position analysis

Whereas the FSA allocates its costs to business segments, as set out above, it does not allocate assets and liabilities to those segments. This is for two reasons. Firstly our working capital cannot be allocated to business segments. Secondly, as we are not a profit making organisation, we do not consider return on capital measures.

Geographical analysis

The FSA regulates entities that operate within the UK financial services industry including the regulation of foreign domiciled entities operating within the UK. The foreign domiciled entities account for less than 10% of the fee base of the FSA therefore no geographical analysis is presented.

5. Surplus before taxation for the year

The surplus for the year has been arrived at after charging the following, which are included in administrative costs:

	Note	2011 £m	2010 £m
Depreciation of property, plant and equipment	10	13.8	11.0
Amortisation of intangible assets	9	10.7	7.2
Employment costs	6	276.8	224.4
Operating lease rentals	17	15.2	13.8

In accordance with our accounting policy, we review the carrying value of intangible assets to determine whether there has been any impairment loss, and if so, the extent. The impairment loss for the current period totalled £3.7m (2009: £nil).

Auditors

At the Annual Public Meeting (APM) on the 24 June 2010, Grant Thornton UK LLP did not offer itself for reappointment as auditor. The National Audit Office (NAO) was appointed as auditor on the 24 August 2010.

Auditor's remuneration for audit services is set out below:

Total fees	12 months to 31 March 2011		12 months to 31 March 2010	
	£'000	%	£'000	%
Fees payable to the FSA's auditor for the audit of the FSA's annual accounts	84	100	86	79
Fees paid to the FSA's auditor or their associates in connection with non-audit work				
• Secondments	-	-	18	17
• Other services	-	-	5	4
Total	84	100	109	100

All fees payable to the auditor are stated inclusive of VAT, as VAT is not generally recoverable by the FSA.

6. Employee information

The average number of full-time equivalent employees (including executive directors) during the year was 3,291 (2010: 2,952). The average number of permanent full time equivalent employees in each Business Unit during the year was as follows:

	2011	2010
Supervision	1,115	988
Risk	880	672
Operations	542	550
Direct Reports	435	463
Enforcement	319	279
	3,291	2,952

As at 31 March 2011, the FSA had 3,337 (2010: 3,150) permanent full-time equivalent employees on its payroll.

Employment costs (including executive directors) comprise:	Notes	2011 £m	2010* £m
Gross salaries and taxable benefits		224.7	195.2
Employer's National Insurance costs		22.7	18.9
Defined contribution scheme		29.3	18.9
Pension curtailments		-	(9.9)
Other employer's pension costs included in administrative costs		0.1	1.3
	5	276.8	224.4
Net pension finance costs (included in other finance costs)	15	3.0	6.4
Actuarial losses in respect of the defined benefit pension scheme	15	13.3	38.3
Total employment costs		293.1	269.1

* Restated – the 2010 staff cost numbers have been restated given further pension information was received.

7. Other revenue

Other revenue comprises:

	2011 £m	2010 £m
Continuing operations:		
Application fees and other regulatory income	13.1	14.9
Transaction reporting services	7.0	13.5
Publications and training services	1.2	1.8
Benchmarking income	0.1	0.2
Solvency II income	16.0	5.8
Professional fees recovered	0.8	4.0
Other sundry income	5.9	3.8
Total continuing operations	44.1	44.0
Discontinuing operations:		
Other sundry income	-	0.1
Total discontinuing operations	-	0.1
Total other revenue	44.1	44.1

8. Taxation

The tax charge on ordinary activities is:

	2011 £m	2010 £m
Current tax on continuing operations	0.4	0.1
Corporation tax charge for the year on continuing operations	0.4	0.1

Corporation tax for 2010/11 is calculated at a rate of 28% (2010: 23.2%) on the estimated assessable surplus for the year. The total charge for the year can be reconciled to the accounting surplus as follows:

	2011 £m	2010 £m
Surplus before tax on continuing operations	30.3	51.2
Tax at 28% (2010: 23.2%) thereon	8.5	11.9
Effects of:		
Adjustment for activities not subject to corporation tax	(8.1)	(11.8)
Current tax charge for the year	0.4	0.1
Effective tax rate for the year	1.3%	0.2%

Under an agreement with Her Majesty’s Revenue and Customs, the company is not subject to corporation tax on income arising from its regulatory activities. Consequently, the tax charge arises solely on net investment income.

9. Intangible assets

	Software development costs £m
Cost	
At 1 April 2009	67.8
Additions – internally generated	22.7
At 1 April 2010	90.5
Additions – internally generated	36.3
Impairment losses recognised in the statement of comprehensive income	(3.7)
At 31 March 2011	123.1
Amortisation	
At 1 April 2009	28.0
Charge for year	7.2
At 1 April 2010	35.2
Charge for year	10.7
At 31 March 2011	45.9
Net book value	
At 31 March 2011	77.2
At 31 March 2010	55.3
At 31 March 2009	39.8

At 31 March 2011, expenditure classified as work in progress totalling £45.0m had been capitalised on software developments that were not yet in operation (2010: £28.8m).

10. Property, plant and equipment

	Leasehold improvements £m	Computer equipment £m	Furniture and equipment £m	Total £m
Cost				
At 1 April 2009	33.1	73.5	17.8	124.4
Additions	2.4	13.1	1.1	16.6
Disposals	-	(0.3)	-	(0.3)
At 31 March 2010	35.5	86.3	18.9	140.7
Transfer	-	3.4	(3.4)	-
Additions	4.2	21.4	3.0	28.6
Disposals	(1.7)	(2.3)	(2.3)	(6.3)
At 31 March 2011	38.0	108.8	16.2	163.0
Accumulated depreciation and impairment				
At 1 April 2009	15.8	46.6	5.0	67.4
Charge for year	2.4	7.1	1.5	11.0
Disposals	-	(0.3)	-	(0.3)
At 31 March 2010	18.2	53.4	6.5	78.1
Transfer	-	0.7	(0.7)	-
Charge for year	2.6	9.8	1.4	13.8
Disposals	(1.7)	(2.2)	(2.3)	(6.2)
At 31 March 2011	19.1	61.7	4.9	85.7
Carrying amount				
At 31 March 2011	18.9	47.1	11.3	77.3
At 31 March 2010	17.3	32.9	12.4	62.6
At 31 March 2009	17.3	26.9	12.8	57.0

The FSA has reviewed the residual values used for the purposes of depreciation calculations, with appropriate provisions made. The review did not identify any requirement for adjustment to the residual values used in the current or prior periods. Residual values are reviewed and updated annually.

11. Current assets

	2011 £m	2010 £m	2009 £m
Fee receivables	1.4	3.3	3.5
Other debtors	1.1	1.1	1.0
Prepayments and accrued income	11.9	9.2	13.0
Trade and other receivables	14.4	13.6	17.5
Cash deposits	97.1	26.9	–
Cash and cash equivalents	3.0	4.1	0.2
Total current assets	114.5	44.6	17.7

The average credit period taken is 37 days (2010: 37 days). A late penalty fee of £250 is payable on periodic fees not paid by the due date. If payment is not received by the due date interest is charged on the outstanding balance at the Bank of England Repo rate plus 5%.

In accordance with IFRS 7, with the exception of prepayments and accrued income, all items within current assets are classified as loans and receivables.

All of the FSA's fee and other receivables have been reviewed for indications of impairment. Certain fee receivables were found to be impaired and a provision of £1.2m (2010: £1.1m) has been made for the estimated irrecoverable amounts from fees invoiced. This provision has been determined by reference to past default experience.

The directors consider that the carrying amount of trade and other receivables approximates their fair value.

In addition, some of the unimpaired fee receivables are past due as at 31 March 2011. The age of fee receivables past due, but not impaired is as follows.

	2011 £m	2010 £m
Not more than three months	0.4	0.8
More than three months but not more than six months	0.1	–
More than six months but not more than one year	–	–
More than one year	0.2	0.1
	0.7	0.9

Our policy is to begin to review receivables systematically for recoverability when they are more than three months past due. The amounts above are in the course of collection and we have had no specific evidence that any of these receivables are impaired.

The balances that are over one year old consist of three debts. All relate to expected creditor dividend payments arising from the realisation of assets of liquidated debtor firms.

Cash and cash equivalents

Bank balances and cash comprise cash held by the FSA and short-term fixed-rate bank deposits with an original maturity of 12 months or less. The carrying amount of these assets approximates their fair value.

Credit risk

The FSA's principal financial assets are cash deposits, cash, together with fee and other receivables. Liquid funds are placed with counterparties with high credit ratings, as assigned by credit rating agencies.

The FSA's credit risk is primarily attributable to its fee receivables. The amounts presented in the balance sheet are net of allowances for doubtful receivables. An allowance for impairment is made where there is an identified loss event that, based on past experience and management's forecasts, is evidence of a reduction in the recoverability of the cash flows.

The FSA has no significant concentration of credit risk as its exposure is spread over a number of counterparties.

Interest rate risk

Other than cash held in bank accounts, all of the FSA's cash and cash equivalents are fixed-rate fixed-term deposits, and so are not sensitive to variations in interest rates.

Liquidity risk

The FSA manages its liquidity by carefully monitoring the projected income and expenditure related to its day-to-day business. Liquidity needs are monitored in various time bands, on a day-to-day, week-to-week and rolling 30-day basis. Each month, the FSA identifies long-term liquidity in a 180 and 360 day window, up to the point when it next expects to bill the majority of fees.

12. Current liabilities

	2011 £m	2010 £m	2009 £m
Trade creditors and accruals	98.6	83.9	70.7
Other taxation and social security	7.0	6.7	5.6
Financial penalties to be applied against fees receivable	92.5	33.5	28.4
Fees in advance	33.9	20.5	26.8
Trade and other payables	232.0	144.6	131.5
Current tax liabilities	0.2	-	0.5
Provisions	-	0.8	-
Borrowings	-	-	2.0
Total current liabilities	232.2	145.4	134.0

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and ongoing costs. The average credit period taken for trade payables is 30 days (2010: 30 days). The directors consider the carrying amount of trade payables approximates their fair value.

In accordance with IFRS 7, the following items are classified as financial liabilities measured at amortised cost:

- trade creditors and accruals;
- financial penalties;
- provisions; and
- borrowings.

Non-current payables

Non-current liabilities measured at amortised cost

A lease accrual of £16.0m (2010: £14.6m, 2009: £14.6m), being the cumulative difference between cash paid and expense recognised on operating leases for land and buildings, is recognised as a long-term liability. Details of the above leases can be found in note 17.

As at 31 March 2011, the FSA's liabilities have contractual maturities which are summarised below.

	Current				Non-current			
	Within 6 months		6 to 12 months		1 to 5 years		Later than 5 years	
	2011 £m	2010 £m	2011 £m	2010 £m	2011 £m	2010 £m	2011 £m	2010 £m
Trade creditors and accruals	90.4	74.3	8.2	9.6	7.5	3.5	8.5	11.1
Other taxation and social security	7.0	6.7	-	-	-	-	-	-
Financial penalties to be applied against fees receivable	92.5	33.5	-	-	-	-	-	-
Fees in advance	33.9	20.5	-	-	-	-	-	-
Current tax liabilities	0.2	-	-	-	-	-	-	-
Provisions	-	0.8	-	-	-	-	-	-
	224.0	135.8	8.2	9.6	7.5	3.5	8.5	11.1

13. Borrowings

At 31 March 2011, the FSA had available credit facilities of £151m (2010: £151m) made up of two £75m undrawn committed borrowing facilities in respect of which all conditions precedent had been met, and an undrawn £1m overdraft facility.

A revolving credit facility for £75m was taken out with Lloyds Banking Group on 31 March 2010 and expires 30 March 2013, with any drawings made on the day before expiry being repayable in full by 30 June 2013.

The revolving credit facility with HSBC Banking Group was taken out on 25 March 2010 and any future drawings are repayable in full by 27 May 2012.

The £1m overdraft facility with Lloyds Banking Group is due to expire on 30 June 2011. This facility is reviewed and renewed (where appropriate) on an annual basis.

All borrowing facilities are unsecured.

14. Long-term provisions

	Total £m
At 31 March 2011	-
At 31 March 2010	(0.1)

The existing provision of £39,000 relates to the premises the FSA rents on the 24th floor, Canary Wharf Tower, London. The lease will expire in November 2011 and the FSA has a commitment to leave the premises in its original condition.

15. Retirement benefit obligation

The FSA operates a tax-approved pension scheme, the FSA Pension Plan, which is open to all employees. The pension scheme was established on 1 April 1998 and operates on both a defined benefit (the Final Salary section) and defined contribution (the Money Purchase section) basis. Since 1 June 1998, all employees joining the FSA, other than those joining from other regulatory bodies whose functions were transferred to the FSA, have been eligible only for the Money Purchase section of the scheme. The Money Purchase section is part of a flexible benefits programme and members can, within limits, select the amount of their overall benefits allowance that is directed to the pension scheme.

From 1 April 2010, after consulting with members, the FSA ceased the accrual of future service for members of the Final Salary section of the Plan. These changes affected all active members of the Final Salary section of the Plan who from 31 March 2010 became deferred members of the Final Salary section and were offered membership of the Money Purchase section from 1 April 2010.

Final Salary Section

The most recent actuarial valuation of the FSA Pension Plan was carried out as at 31 March 2010 by an independent actuary, using the projected unit method, and was signed in March 2011. The results of this valuation have been updated for the purpose of IAS 19 as at March 2011, to allow for any changes in assumptions and movements in liabilities over the period.

The major assumptions used for the purpose of actuarial assumptions were as follows.

	At 31 March 2011	At 31 March 2010
Corporate bond discount rate	5.6%	5.7%
Expected return on scheme assets	6.05%	6.6%
Retail price inflation (R.P.I)	3.5%	3.5%
Future pension increases	3.35%	3.35%

The Final Salary section of the Plan ceased to provide future service benefits after 31 March 2010. All active members as at 31 March 2010 of the Final Salary section became deferred members as at this date and their benefits calculated based on their Final Pensionable Salary as at 31 March 2010. Future salary increases after 31 March 2010 will not impact these members' pension and their pension (in excess of any GMP (Guaranteed Minimum Pension)) will increase broadly in line with the Retail Prices Index.

The change in the pension increase assumptions have resulted in a decrease of £3.3m in the present value of the pension funded obligation and the deficit of the Plan.

In assessing the value of funded obligations, the mortality assumptions for the Pension Plan are based on current mortality tables and allow for future improvements in life expectancy. The mortality assumptions for 2011 are based on an actuarial table 'SAPS Light, with CMI 2009 projections and a 1.25% floor'.

The table below illustrates the assumed life expectancies at retirement of staff when they retire (staff are assumed to retire at the age of 60).

	2011 Years	2010 Years
Retiring today		
Males	28.5	28.6
Females	29.6	31.8
Retiring in 15 years		
Males	29.8	29.6
Females	31.1	32.6

The results of the valuation are sensitive to changes in the assumptions referred to above.

The table below provides an estimate of the sensitivity of the estimates of the present value of pension obligation, and the cost of servicing those obligations, to small movements in those assumptions.

Assumption	Sensitivity	Increase/(decrease) in pension obligation at 31 March 2011		Increase/(decrease) in pension cost in 2010/11	
		£m	%	£m	%
Base line	Assumptions as above – no change	451.9	-	4.2	-
Discount rate	10 bps increase to 5.7%	(9.3)	(2.1%)	(0.1)	(2.0%)
Discount rate	10 bps decrease to 5.5%	9.6	2.1%	0.1	1.9%
Longevity	1 additional year of life at age 60	7.5	1.7%	0.4	10.0%
Inflation	3.6%	9.8	2.2%	0.6	13.0%

The amount recognised in the balance sheet is as follows.

	2011 £m	2010 £m	2009 £m
Fair value of plan assets	339.7	316.6	222.8
Less: Present value of funded obligations	(451.9)	(427.2)	(310.0)
Deficit in the scheme	(112.2)	(110.6)	(87.2)
Unfunded pension liabilities	(2.3)	(2.1)	(1.7)
Net liability recognised in the statement of financial position	(114.5)	(112.7)	(88.9)

A small number of current and former employees have benefit promises that cannot be delivered entirely through the tax-approved scheme described above. At 31 March 2011 the liability is £2.3m (2010: £2.1m) to cover the cost of these promises.

Amounts recognised in the statement of comprehensive income for the defined benefit plan are as follows.

	2011 £m	2010 £m
Current service cost	-	6.6
Past service cost	-	1.1
Administration expenses	-	7.7
Expected return on plan assets	21.1	14.2
Interest on scheme liabilities	(24.1)	(20.6)
Other net finance costs	(3.0)	(6.4)

Current service costs and past service costs are disclosed as administration expenses, expected return on plan assets and interest cost are disclosed as interest income in the statement of comprehensive income and actuarial losses of £13.3m (2010: losses of £38.3m) are recognised in the period in which they occur as part of the statement of recognised income and expense.

Changes in the present value of the defined benefit obligation are as follows.

	2011 £m	2010 £m	2009 £m
Opening obligation	(427.2)	(310.0)	(363.0)
Current service cost	-	(6.6)	(8.3)
Past service cost	-	(1.1)	(0.3)
Benefits paid	9.9	7.9	7.3
Interest cost	(24.1)	(20.6)	(22.1)
Actuarial (losses)/gains	(10.5)	(106.7)	76.4
Curtailments	-	9.9	-
Closing obligation	(451.9)	(427.2)	(310.0)

Changes in the fair value of plan assets are as follows.

	2011 £m	2010 £m	2009 £m
Opening fair value of plan assets	316.6	222.8	273.3
Expected return on plan assets	21.1	14.2	20.2
Actuarial losses	(2.8)	68.4	(78.1)
Contributions by the employer	14.7	19.1	14.7
Benefits paid	(9.9)	(7.9)	(7.3)
Closing fair value of plan assets	339.7	316.6	222.8

The fair value of plan assets and the expected rates of return were as follows.

	Expected rate of return at 31 March 2011	Fair value at 31 March 2011 £m	Expected rate of return at 31 March 2010	Fair value at 31 March 2010 £m
Equity Securities	7.1%	169.5	7.0%	186.5
Debt Securities	5.5%	140.4	5.5%	100.8
Real Estate	6.0%	27.2	7.0%	24.0
Cash	0.5%	2.6	0.5%	5.3
Closing fair value of plan assets	6.1%	339.7	6.6%	316.6

Cumulative actuarial gains and losses recognised in equity were as follows.

	2011	2010
	£m	£m
1 April	(91.9)	(53.6)
Net actuarial losses recognised in the year	(13.3)	(38.3)
At 31 March	(105.2)	(91.9)

There are no deferred tax implications of the above deficit as corporation tax is only payable on interest receivable by the company.

The plan assets do not include any of the FSA's own financial instruments, nor any property occupied by, or other assets used by the FSA.

The expected rates of return on individual categories of plan assets are determined by reference to relevant market expectations at the beginning of the period for returns over the lifetime of the obligations.

The history of differences between expected and actual returns on plan assets and gains and losses on scheme liabilities are as follows.

	2011	2010	2009	2008	2007
Defined benefit obligation (£m)	(451.9)	(427.2)	(310.0)	(363.0)	(367.1)
Fair value of plan assets (£m)	339.7	316.6	222.8	273.3	289.1
Net deficit (£m)	(112.2)	(110.6)	(87.2)	(89.7)	(78.0)

Experience adjustments on scheme assets:

Amount (£m)	(2.8)	68.4	(78.1)	(40.9)	(8.6)
percentage of scheme assets	0.8%	21.6%	35.1%	15.0%	3.0%

Experience gains and losses on scheme liabilities:

Amount (£m)	(13.5)	(0.6)	0.6	(0.3)	(0.7)
percentage of the present value of scheme liabilities	(3.0%)	(0.1%)	0.2%	0.1%	0.2%

As the Plan closed to future benefit accrual with effect from 31 March 2010, no accrual funding contributions were payable for 2010/11. However, deficit contributions continued to be paid; deficit contributions totalling £14.0m were paid for 2010/11. The Scheme Specific Valuation (SSV) as at March 2010 revealed a deficit of £156.0m. As a result, the deficit payments have increased and we have committed to pay contributions of £19.8m pa over the next ten years from 1 April 2011 to address this shortfall.

Defined contribution scheme

The total expense recognised in the statement of comprehensive income of £29.3m (2010: £18.9m) represents contributions payable to the plan by the FSA at rates specified in the rules of the Plan.

16. Capital commitments

The FSA had entered into contracts at 31 March 2011 for intangible capital expenditure totalling £5.9m (2010: £6.2m), which is not provided for in the accounts.

17. Operating lease arrangements

	2011 £m	2010 £m
Minimum lease payments under operating leases recognised as an expense in the year:	15.2	13.8

At the balance sheet date, the FSA had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows.

	2011 £m	2010 £m
Within one year	14.8	13.3
In the second to fifth years inclusive	69.0	63.4
After five years	48.3	64.1
	132.1	140.8

Operating lease payments represent rentals payable by the FSA for certain of its office properties.

The lease on 25 The North Colonnade, Canary Wharf, London expires in 2018. Under the terms of the lease, the rent for the period from 4 November 2008 until 3 November 2018 will increase in line with RPI subject to a minimum annual increase of 2.5% per annum and a maximum of 5% per annum. As mentioned in note 15, our current assumption for RPI is 3.5% per annum.

The lease on 18th floor, Canary Wharf Tower, London, was taken out in March 2008 and contains provision for a rent review in March 2013. The lease will expire in November 2018.

A short-term lease for the 24th floor, Canary Wharf Tower, London, was taken out in December 2010. The lease will expire in November 2011.

The lease on the 25th floor, Canary Wharf Tower, London, was taken out in November 2010 and contains provision for a rent review in November 2015. The lease will expire in November 2018.

The lease on the 26th floor, Canary Wharf Tower, London, was taken out in May 2010 and contains provision for a rent review in May 2015. The lease will expire in November 2018.

The lease on the 27th floor, Canary Wharf Tower, London, was taken out in July 2010 and contains provision for a rent review in July 2015. The lease will expire in November 2018.

The lease on Quayside, Edinburgh was taken out in September 2005 and contains provision for a rent review in September 2015. The lease will expire in August 2020.

18. Related party transactions

Remuneration of key management personnel

The remuneration of key management personnel of the FSA, is set out below in aggregate for each of the categories specified in IAS 24 Related Party Disclosures. Of this group, 26 (2010: 29) personnel received remuneration of £100,000 or more for the year. Further information on individual directors is provided in the audited part of the Corporate Governance Statement on pages 126 to 137.

	2011 £m	2010 £m
Short-term benefits	10.1	9.8
Post-employment benefits	0.9	1.0
Termination benefits	0.2	0.2
	11.2	11.0

There were no other transactions with key management personnel in either year.

Significant transactions with other financial services regulatory organisations

The FSA enters into transactions with a number of other financial services regulatory organisations. The nature of the FSA's relationship with these organisations and the significant transactions entered into between the FSA and these organisations are set out below.

While the FSA is required under various statutes (Financial Services Act 2010, and FSMA) to establish the financial services regulatory organisations set out on page 170 and 171, it is the individual organisations themselves that are required to perform the functions.

Separately, while the FSA has the right to appoint and remove the directors of the various organisations, the Companies Act 2006 requires that the appointed directors have to exercise independent judgement.

The fact that the FSA does not have statutory responsibility for the functions of these organisations means that its separate powers to appoint and remove directors to the boards of these organisations, cannot be exercised for the benefit of the FSA.

The failure of this benefit test means that the FSA does not control these organisations as defined under International Accounting Standard 27 – Consolidated and Separate Financial Statements. It does however consider these organisations to be related parties.

a) The Financial Services Compensation Scheme Limited (FSCS)

During the year, the FSA provided an agency service to FSCS to collect tariff data, issue levy invoices and collect levy monies on its behalf. The net amount of fees collected that remained to be paid over by the FSA to FSCS at 31 March 2011 was £1.6m (2010: £0.4m). The charge for the service was £0.3m (2010: £0.3m).

The FSA is a party to the lease agreement for FSCS's premises, occupied from 18 June 2001 at the 7th floor at Lloyds Chambers, Portsoken Street, London, as guarantor of performance of the lease. This lease is for a term from 13 February 2001 to 21 June 2018 at a current annual rental and related out-goings of £1.2m. This guarantee was provided when the FSCS was in its start-up phase, ahead of its formal fee-raising powers being granted under the FSMA 2000. The FSCS did not provide any consideration in return for that guarantee. As there is not an active market for such guarantees of this nature, no valuation technique could be used to calculate a fair value. Consequently, given the lack of consideration, and the strength of the financial covenant of both the FSCS funding arrangements, no fair value was assigned on inception.

b) The Financial Ombudsman Service Limited (the ombudsman service)

The FSA is the principal employer in the FSA Pension Scheme described in note 15. The ombudsman service is also a participating employer in the same scheme making contributions at the same overall rate as the FSA. The assets and liabilities disclosed in note 15 represent only those that relate to the employees of the FSA. The total number of scheme members is 1,782 (2010: 2,212) of which 1,665 are, or were, employees of the FSA (2010: 2,072) and 117 of the ombudsman service (2010: 140).

In 2005/6 the FSA entered into an agency agreement with the ombudsman service to collect tariff data, issue levy invoices and collect levy monies on its behalf for its fees for 2006/7 onwards. The charge for that service is £0.1m (2010: £0.1m). As at 31 March 2011, £0.1m of fees relating to 2010/11 invoices had been collected but not paid to the ombudsman service, together with a further £1.3m for on-account fees for 2011/12 (2010/11: £1.6m).

The FSA is a party to the lease agreement for part of the ombudsman service's premises at South Plaza II, London, as guarantor of performance of the lease, which is for a 15-year term from 2 November 1999, at a current annual rental of £1.1m. The guarantee was provided when the ombudsman service was in its start-up phases, ahead of its formal fee-raising powers being granted under the FSMA. The ombudsman service did not provide any consideration in return for the guarantee. Given the lack of consideration, and the strength of the financial covenant of the ombudsman service funding arrangements, no fair value was assigned on inception. The current market value of the guarantee has been calculated and determined to be immaterial.

c) Money Advice Service

During the year, the FSA provided an agency service to the Money Advice Service. The scope of the service provided included the provision of finance, HR, IS and facilities. The charge for the service was £2.7m.

Part of the finance service included the collection of tariff data, issuing levy invoices and collecting levy monies on the behalf of the Money Advice Service. The net amount of fees collected that remained to be paid over by the FSA to the Money Advice Service at 31 March 2011 was £3.4m.

d) **The Office of the Complaints Commissioner (OCC)**

The FSA funds the activities of the Complaints Commissioner through the periodic fees it raises. Up to 31 August 2004, the costs of those activities were met directly by the FSA. In August 2004, however, the OCC, a company limited by guarantee, was incorporated. Since 1 September 2004, the purpose of this company has been to administer complaints against the FSA that are handled by the Complaints Commissioner. In doing so, it employs staff, owns assets used by the Commissioner and his staff, and enters into contracts for goods and services in furtherance of complaints handling activities. During 2010/11, the FSA has transferred £0.5m (2010: £0.5m) to the OCC to cover the latter's running costs, which have been expensed in the FSA's statement of comprehensive income. At 31 March 2011, the balance owing to the FSA from the OCC was £nil (2010: £nil).

By virtue of certain provisions contained in the Memorandum of Association of the OCC, the FSA has the right to appoint and remove the Complaints Commissioner, who is both a member and a director of the company, and as such has the ability to control the OCC. Because of this, the OCC is actually a subsidiary of the FSA. However, the scale of the activities of the OCC is immaterial compared to that of its parent company. Accordingly, the FSA has not prepared group accounts, including the OCC, on the grounds that the exclusion of the OCC from the FSA's accounts is not material to those accounts providing a true and fair view.

19. Contingent liabilities

As described in note 19, the FSA acts as guarantor for leases entered into by the Financial Services Compensation Scheme and the Financial Ombudsman Service. Given the strength of those organisations' fee-raising arrangements, no liabilities are expected to crystallise for those guarantees.

In discharging its responsibilities under FSMA and its predecessor legislation, the FSA faces the possibility of claims being made against it as a result of that work. On the basis of the information presently available to it, the FSA believes that any claims would have no real prospect of success. Accordingly, no provision has been made in the accounts for these matters.

20. Notes to the cash flow statement

	Notes	2011 £m	2010 £m
Surplus/(Deficit) for the year from continuing operations		29.9	51.1
Adjustments for:			
Interest received on bank deposits		(1.6)	(0.3)
Corporation tax expense	8	0.4	0.1
Amortisation of other intangible assets	9	10.7	7.2
Impairment loss on intangible assets	9	3.7	-
Depreciation of property, plant and equipment	10	13.8	11.0
Loss on disposal of property, plant and equipment	10	0.1	-
Increase/(Decrease) in provisions	14	(0.9)	0.8
Difference between pension costs and normal contributions	15	2.3	4.7
Additional cash contributions to reduce pension scheme deficit	15	(14.0)	(9.8)
Increase/(Decrease) on unfunded pension liability	15	0.2	0.4
Curtailments on pension liability – pension plan settlement	15	-	(9.9)
Operating cash flows before movements in working capital		44.6	55.3
Decrease/(Increase) in receivables	11	(0.8)	3.9
Increase in payables	12	88.8	13.1
Net cash generated from operations		132.6	72.3

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The following appendices will appear on our website only:

www.fsa.gov.uk/Pages/Library/Corporate/Annual/ar10_11_appendices.shtml

- Appendix 1 Performance against 2010/11 milestones
- Appendix 2 Enforcement activity 2010/11
- Appendix 3 FSA and Competition
- Appendix 4 Accountability
 - The FSA's response to: The Practitioner Panel
 - The Smaller Business Practitioner Panel
 - The Consumer Panel
- Appendix 5 Complaints against the FSA 2010/11
- Appendix 6 The FSA's response to the Complaints Commissioner's Annual Report for 2010/11
- Appendix 7 Data



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Mr Diarmuid O'Hegarty
London Metal Exchange Ltd
56 Leadenhall St
London
EC3A 2BJ



28 October 1999

Our Ref: J.4.2


Dear Diarmuid

RECOGNITION ORDER

Please find attached a certified copy of the Securities and Investments Board's recognition order in respect of the London Metal Exchange, dated 25 April 1988.

Please do not hesitate to contact me if you have any further queries.

Yours sincerely


Jennifer Skeels
Assistant Company Secretary

THE SECURITIES AND INVESTMENTS BOARD

RECOGNITION

OF

THE LONDON METAL EXCHANGE LIMITED

The Securities and Investments Board, in exercise of the powers conferred by section 37 of the Financial Services Act 1986, and now exercisable by the Board, hereby makes the following order:-

WHEREAS:-

1. The London Metal Exchange Limited has applied to the Board for an order declaring it to be a recognised investment exchange for the purposes of the Act.
2. That application was accompanied by a copy of the applicant's rules, a copy of any guidance issued by the applicant which was intended to have continuing effect and was issued in writing or other legible form, and particulars of arrangements made or proposed to be made by the applicant for the provision of clearing services.
3. The Board has been furnished with all such information as it has required in connection with the application.
4. The Board has sent to the Secretary of State a copy of the rules and of guidance and arrangements of which copies or particulars were furnished with the application together with any other information supplied with or in connection with the application.
5. The Secretary of State has given leave to the Board to make this Order.

6. It appears to the Board from the information furnished by the investment exchange and having regard to other information in its possession that the requirements of Schedule 4 to the Act for recognition of the investment exchange are satisfied and that the Board should exercise its discretion to grant recognition.

NOW, THEREFORE:-

1. The Securities and Investments Board hereby declares The London Metal Exchange Limited to be a recognised investment exchange for the purposes of the Financial Services Act 1986.
2. This Order takes effect on the date on which it is made.

By Order of the Board.

Kenneth Bessell

25th April, 1988

Certified as a true copy

[Signature]
.....
Company Secretary

The EU/UK Market Abuse Regime
– Overview

SLAUGHTER AND MAY

December 2011

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1. The EU/UK market abuse regime – overview

1.1 THE UK REGIME

Since December 2001, all major UK markets have been subject to the provisions of the Financial Services and Markets Act 2000 ("FSMA" or the "Act") which prohibit "market abuse", the commission of which may be penalised with unlimited fines imposed by the Financial Services Authority (the "FSA"), subject to a right of appeal to the Financial Services and Markets Tribunal.

The Act as originally enacted identified three types of market abuse: misuse of non-public material information, the creation of false or misleading market impressions and market distortion. The Act also provided that no behaviour of these descriptions amounted to market abuse unless contrary to the standards of a hypothetical "regular user" of the market concerned.

The FSA elaborated on the statutory provisions with what in practice has been the most important document relating to the regime: the Code of Market Conduct ("the Code"). The Code has a statutory basis, in that if it describes behaviour which, in the opinion of the FSA, does not amount to market abuse (under the original provisions of the Act) then that is conclusive of the matter. The Code also describes forms of conduct which, in the FSA's opinion, are likely to amount to market abuse (and this has been amended to take account of the new provisions, discussed further below). Even though the Code in this case is not conclusive, but only represents the FSA's views, market participants have tended to follow the Code as a quasi-rule book unless unusual circumstances suggest

that individual guidance should be sought from the FSA in respect of a particular transaction or course of conduct.

1.2 THE MARKET ABUSE DIRECTIVE

The EU's Market Abuse Directive (2003/6/EC) (the "Directive") is one of a number of recent EU initiatives implementing the Financial Services Action Plan for completing the single market for financial services. The aim of the Directive is to promote clean and efficient markets, regulated in a harmonised way throughout the EU.¹ To this end, the Directive requires member states to outlaw insider dealing and market abuse and to provide for timely disclosure of price sensitive information to market users.

The Directive resulted in the UK making changes to the existing provisions of the Act. These changes extend to new areas, such as rules governing the disclosure of price sensitive information by issuers of securities and the preparation of investment research.

The Directive is not, in most respects, a "maximum harmonisation" directive (the fact that it is not means that member states may, if they so choose, adopt their own supplementary market abuse rules). However, the Directive does lay the ground for exclusive, EU-wide rules in one area: stabilisation. This has been

¹ Whilst the terms EU and Community are used in this memorandum, the Market Abuse Directive is included in the EEA Agreement thus extending its application to Iceland, Liechtenstein and Norway.

achieved by means of a Stabilisation and Share Buy-Back Regulation (2273/2003/EC) having direct effect throughout the EU.

In June 2010 the European Commission launched a public consultation on a review of the Directive. Following the consultation, in October 2011, the Commission published its legislative proposals. These proposals are discussed briefly in section 17 and in more detail in our publication “The European Commission’s proposals for the revision of MiFID and MAD” available on our website.

1.3 APPROACH TO IMPLEMENTATION

The UK was therefore given a measure of discretion in implementing the Directive, except in the case of stabilisation. In respect of market abuse, it could have relied on the existing regime in the Act as having already established broad compliance with the Directive; but as the Directive and the existing provisions were not co-extensive and differed in some material respects, this option was never seriously considered. In reality, there were two choices:

- to scrap the existing provisions in their entirety and implement the Directive requirements as a new exclusive set of provisions; or
- to implement the Directive requirements but retain certain existing provisions where these have a wider scope than the Directive requirements.

The UK Government decided on the second option. The main concerns about the first option were:

- The previous UK regime covered more UK markets than would be covered under the Directive, which applies to EU “regulated markets” (see 1.15). Commodity markets are not at present regulated markets; nor is the Alternative Investment Market (“AIM”) or the London Stock

Exchange’s Professional Securities Market (“PSM”). (Conversely, the Directive provisions are wider in one respect, in that market abuse in respect of an investment traded on any EU regulated market is now caught if the abusive behaviour occurs in the UK.)

- The Act as originally enacted expressly covered inaction which leads to the creation of a false market (for example the failure of a company to announce price sensitive news). Inaction is arguably not caught by the Directive.
- The Directive applies to “transactions”. Certain dubious activities which could affect commodities underlying derivatives (and thus the price or value of the derivatives) may not be “transactions” for these purposes.
- The definition in the Directive of inside information is arguably narrower, in particular because the definition requires that such information be “precise”, and (as noted in the Government’s July 2009 paper, *Reforming Financial Markets*) so may not capture all kinds of information considered “abusive to deal on”.

As discussed in more detail below at 13.5, the retained regular user provisions enabled the FSA (rather questionably) to introduce restrictions on short selling at short notice in 2008.

Some of the policy considerations listed above can be readily understood and accepted, especially those concerns about major markets falling outside the scope of the regime. However, the decision to maintain two sets of provisions to address insider dealing (in addition to the existing criminal law, which remains unchanged) has the potential for great confusion and resulting cost, for doubtful extra benefit. With a dual regime, it is necessary to determine whether a piece of information falls within the scope of the provisions derived from the Directive as opposed

to the retained original provisions. In many cases no certain answer will be arrived at – it will be uncertain which regime applies. As there are material differences between the two regimes, this is not a satisfactory state of affairs.

1.4 CATEGORIES OF MARKET ABUSE

The result of the conflation of the new EU and original UK approaches is that there are now seven types of behaviour which can amount to market abuse for the purposes of FSMA:

- (i) insider dealing (in the Directive sense);
- (ii) improper disclosure of inside information (Directive);
- (iii) misuse of relevant information not generally available, not caught under (i) or (ii), and contrary to the standards of the regular user (retained provision of the Act);
- (iv) transactions or orders to trade which create false market impressions or artificially support prices (Directive);
- (v) transactions or orders to trade which employ "fictitious devices or any other form of deception or contrivance" (Directive);
- (vi) disseminating false or misleading information (Directive); and
- (vii) behaviour creating false or misleading impressions or market distortion not caught under (iv) or (v) above and contrary to the standards of a regular user (retained provision). In practice, this category of abuse will be relevant to behaviour which does not amount to a "transaction" under (iv) in an investment (for example, misleading transactions in an underlying commodity).

1.5 INSIDE INFORMATION

Some confusion may be caused by the two concepts of inside information and relevant information, which are now set side by side. From the Directive comes the requirement that inside information be of a "precise nature". "Precise" information is further defined as being information which:

- indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and
- is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of the investment in question.

This definition is to be contrasted with the original test in the Act – if information, not being generally available were available to a "regular user of the market", would it be likely to be "regarded by him as relevant when deciding the terms on which transactions in [investments] should be effected"? Furthermore, the "behaviour" based on such information must be such that the "regular user" would regard the behaviour as a "failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market".

What are the main differences in practice?

- The prohibition derived from the Directive extends only to dealings in investments. The prohibition derived from the original provisions of the Act goes further and extends to behaviour "in relation to" investments, which does not necessarily amount to dealing in those investments. The Code gives an example of the insider who places a fixed odds bet on the performance of a share price based on inside information.

- The Directive only covers information which is "precise" as defined. In theory there might be information which is "imprecise" in that its effect (bad or good) on the price of an investment cannot be calculated but nevertheless if the circumstances or events occur will very likely have a significant effect one way or the other. In such a case, an insider might enter into a derivative which will profit from a sharp movement in prices (whether up or down).

One might reasonably ask why the Government did not simply retain the original insider dealing provisions of the Act. The answer is that it was felt that the "regular user" test was not compatible with the Directive – insider dealing might take place within the Directive's meaning (and fall within the basic description of misuse of information in the original provisions of the Act) but nonetheless not amount to market abuse under the original provisions of the Act because the dealing was not contrary to the standards of the regular user.

In conclusion, the series of questions to be asked when considering a particular insider dealing question include:

- Is there a dealing in an investment?
- Is the information concerned inside information as defined?

If the answer to both these questions is yes, then the conduct will fall to be assessed against the prohibition derived from the Directive.

Conversely, if the answer to either question is no, then the conduct falls to be assessed by reference to the retained provisions, including the standards of the regular user. In both cases, the sanctions – unlimited financial penalties – are the same.

1.6 CODE OF MARKET CONDUCT

The FSA revised the Code to take account of the changes brought about by the Directive's implementation. Some previous safe harbours were removed; but in many cases the FSA simply then added guidance to the effect that certain action is not likely to be market abuse in any event (and therefore does not require a safe harbour).

In the case of trading information (that is information which a firm has about impending or recent transactions), the Code now combines somewhat imprecise safe harbours derived from the Directive with indicative guidance as to how these safe harbours might apply:

- for market makers and other persons dealing as principal, there is a safe harbour for "pursuing their legitimate business of such dealing". The Code's guidance indicates that "legitimate business" could include the hedging of market risk, and associated trading in connection with a client order where the trading has no impact on price or there has been adequate disclosure to the client;
- for those carrying out client orders, the "dutiful carrying out" of such orders also has a safe harbour derived from the Directive. The Code's guidance indicates that, for example, behaviour engaged in with a view to facilitating or ensuring the effective carrying out of an order is likely to be "dutiful"; and
- having inside information about a target company, such information being used to facilitate a takeover of the target, is also within a safe harbour. Such information could either consist of knowledge of the impending bid itself or be information about the target derived from due diligence.

1.7 ISSUER DISCLOSURE OF INSIDE INFORMATION

The Directive requires that all issuers whose securities are traded on a regulated market must meet minimum ongoing disclosure requirements.

The disclosure requirements use the same concept of "inside information" discussed above.

Disclosure rules (the Disclosure and Transparency Rules, or DTRs) are made by the FSA and apply to all issuers of equity and debt securities admitted to UK regulated markets. The rules impose requirements to:

- publish inside information in a timely manner (except that an issuer may delay publication of inside information when early publication would be contrary to its "legitimate interests");
- publish changes to previously published inside information;
- refrain from disclosing inside information selectively to any third party, unless that third party owes a duty of confidence to the issuer;
- make arrangements to draw up lists of those persons who have access to inside information. These arrangements must extend to external advisers; and
- require senior management (and their connected persons) to disclose transactions in the issuer's shares or in any derivative instrument related to those shares.

The basic requirement, to disclose inside information, is not materially different from the existing requirement in the listing rules to notify information which, if made public, would be likely to lead to substantial movement in the price of a company's listed securities.

1.8 DELAYING DISCLOSURE

This important exception, allowing an issuer to delay announcement, is materially different from previous listing rules. The rule reads:

"An issuer may, under its own responsibility and at its own risk, delay the public disclosure of inside information, such as not to prejudice its legitimate interests provided that:

1. such omission would not be likely to mislead the public;
2. any person receiving the information owes the issuer a duty of confidentiality, regardless of whether such duty is based on law, on regulations, on articles of association or contract; and
3. the issuer is able to ensure the confidentiality of that information."

There is no definition of "legitimate interests" and, as the rule makes clear, it is for the company to judge what they are – at its own risk. However, the FSA sets out some guidance in this area, which includes:

- Whereas investors understand that there is information which must be kept confidential until developments come to fruition and an announcement can be made, and therefore will not be misled by the lack of earlier disclosure, it is likely that investors would be misled by failure to make an announcement following rumours about the supposedly confidential matter.
- Negotiations in course, or related elements, may be kept confidential where the outcome or normal pattern of these negotiations would be likely to be affected by public disclosure.

- In particular, negotiations concerning the financial survival of an issuer can be kept confidential for a limited period (but not the fact that the issuer is in financial difficulty).

In December 2008, the DTRs were amended to make it clear that a bank may have a legitimate interest in delaying disclosure of liquidity assistance received by it (or a member of its group) from the Bank of England or another central bank². This clarification was introduced as a result of the difficulties faced by Northern Rock at the outset of the credit crunch, where the announcement of liquidity support had such an adverse impact on consumer confidence that it was counter-productive to the aims of the support given.

Criticism has been expressed of the “not likely to mislead the public” condition as being extremely difficult to apply in practice. In practice the phrase is construed narrowly so that the presumption is typically that disclosure must be made.

1.9 SELECTIVE DISCLOSURE

Information that is being kept confidential may be disclosed selectively to persons owing a duty of confidence to the issuer, but if such disclosure is made it should be only for the purposes of the recipient's employment, profession or duties. Recipients may include:

- advisers,
- persons with whom the issuer is in negotiation,
- employee representatives,
- government or regulatory agencies,
- major shareholders,

² DTR 2.5.5AR

- lenders to the issuer, and
- credit rating agencies.

The clear expectation, and indeed the practice, is that selective disclosure will be on a short-term basis as a matter of practical expediency and not therefore an “ordinary course” practice.

1.10 INSIDER LISTS

Insider lists of those with access to inside information must be maintained. Individuals to be recorded on the list include not only the officers and employees of the issuer but also its agents and professional advisers. The list must contain the following information:

- the identity of each person having access to inside information;
- the reason why any such person is on the list; and
- the date on which the list was created and updated.

Further, every person who is an insider (including external advisers) must “acknowledge the legal and regulatory duties entailed and [be] aware of the sanctions attaching to the misuse or improper circulation of such information”. In practice, issuers will typically require their advisers to maintain their own separate insider lists and this is allowed for by the DTRs.

1.11 INSIDE INFORMATION: COMMODITY DERIVATIVES

For commodity derivatives, European legislators originally concluded that a different definition of inside information was needed, because of the different nature of the instruments concerned and the special

nature of practices in the commodity derivatives market.

Inside information in relation to commodity derivatives is therefore defined as information of a “precise nature which users of markets in which the derivatives are traded would expect to receive in accordance with any accepted market practices on those markets”.

Market users’ expectation is defined to extend to information which is either “routinely made available to the users of the markets, or required to be disclosed in accordance with any statutory provision, market rules, or contracts or customs on the relevant underlying commodity market or commodity derivatives market”.

This rather more subjective definition has, in recent years, led regulators to become concerned that the commodity derivative markets may be more vulnerable to abusive practices than was ever intended to be the case. The European Commission is now reviewing this definition as part of its broader review of the Directive which is scheduled for adoption by the end of 2011.

1.12 STABILISATION AND SHARE BUY-BACK PROGRAMMES

Commission Regulation 2273/2003 sets out EU law in relation to stabilisation and share buy-back programmes. The Regulation takes direct effect throughout the EU without need for national implementation.

The stabilisation regime replaces, and is somewhat narrower than, the FSA's previous stabilisation rules but only in respect of securities traded on a regulated market. More liberal (UK-specific) stabilisation rules apply to other securities – for example, Eurobonds traded on the LSE's PSM.

1.13 INVESTMENT RESEARCH

The Directive provides for a general requirement that there be “appropriate regulation” of the way in which investment research relating to securities traded on a regulated market is conducted and its conclusions presented. The Directive leaves the detail of such regulation to be provided by further EU legislation. The further legislation is found in a subsidiary directive on investment research. This subsidiary directive provides for detailed rules covering the following matters:

- disclosure of the identity of the person responsible for the production of research and the name of the individuals involved in its preparation;
- standards of fair presentation (such as ensuring that facts are distinguished from interpretations);
- disclosure of material sources, bases of valuation and risks associated with the recommendation;
- disclosure of material interests or conflicts of interests;
- specific disclosure of major shareholdings in the issuer of the investment or other significant business relationships.

The subsidiary directive also imposes requirements on those who disseminate recommendations prepared by others.

The overwhelming bulk of investment recommendations is produced by authorised firms; and it is for the FSA to make rules which meet the requirements of the Directive. The newspaper industry also produces investment recommendations in the financial pages of newspapers. For the media, the Directive's requirements are implemented in the UK by the Investment Recommendations Regulations (Media) 2005. However, these have limited impact. The Regulations do not apply where producers of

recommendations are subject to suitable industry codes of practice, which is generally the case for the UK press.

This aspect of the Directive and its implementation in the UK is not discussed further in this memorandum.

1.14 REPORTING MARKET ABUSE

The Directive requires investment firms and credit institutions to make reports of transactions which they have reasonable grounds for suspecting involve market abuse.

The FSA made rules in its Supervision manual to implement this requirement. Reports must be made to the FSA; this obligation stands alongside the obligation under the Proceeds of Crime Act 2002 to report suspected money laundering to the Serious Organised Crime Agency.

1.15 REGULATED MARKETS

The Directive and its related instruments are concerned with activities taking place on "regulated markets". This is a term of art meaning those markets which have been notified to the European Commission by Member States as meeting conditions prescribed by the Markets in Financial Instruments Directive (2004/39/EC) article 4.1.14. Because it is not mandatory to notify a market even if it meets the conditions, to some extent regulated market status is optional. The authorities in some Member States have deliberately chosen to keep certain markets as unregulated markets for the benefit of certain types of issuer who would find meeting the obligations flowing from regulated market status unduly burdensome (for example, a non-EU issuer which would have to restate its accounts in accordance with International Financial

Reporting Standards). In the UK, neither the PSM nor AIM is a regulated market.

1.16 COVERAGE OF THIS MEMORANDUM

The remainder of this memorandum looks in more detail at the market abuse regime, including the FSA's attempts in 2008 to restrict short selling, as well as the related share buy-back and stabilisation safe harbours.

It does not consider further the DTRs or the rules relating to investment research, as these topics must be examined in their own significant and extensive regulatory contexts.

2. Definition of market abuse

2.1 THE STATUTORY DEFINITION

The statutory definition of market abuse is set out in Part VIII of the Act, which has been comprehensively amended by the Market Abuse Regulations. Part VIII also provides for the adoption of the Code and the procedure for imposing fines.

The definition of market abuse is complex, reflecting the policy decision to fit the Directive's requirements and concepts alongside provisions retained from the definition of market abuse as originally enacted ("retained provisions"). However, material derived from the Directive is now the central feature of the regime.

Market abuse is defined by the Act as behaviour (whether by one person alone or by two or more persons jointly or in concert) which:

1. Occurs in relation to:

- (a) qualifying investments admitted to trading on a prescribed market,
- (b) qualifying investments in respect of which a request for admission to trading on such a market has been made, or
- (c) in the case of insider trading (in the Directive sense) or disclosure of inside information (Directive), investments which are related investments in relation to such qualifying investments, and

2. Falls within any one or more of the seven types of behaviour set out below³:

- (a) where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information related to the investment in question (Directive).
- (b) where an insider discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties (Directive).
- (c) where the behaviour does not fall within (a) or (b) but:
 - (i) is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be, or would likely be, regarded by him as relevant when deciding the terms on which transactions in qualifying investments should be effected, and
 - (ii) is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

³ Section 118(1) FSMA

This is "misuse of information" market abuse (a retained provision).

(d) where the behaviour consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which:

(i) give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments, or

(ii) secure the price of one or more such investments at an abnormal or artificial level.

This is "manipulating transactions" market abuse (Directive).

(e) where the behaviour consists of effecting transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance. This is "manipulating devices" market abuse (Directive).

(f) where the behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading. This is "dissemination" market abuse (Directive).

(g) where the behaviour does not fall within (d), (e) or (f) above but:

(i) is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments, or

(ii) would be, or would likely be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment,

and the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market. This is "misleading behaviour and distortion" market abuse (a retained provision).⁴

The retained provisions (c) and (g) were originally intended to cease to have effect on 30th June 2008. This was subsequently extended to 31st December 2009, and then to 31st December 2011⁵ (see also section 16 of this paper for more detail concerning the retention of these provisions). The categories of behaviour to which the retained provisions might apply (not being caught by the Directive provisions) are discussed later.

It should be noted that a person may commit market abuse without having any intention to abuse the market or otherwise being reckless or negligent as to doing so⁶.

2.2 PRESCRIBED MARKETS AND QUALIFYING INVESTMENTS

The Act gives the Treasury power to prescribe by order the markets and investments to which the regime

⁴ Section 118(2)-(8) FSMA

⁵ Section 118(9) FSMA and SI 2009/3128

⁶ *Winterflood Securities Limited v FSA* [2010] EWCA Civ 423, where the Court of Appeal decided that a person could commit market abuse by entering into artificial transactions or price positioning without an "actuating purpose" to mislead or distort the market.

applies. The relevant order⁷ (as amended by the Market Abuse Regulations) prescribes all markets which are established under the rules of a UK recognised investment exchange.

In addition, for the purpose of the market abuse provisions derived from the Directive (but not the retained provisions), the order prescribes all regulated markets within the European Economic Area ("EEA").

"Regulated markets" are markets notified to the European Commission (see 1.15 above), and include most major European stock exchanges. The requirement for the market abuse regime to extend beyond the UK in this way derives from the Directive.

All financial instruments covered by the Directive are prescribed as qualifying investments. These include:

- Transferable securities (shares and securities equivalent to shares, bonds and other forms of securitised debt; and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement).
- Units in collective investment undertakings.
- Money market instruments.
- Financial futures contracts, including cash-settled instruments.
- Forward rate interest rate agreements.
- Interest rate, currency and equity swaps.
- Options to acquire or dispose of any instrument falling into these categories, including equivalent

cash settled instruments, in particular options on currency and on interest rates.

- Commodity derivatives.
- Any other instrument admitted to trading on a regulated market in a Member State or for which a request for admission to trading on such a market has been made.⁸

This list covers all instruments dealt in on UK recognised investment exchanges.

2.3 RELATED INVESTMENTS, PHYSICAL COMMODITIES AND OTC DERIVATIVES

So far as market abuse consisting of either insider dealing or improper disclosure is concerned, dealings or disclosures in respect of "related investments" are caught. A "related investment" means an investment whose price or value depends on the price or value of the qualifying investment concerned. Thus, dealing in an OTC derivative (such as a spread bet on a share price) on the basis of inside information relating to the issuer of the share would be market abuse.

The retained provisions (misuse of information and misleading behaviour or distortion) are expanded in a somewhat different way to cover behaviour which occurs in relation to:

- anything which is the subject matter of, or whose price or value is expressed by reference to the price or value of, the relevant qualifying investments; and
- investments (whether qualifying or not) whose subject matter is the relevant qualifying investments.⁹

⁷ Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 SI 2001/996

⁸ Article 1(3) Directive 2003/6/EC
⁹ Section 118A(3) FSMA

In practice, the real difference between the two formulations is that behaviour in relation to a commodity underlying a traded derivative contract is caught. An example is behaviour in relation to a precious metal which affects the price of a futures contract in that metal.

2.4 TERRITORIAL SCOPE

The Act provides that behaviour which might otherwise constitute market abuse for the purposes of the Act shall be disregarded unless it occurs:

- in the United Kingdom; or
- in relation to qualifying investments which are admitted to trading on a prescribed market situated in, or operating in, the United Kingdom. For the purposes of the retained provisions only (misuse of information and misleading behaviour or distortion¹⁰), the reference to a prescribed market "operating in the United Kingdom" includes any such market accessible electronically in the United Kingdom (which means that it is possible under the rules of the market in question to enter into transactions on the market electronically from a place of business in the United Kingdom);¹¹ or
- in relation to qualifying investments for which a request for admission to trading on such a prescribed market has been made; or

¹⁰ Sections 118(4) and (8) FSMA

¹¹ Section 118A(2) FSMA. This provision clarifies that even if a prescribed market has no physical presence in the UK, but is nevertheless accessible electronically in the UK, abusive behaviour within section 118(4) or section 118(8) still falls within the market abuse regime. However, note that the prescribed market must, for the purposes of sections 118(4) and 118(8), continue to fall within the definition of a prescribed market – i.e. a market established under the rules of a UK recognised investment exchange.

- in the case of insider dealing and improper disclosure market abuse (both Directive), in relation to investments which are related investments in respect of such qualifying investments.¹²

It is to be noted, therefore, that conduct with no apparent territorial connection with the United Kingdom (other than the fact that it relates to an investment traded in the United Kingdom) is subject to the UK market abuse regime. This was confirmed by a 2006 decision of the Financial Services and Markets Tribunal, which held that the scope of the regime extends to trading in securities on an overseas market (not being a prescribed market) if securities of the same kind are in fact traded on a prescribed market.¹³

Such overseas trading may, of course, also fall within the scope of a local market abuse regime. However, behaviour in respect of qualifying investments trading on prescribed markets operating outside of the UK is only covered if the behaviour occurs in the UK.

2.5 THE REGULAR USER TEST

The retained provisions are subject to a further condition before market abuse can be found to have occurred. Conduct which amounts to either misuse of information or misleading behaviour or distortion will not amount to market abuse unless there is also a risk of damage to confidence in the market as a result. In some cases the likelihood of damage to confidence is obvious, e.g. in respect of fraudulent conduct, market rigging and insider dealings. In other cases, it will be more difficult to assess.

For the retained provisions, the Act makes use of the concept of a "regular user". Conduct is only abusive if it would be regarded by a regular user of the market

¹² Section 118A(1) FSMA

¹³ *Phillipe Jabré v FSA*, FSMT Decision No.36

concerned who was aware of the conduct as a failure to observe the standard of behaviour reasonably to be expected of a person in the position of the alleged abuser.¹⁴

The Act states that a regular user is, in relation to a particular market, a reasonable person who regularly deals on that market in investments of the kind in question.¹⁵ This is intended to establish an objective standard by which conduct is to be assessed. Whether the test is satisfied should depend on the particular market and should change as standards of market conduct develop over time. It follows that behaviour that was not previously considered to be abusive may become so as a result of changes in standards.

The standards expected by the regular user may not be the same as the standards expected by customers of the market, or by the investing public generally, and the focus of the test is on the expectations of professional users of the market. However, the FSA has made clear that the standards to be attributed to the regular user are not identical to the standards actually prevailing in a given market at any particular time (see further the commentary on the FSA's short selling restrictions at 13.5). Conduct, even if widespread and accepted by actual market participants, may still amount to market abuse if the hypothetical regular user would regard it as unacceptable. An example given by the FSA concerns the trading of futures contracts on the London Futures and Options Exchange ("London FOX") market in 1991. Several firms carried out transactions with the object of increasing the appearance of activity and liquidity in such contracts at the request of, and with the encouragement of, senior officials at London FOX. In the view of the FSA, such conduct was abusive, even though it was accepted by both the exchange and market participants at the time.

2.6 LEGITIMATE BUSINESS AND ACCEPTED MARKET PRACTICES

The market abuse provisions which derive from the Directive do not employ the "regular user" concept. Instead, insider dealing and manipulating transactions market abuse are subject to two important exceptions:

- there is deemed to be no use of inside information by market makers, bodies authorised to act as counterparties, or persons authorised to execute orders on behalf of third parties, who have inside information, provided that such persons can confine themselves, in the first two cases, to pursuing their legitimate business of buying or selling financial instruments or, in the last case, to carrying out an order dutifully; and¹⁶
- there is no manipulating transaction if the person who entered into the transaction or issued the order to trade establishes that his reasons for doing so are legitimate and that the transaction or order to trade conformed to accepted market practices on the market concerned.¹⁷

"Accepted market practices" mean practices that are reasonably expected in one or more financial markets and accepted by the FSA in accordance with guidelines adopted by the European Commission. This is a more prescriptive version of the regular user test and there are currently no FSA-specified accepted market practices.

These concepts are employed by the FSA in the Code of Market Conduct and are discussed later.

¹⁴ Sections 118(4) and (8) FSMA

¹⁵ Section 130A(3) FSMA

¹⁶ MAR 1.3.7C; 1.3.12C

¹⁷ MAR 1.6.6E

3. The code of market conduct

3.1 THE CODE

The Act says that the FSA must produce a code containing guidance on whether behaviour amounts to market abuse.¹⁸ Matters which the Code may specify include:

- descriptions of behaviour that, in the opinion of the FSA, does not amount to market abuse (“safe harbours”);
- descriptions of behaviour that, in the opinion of the FSA, amounts to market abuse;
- factors that are to be taken into account in determining whether or not behaviour amounts to market abuse;
- descriptions of behaviour that are accepted market practices in relation to one or more specified markets; and
- descriptions of behaviour which are not accepted market practices in relation to one or more specified markets.¹⁹

The last two matters relate to the provisions derived from the Directive.

The FSA is required to consult when publishing or amending the Code, except in cases of “urgent need”.²⁰

3.2 FUNCTION OF THE CODE

The Code is intended to give guidance on the market abuse regime. It does not have the effect of modifying or extending existing obligations, such as disclosure obligations under the DTRs, the Takeover Code, or the rules of any exchange.

Where the Code describes behaviour as not amounting to market abuse, such behaviour is conclusively deemed to be not abusive. Otherwise, compliance with the Code is evidence that a person has not committed market abuse, while engaging in conduct described in the Code as market abuse is evidence that he has committed it. As it is for the FSA to enforce the regime, market participants may fairly safely rely on the Code.

The Code is not an exhaustive description of all types of behaviour which may or may not constitute market abuse. In particular, the descriptions of behaviour which, in the opinion of the FSA, amount to market abuse should be read in the light of the elements specified by the Act as constituting the relevant type of market abuse and any relevant descriptions of behaviour which, in the opinion of the FSA, do not

¹⁸ Section 119(1) FSMA

¹⁹ Section 119(2) FSMA

²⁰ Section 121(1)-(6) FSMA. The introduction of short selling controls in 2008 by way of additions to the Code was deemed to be such a case of “urgent need”

amount to market abuse. Likewise, the Code does not exhaustively describe all the factors to be taken into account in determining whether behaviour amounts to market abuse. If factors are described, "they are not to be taken as conclusive indications, unless specified as such, and the absence of a factor mentioned does not, of itself, amount to a contrary indication".²¹

Conduct which falls outside the Code will be assessed directly under the Act. Given the broad scope of the definitions under the Act, this may give rise to practical difficulties where a firm proposes to enter into an innovative transaction or trading strategy not covered by the Code. In such cases, the firm may wish to consider seeking informal or formal guidance from the FSA, or legal advice, before embarking on the transaction.

3.3 STRUCTURE OF THE CODE

The Code sets out and gives guidance as to the main concepts used in the Act and then works through the seven types of market abuse, giving guidance on each. It sets out certain safe harbours and, in an Annex, sets out the European rules relating to share buy-back programmes and stabilisation (see section 15).

Provisions of the Code are identified by a letter, determining their status. There are four kinds of provisions: (a) those which describe behaviour which, in the opinion of the FSA, does not amount to market abuse; (b) those which describe behaviour which in the opinion of the FSA does amount to market abuse; (c) those which identify factors that in the opinion of the FSA are to be taken into account in determining whether behaviour amounts to market abuse; and (d) those which contain guidance which is not binding and does not have evidential effect. Provisions of type (a)

are binding by virtue of section 122(1) FSMA and can be relied upon in the knowledge that such behaviour does not constitute market abuse. These are the "safe harbours" and are identified by the designation "C". Provisions of types (b) and (c) are evidential in nature. They reflect the opinion of the FSA and may be taken into account when deciding whether behaviour constitutes market abuse. They are identified by the designation "E". Provisions of type (d) contain guidance only and are identified by the designation "G".²²

Provisions which are reproduced directly from EU legislation, such as the buy-back and stabilisation rules, are designated by the letters "EU".

3.4 RELATIONSHIP WITH OTHER LAWS AND REGULATIONS

The provisions of the Act and the Code are not aligned with existing criminal sanctions for market manipulation and insider dealing. Conduct which is not a crime may still be punished as market abuse. Conversely, conduct which is not market abuse may in theory be punishable as, for example, criminal insider dealing under the Criminal Justice Act 1993. Apart from the safe harbours referred to later, compliance with the FSA's own rules or the rules of any exchange or clearing house will not of itself provide protection from a finding of market abuse. Firms therefore need to have in place systems and procedures to ensure that they comply with each of the regimes to which they may be subject. Where one regime imposes stricter requirements than the others, firms and individuals will need to comply with the most onerous.

However, the FSA will of course take into account the extent to which behaviour complies with other applicable regimes. Conversely, failure to comply

²¹ MAR 1.1.6G; MAR 1.1.7G. The Court of Appeal also took this approach in *Winterflood Securities Ltd & Ors v FSA* [2010] ECCA Civ 423

²² *Winterflood Securities Ltd & Ors v FSA* [2010] ECCA Civ 423

with such a regime rule will not of itself create a presumption that there has been market abuse.

3.5 BEHAVIOUR PRIOR TO A REQUEST FOR ADMISSION TO TRADING

The Code discusses two general issues which apply regardless of the form which alleged market abuse might take.

First, the Code says that behaviour which occurs prior to a request for admission to trading could nevertheless fall within the regime, on the basis that it is "in relation to" an investment admitted to trading or in respect of which a request for admission to trading has been made, in the following circumstances:

- if the behaviour is in relation to qualifying investments in respect of which a request for admission to trading on a prescribed market is subsequently made; and
- if the behaviour continues to have an effect once an application has been made for the qualifying investment to be admitted to trading or it has been so admitted.²³

²³ MAR 1.2.5E

3.6 WHEN "INACTION" MIGHT AMOUNT TO MARKET ABUSE

For the purposes of the Act, "behaviour" includes action or inaction (section 130A(3)). The Code specifies the following kinds of inaction as being potentially within the regime:

- if the person concerned has failed to discharge a legal or regulatory obligation (for example, to make a particular disclosure); or
- if the person concerned has created a reasonable expectation that he will act in a particular manner, as a result of his representations (by word or conduct), in circumstances which give rise to a duty or obligation to inform those to whom he made the representations that they have ceased to be correct, and he has not done so.²⁴

3.7 ENCOURAGING MARKET ABUSE

Section 123(1)(b) of the Act provides that the FSA may sanction a person who by taking or refraining from taking any action has required or encouraged another person to engage in behaviour, which if engaged in by the first person, would amount to market abuse.

The Code gives as examples the director of a company who has inside information instructing an employee to deal in qualifying or related investments in respect of which the information is inside information; or a person who recommends or advises a friend to engage in behaviour which, if he himself engaged in it, would amount to market abuse.

²⁴ MAR 1.2.6E

4. Insider dealing and improper disclosure (Directive provisions)

The Act defines inside information differently depending on whether it is in respect of commodity derivatives or other investments.

4.1 INSIDE INFORMATION – GENERAL INVESTMENTS

The Act uses the definition provided by the Directive. Inside information is information:

- of a precise nature;
- which is not generally available;
- which relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments; and
- which would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.²⁵

The Act further provides that information is “precise” if it:

- indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur; and

²⁵ Section 118C(2) FSMA

- is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of the qualifying investments or related investments.²⁶

The Act also provides that information would be likely to have a significant effect on price if *and only* if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.²⁷ This provision was considered by the Upper Tribunal in *David Massey v The Financial Services Authority*²⁸, where it was held that it gave a special meaning to the phrase “significant effect on price”, in effect supplanting the ordinary meaning. The Tribunal held, surprisingly, that the only “significance” which has to be considered is whether the reasonable investor would take the information into account in making an investment decision; if he would, the FSA (or at least the Tribunal) can regard the significance test to have been satisfied. The alternative (and perhaps better) view would have been that the provision requires price effect to be approached with a cool head, discounting any panicky or irrational response to the information.

In the *Spector Photo* case²⁹ (discussed further at 4.6) the European Court of Justice held that capacity to have a significant effect on prices must be assessed in the light of the content of the information at issue and

²⁶ Section 118C(5) FSMA

²⁷ Section 118C(6) FSMA

²⁸ FIN/2009/0024

²⁹ *Spector Photo Group NV & Chris Van Raemdonck v CBFA* (Case No. C-45/08) ECJ, 23 December 2009

the context in which it occurs. It is thus not necessary, when determining whether information is inside information, to examine whether its disclosure *actually* had a significant effect on the price of the financial instruments to which it relates.³⁰

The Act further provides that information which can be obtained by research or analysis conducted by, or on behalf of, users of a market is to be regarded as being generally available to them.³¹

The Code elaborates the concept of "generally available" further and states that the following are indications that information is generally available and therefore not inside information:

- information which has been disclosed to a prescribed market through an information service or otherwise in accordance with market rules;
- information which is contained in records which are open to public inspection;
- information which is otherwise generally available, including on the internet, or in some publication (even if only available on payment of a fee) or information derived from information which has been made public;
- information which can be obtained by observation by members of the public without infringing rights or obligations of privacy, property or confidentiality (the Code gives as an example a train passenger observing a burning factory and using that information to decide to sell shares in the company owning the factory);

³⁰ Paragraph 69 of the judgment. However, gains realised from insider dealing may be a relevant consideration for the purposes of determining a sanction which is effective, proportionate and dissuasive. The method of calculation of those economic gains and, in particular, the date or the period to be taken into account are to be determined by national law (paragraph 73 of the judgment).

³¹ Section 118C(8) FSMA

- information which can be obtained by analysing or developing other information which is generally available.³²

The Code states that it is not relevant that the information is only generally available outside the UK or that information can only be observed or derived by analysis by someone with above-average financial resources, expertise or competence.³³

4.2 INSIDE INFORMATION – COMMODITY DERIVATIVES

The Act provides that in relation to commodity derivatives, inside information is information:

- of a precise nature;
- which is not generally available;
- which relates, directly or indirectly, to one or more such derivatives; and
- which users of markets on which the derivatives are traded would expect to receive in accordance with any accepted market practices on those markets.³⁴

It is perhaps curious that it is not a requirement of the definition that the information would be likely to have a significant effect on the price of any commodity derivative.

The Act provides that users of commodity markets are to be treated as expecting to receive information relating to derivatives in accordance with any accepted market practices, which is:

- routinely made available to the users of those markets; or

³² MAR 1.2.12E

³³ MAR 1.2.13E

³⁴ Section 118C(3) FSMA

- required to be disclosed in accordance with any statutory provision, market rules, or contracts or customs on the relevant underlying commodity market or commodity derivatives market.³⁵

As mentioned in section 1.11 earlier, the European Commission is reviewing the definition of inside information in relation to commodity derivatives as part of its broader review of the Directive.

4.3 INSIDE INFORMATION – EXECUTION OF ORDERS

The Act makes special provision for the situation where a trader has information about a pending but unexecuted client order, knowledge of which is price sensitive. In this case, the definition of inside information which applies for general investments also applies to pending orders for commodity derivatives.³⁶

The Code provides that an order is likely to be "pending" if a trader is approached in relation to a transaction and:

- the transaction is not immediately executed at arm's length at a price quoted by the trader; and
- the trader has assumed a legal or regulatory obligation relating to the manner or timing of execution (e.g. a best and/or timely execution duty under the FSA's rules).³⁷

4.4 INSIDERS

An insider is defined by the Act as any person who possesses inside information:

- as a result of his membership of the "administrative, management or supervisory bodies" of an issuer of qualifying investments;

- as a result of his holding in the capital of an issuer of qualifying investments (i.e. a share or debenture holder);
- as a result of having access to the information through the exercise of his employment, profession or duties (which would include outside professional advisers or, indeed, contract cleaners);
- as a result of his criminal activities; or
- which he has obtained by other means which he knows, or could reasonably be expected to know, is inside information.³⁸

The Code says of this last element that the following factors may indicate that a person is an insider:

- if a normal and reasonable person in a position of the person who has obtained the inside information would know or should have known that the person from whom he received it is an insider (for example, the waiter who overhears the conversation of someone he knows to be the director of a well-known company); and
- if a normal and reasonable person in a position of the person who has obtained that information would know or should have known that it is inside information.³⁹

The other categories of insider do not need to know that the information concerned is inside information to fall within the market abuse provisions.

³⁵ Section 118C(7) FSMA

³⁶ Section 118(4) FSMA

³⁷ MAR 1.2.16E

³⁸ Section 118B FSMA

³⁹ MAR 1.2.8E

4.5 TRADING INFORMATION

An important consideration for market participants concerns the extent to which the market abuse regime may inhibit dealings in the normal course of business by a firm which may have information about its own or its clients' transactions, such information necessarily arising in the normal course of business. This area is examined in more detail below; but of importance to the analysis is the Code's concept of "trading information". The Code borrows the definition found in the criminal insider dealing provisions of the Criminal Justice Act 1993. Trading information is information of the following kinds:

- that investments of a particular kind have been or are to be acquired or disposed of, or that their acquisition or disposal is under consideration or the subject of negotiation;
- that investments of a particular kind have not been or are not to be acquired or disposed of;
- the quantity of investments acquired or disposed of or to be acquired or disposed of whose acquisition or disposal is under consideration or the subject of negotiation;
- the price (or range of prices) at which investments have been or are to be acquired or disposed of or the price (or range of prices) at which investments whose acquisition or disposal is under consideration or the subject of negotiation may be acquired or disposed of; or
- the identity of the persons involved or likely to be involved in any capacity in an acquisition or disposal.⁴⁰

Trading information is not treated as falling outside the market abuse regime. Rather, when trading information does amount to inside information

then whether or not dealing on the basis of trading information is to be regarded as market abuse depends crucially on the capacity in which, and the purposes for which, the insider deals, as will be explained later.

4.6 WHAT IS DEALING "ON THE BASIS OF" INSIDE INFORMATION?

As set out in 2.1 above, insider dealing occurs when an insider deals or attempts to deal in a qualifying or related investment on the basis of inside information relating to the investment in question. The phrase "on the basis of" has always been thought to imply an element of causality between the possession of inside information and the dealing, but see further the comments on the *Spector Photo* case below in which the European Court of Justice handed down an opinion which departs from this reasoning.

The Code as currently written, however, provides that in the following cases it is likely that there is not a causal link between the possession of information and the dealing:

- if the decision to deal or attempt to deal was made before the person possessed the relevant inside information;
- if the person concerned is dealing to satisfy a legal or regulatory obligation which came into being before he possessed the relevant inside information; or
- in the case of an organisation, if none of the individuals in possession of the inside information:
 - had any involvement in the decision to deal;
 - behaved in such a way as to influence, directly or indirectly, the decision to engage in the dealing; or

⁴⁰ GLOSSARY

- had any contact with those who were involved in the decision to deal whereby the information could have been transmitted.⁴¹

In the last case, the presence or absence of a Chinese wall may be critical. The Code says that where the inside information is held on one side of a wall, and the decision to deal is taken on the other, then that is evidence that the organisation did not deal on the basis of inside information.⁴²

Conversely, if inside information is the reason for, or a material influence on, the decision to deal or attempt to deal, the Code says that this indicates that the person's behaviour is "on the basis of" inside information.⁴³ Note, however, that following the *Spector Photo* case (discussed immediately below), the FSA's view is that it is not necessary to provide evidence of a person's intention in order to prove insider dealing. The FSA is therefore consulting on a proposal to delete this provision.⁴⁴

Spector Photo case

The European Court of Justice ("ECJ") opinion given in the *Spector Photo* case has introduced ambiguity into this area by deciding that there need be no causal link between the holding of the inside information and the dealing. The ECJ said that "once the constituent elements of insider dealing laid down in Article 2(1) of [the Market Abuse Directive] are satisfied, it is thus possible to assume an intention on the part of the author of that transaction".

Even though EU law enshrines the principle of the presumption of innocence, this principle does not, according to the ECJ, override the presumption implied in Article 2(1), because the latter presumption is open to rebuttal by the defendant: this "safeguard" means that the presumption of intention is a reasonable one.

Thus far, the opinion of the ECJ is fairly uncompromising, with possibly very harsh implications for certain classes of defendants. It could also have considerable implications for the legislative provisions in FSMA which purport to implement the Directive but are drafted on the basis of the somewhat different interpretation of it outlined above.

However, after hearing submissions, the ECJ in *Spector Photo* sought to draw a distinction between the situation where a person may, on the interpretation summarised above, fall within the scope of Article 2(1) but deals in a way which does not harm the "interests protected by [the Directive]" and the situation where a person who falls within the scope of the Article and does deal in a way which is "capable of infringing those interests". The latter is to be penalised; the former not. The purpose of the Directive, in the words of the ECJ, "is to protect the integrity of the financial markets and to enhance investor confidence, which is based, in particular, on the assurance that investors will be placed on an equal footing and protected from the misuse of inside information".⁴⁵

It is perhaps as well that the opinion coincides with the final stages of the Commission's review of the workings of the Directive (see section 1.11 above). It is therefore open to the Commission to propose amendments to the Directive to clarify or respond to the impact of the ECJ's potentially far-reaching decision. However, this process will not be free from contention, nor will it be swift.

The decision appeared to create uncertainties for the UK regime, but the FSA's formal response⁴⁶ denied that FSMA or the Code of Market Conduct were inconsistent with *Spector*, apart from the need to delete one provision of the Code (former MAR 1.3.4E) which referred to a person's "reasons" for dealing and thus suggested the need for the FSA to prove a mental element.

⁴¹ MAR 1.3.3E

⁴² MAR 1.3.5E

⁴³ MAR 1.3.4E

⁴⁴ FSA Consultation Paper 10/22. The provision is contained in MAR 1.3.4E.

⁴⁵ Paragraph 62 of the *Spector* judgment

⁴⁶ Handbook Notice 107 February 2011

Although the FSA has declined to revise the Code of Market Conduct any further, the implication of its refusal appears to be that a person can still rely on those provisions of the Code, discussed above, which give examples of dealing which would not be regarded as being "on the basis" of inside information, for lack of a causal connection between insider knowledge and the dealing. The FSA has decided, in effect, that those provisions are to be read as examples where a *Spector* presumption of "use" stands rebutted.

The preamble to the Directive itself also contains some examples of dealings which should not, in themselves, constitute "use of inside information" within Article 2(1) (and these are reflected to an extent in the existing Code guidance):

- the legitimate entering into of market transactions by market-makers and bodies authorised to act as counterparties, and the dutiful execution of orders on behalf of third parties (Recital 18);
- the use of inside information relating to another company in the context of a public takeover bid or a merger proposal (Recital 29);
- transactions conducted in the discharge of an obligation that has become due to acquire or dispose of financial instruments where that obligation results from an agreement concluded before the person concerned possessed inside information (Article 2(3));
- the carrying out of a market transaction, in respect of which a prior decision to trade has been made (Recital 30).

Also of relevance is:

- a mention in Recital 24 that the establishment of Chinese walls can contribute to market integrity and combat market abuse, provided they are

"enforced with determination and are dutifully controlled"; and

- safe harbours for share buy-back programmes and stabilisation (see section 15 below).

4.7 BEHAVIOUR LIKELY TO BE INSIDER DEALING MARKET ABUSE

The Code lists four main kinds of behaviour which the Act is designed to prevent or punish:

- dealing on the basis of inside information which is not trading information;
- front running (also known as pre-positioning – this is dealing ahead of an order which a person is to carry out with or on behalf of another), where knowledge of the order is inside information in relation to the dealing, with the purpose of bringing about the anticipated impact of the order on market prices;
- in the context of a takeover, an offeror or a potential offeror using inside information concerning the proposed bid to enter into a transaction in a qualifying investment that provides merely an economic exposure to movements in the price of the target company's shares (for example, a spread bet or other derivative). This is to be contrasted with genuine stake-building; and
- in the context of a takeover, where any advisor to the offeror or potential offeror deals for his own benefit in a qualifying or related investment on the basis of inside information concerning the proposed bid.⁴⁷

⁴⁷ MAR 13 ZE

4.8 INSIDER DEALING MARKET ABUSE – SAFE HARBOURS

The Code provides for four important safe harbours for dealings on the basis of inside information which consists of trading information. It is stated conclusively that the following are not insider dealing market abuse:

- a person's knowledge of his own intentions to deal (otherwise no significant dealings could take place without fear of committing market abuse);⁴⁸
- where market makers and other persons lawfully dealing as principal "pursue their legitimate business" of such dealing (including entering into any underwriting agreement). The Code says that if the dealing is based on inside information which is not trading information, that will be evidence that the behaviour is not "in pursuit of legitimate business interest";⁴⁹
- the "dutiful carrying out", or arranging for the dutiful carrying out of, an order on behalf of another (including as portfolio manager). This safe harbour applies whether or not the person carrying out the order or the person for whom he is acting in fact possesses inside information;⁵⁰
- behaviour by or on behalf of an offeror in relation to a takeover or merger target where the inside information relates to the target.⁵¹

The Code goes on to give examples of legitimate business pursuits and the dutiful execution of orders.

The following, according to the Code, are likely indicators of legitimate business pursuits:

- where trading is carried out in order to hedge a risk, particularly where it neutralises and responds to a risk arising out of other legitimate trading;
- where a trade is done on the basis of inside information about a client's executed transaction but the only reason for the information being inside information is that details of the transaction are not required to be published under any relevant regulatory or exchange obligation or the publication deadline has not yet expired;
- trading by a person in connection with a transaction entered into or to be entered into with a client or potential client where the trading has no impact on the price or there has been adequate disclosure to the client that trading will take place and the client has not objected; or
- where the trading is reasonable by the proper standards of conduct of the market concerned, taking into account any relevant regulatory or legal obligations and the transaction is executed in a way which takes into account the need for the market as a whole to operate fairly and efficiently.⁵²

Conversely, it is likely not to be in pursuit of legitimate business where a person acts in contravention of a relevant legal, regulatory or exchange obligation.⁵³

The Code sets out the following behaviour which is likely to fall within the "dutiful execution of client orders" safe harbour:

- where the person concerned has complied with the FSA's conduct of business rules (COBS) or equivalent rules in another jurisdiction;

⁴⁸ MAR 1.3.6C

⁴⁹ MAR 1.3.7C; MAR 1.3.8C

⁵⁰ MAR 1.3.12C; MAR 1.3.13G

⁵¹ MAR 1.3.17C

⁵² MAR 1.3.10E

⁵³ MAR 1.3.11E

- where the person concerned has agreed with the client that it will act in a particular way when carrying out, or arranging the carrying out of, the order;
- where the person concerned behaved with a view to facilitating or ensuring the effective carrying out of the order;
- where the person concerned behaved reasonably in accordance with the proper standards of conduct of the market concerned and (if relevant) proportional to the risk undertaken by him;
- where the relevant trading of the person concerned is connected with a client transaction (including a potential client transaction) and the trading either has no impact on the price given or to be given to the client or there has been adequate disclosure to the client that trading will take place and the client has not objected.⁵⁴

In the opinion of the FSA, acting on inside information which is not trading information is not likely to be compatible with the dutiful carrying out of a client order.

In the case of takeovers, the Code indicates that there are two kinds of inside information likely to be relevant. The first is the information that the bid is going to happen; the second is the information which an offeror or potential offeror may acquire from the target through due diligence.⁵⁵

The Code also gives guidance as to whether behaviour is "for the purpose of" gaining control of the target and thus within the safe harbour. The safe harbour is likely to be available to:

- transactions in the target company's shares; and
- transactions engaged in for the sole purpose of gaining control of, or effecting a merger with, the target.⁵⁶

Common types of behaviour which will fall within the safe harbour are, according to the Code:

- seeking irrevocable undertakings or expressions of support from those who hold securities in the target;
- making arrangements, including for underwriting and placing, for issues of consideration securities or of securities which are issued to raise cash for the offer;
- associated hedging arrangements by underwriters or placees which are proportionate to the risks assumed by them; and
- making arrangements to offer a cash alternative to a securities consideration offer.⁵⁷

4.9 EXAMPLES OF INSIDER DEALING MARKET ABUSE

The Code sets out various scenarios to illustrate insider dealing. For example, in relation to insider dealing other than in commodity derivatives:

- Y is told by X, a company director, that the company has received a takeover offer at a premium to its current share price. Y subsequently enters into a spread bet in anticipation that the share price will go up when the offer is announced;

⁵⁴ MAR 1.3.15E

⁵⁵ MAR 1.3.18G

⁵⁶ MAR 1.3.19E

⁵⁷ MAR 1.3.17C

- a company's employee finds out that it has lost a significant contract. Before this news is made public, the employee sells the shares he holds in the company.⁵⁸

Insider dealing in relation to commodity derivatives is illustrated by the example of the trader who has knowledge that there has been a significant decrease in the stocks of a certain metal, before (as is routine) that decrease is announced to the market. The trader buys a substantial number of futures contracts on the metal.⁵⁹

Another example demonstrates the definition of inside information relating to pending client orders. An oil derivatives trader receives a large order to buy oil futures. Before executing the order, the dealer deals in those futures for his firm and for his own account, anticipating a significant price rise when he executes the client's order.⁶⁰

The Code illustrates the potentially different effects that the definitions of inside information for trades in commodity and non-commodity investments may have:

- a person having inside information concerning a commodity producing company will commit market abuse by dealing on a prescribed market in the company's shares;
- a person having the same information who deals in a commodity futures contract on a prescribed market will generally commit market abuse only if the information is required to be disclosed under the rules of the relevant commodity futures market.⁶¹

⁵⁸ MAR 1.3.20G

⁵⁹ MAR 1.3.21G

⁶⁰ MAR 1.3.22G

⁶¹ MAR 1.3.23G

4.10 IMPROPER DISCLOSURE

The Act provides that it is market abuse for an insider to disclose inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duty.⁶²

The Code gives two examples:

- a director of a company who discloses inside information to someone else in a social context; and
- directors or senior managers selectively briefing analysts.⁶³

However, there is a safe harbour for any disclosure made to a government or regulatory body (including a takeover panel) in fulfilment of a legal or regulatory obligation or otherwise to such a body in connection with the performance of its functions.⁶⁴

Similarly, disclosure of inside information required or permitted by listing rules or the FSA's DTRs for issuers admitted to trading on a regulated market (or any similar regulatory obligation) does not amount to improper disclosure.⁶⁵

The Code sets out a number of cases in which disclosure is likely to be made in the proper course of a person's employment, profession or duties:

- where the disclosure is permitted by the rules of a prescribed market, the FSA or the Takeover Code; or
- where the disclosure is accompanied by the imposition of confidentiality requirements on the

⁶² Section 118(3) FSMA

⁶³ MAR 1.4.2E

⁶⁴ MAR 1.4.3C

⁶⁵ MAR 1.4.4C

recipient and the disclosure falls into one or more of the following categories:

- the disclosure is reasonable and is to enable a person to perform his job, profession or duties properly;
- the disclosure is reasonable and is for the purposes of facilitating or seeking or giving advice about a transaction or takeover bid (for example, communications with professional advisers);
- the disclosure is reasonable and is for the purpose of facilitating any commercial, financial or investment transaction (including communicating proposals for a transaction to prospective underwriters or places of securities, although such persons will then become insiders themselves and will not be able to deal freely as a consequence);
- the disclosure is reasonable and for the purposes of obtaining a commitment or expression of support in relation to a takeover offer subject to the Takeover Code; or
- the disclosure is in fulfilment of a legal obligation, including to employee representatives or trade unions acting on their behalf.⁶⁶

⁶⁶ MAR 1.4.5E

5. Misuse of information (retained provision)

It is to be recalled that it is only if behaviour does not fall within the Directive-derived insider dealing category of market abuse that the “misuse of information” category is relevant. In practice, this means that it is likely to be at issue in two kinds of circumstance:

- where there is possible abusive behaviour which is other than a dealing in investments; or
- where the information on which behaviour is based (whether or not a dealing) is price sensitive but arguably not “inside information” as defined in FSMA.

The Code notes as an example a person such as a director giving relevant information which is not generally available and relates to matters which a regular user would reasonably expect to be disclosed to users of a particular prescribed market, to another otherwise than in the proper course of the exercise of his employment or duties, where the conduct does not amount to market abuse (improper disclosure), most likely because the relevant information is not within the definition of inside information.⁶⁷

See the statutory definition in 2.1. Note that this category of market abuse employs the concept of the “regular user” (see 2.5).

⁶⁷ MAR 1.5.2E(2)

5.1 ELEMENTS OF MISUSE OF INFORMATION

The Code cross-refers to its discussion of inside information for some of the factors to be taken into consideration as to whether information is “generally available” or whether behaviour is “based on” relevant information.

The Code says that a regular user would likely regard information as relevant information in the following circumstances:

- where the information is reliable, considering how near the person providing the information is, or appears to be, to the original source of that information and the reliability of that source;
- where the information differs from information which is generally available and can therefore be said to be new or fresh information;
- where information relates to possible future developments which are not currently required to be disclosed but which, if they occur, will lead to a disclosure or announcement and the information provides, with reasonable certainty, grounds to conclude that the possible future developments will in fact occur; or
- where there is no other material information which is already generally available to inform users of the market.⁶⁸

⁶⁸ MAR 1.5.6E

5.2 DISCLOSABLE AND ANNOUNCEABLE INFORMATION

The Code says that a regular user would reasonably expect information to be disclosed to the users of the market in question if it is either subject to a formal disclosure requirement or routinely the subject of a public announcement. Behaviour based on such information when it is not generally available would, according to the Code, be likely to be regarded by a regular user as failing to meet the standard of behaviour expected of the person concerned.⁶⁹

Examples of information disclosed in accordance with legal or regulatory requirements are:

- information required to be published under the Takeover Code (or its equivalent in the relevant jurisdiction) on or in relation to qualifying investments;
- information which is required to be disseminated under the DTRs (or their equivalent); or
- information required to be disclosed by an issuer under the laws, rules or regulations applying to the prescribed market on which its qualifying investments are traded or admitted to trading.⁷⁰

Examples of routine public announcements not amounting to a formal disclosure requirement are:

- information which is the subject of official announcement by governments, central monetary or fiscal authorities or a regulatory body;
- changes to credit ratings;

- changes to the constituents of a securities index, where the securities are qualifying investments.⁷¹

Further, for information which relates to possible future developments, it will be relevant information if it is reasonable to believe that the information in question will subsequently become either disclosable or announceable.⁷²

The Code provides for the same sorts of safe harbours for misuse of information as it does for insider dealing.

5.3 EXAMPLES OF MISUSE OF INFORMATION

The Code gives three practical examples:

- A person, learning of a takeover offer from the director of the target, places a fixed odds bet that the target will be the subject of a bid within a short period. The fixed odds bet is not a dealing in qualifying or related investments and is therefore not caught by insider dealing market abuse, even though the information is undoubtedly within the definition of inside information.
- The manager of a proposed issue of convertible or exchangeable bonds, which are to be the subject of a public marketing, "ices" qualifying investments related to those bonds ("icing" refers to the practice of an informal understanding reached with the holder of investments that they will be reserved for a subsequent borrowing by the person reaching the understanding with the holder). The Code considers that where icing has the effect of withdrawing the investments from the lending market to lend subsequently to the issue manager then the icing may be market abuse if other market participants are disadvantaged. Icing is

⁶⁹ MAR 1.5.7E

⁷⁰ MAR 1.5.7E(1)

⁷¹ MAR 1.5.7E(2)

⁷² MAR 1.5.7E(7)

not dealing in an investment for the purposes of insider dealing market abuse.

- A company employee is aware of a contractual negotiation with a major customer who accounts for a substantial part of the company's turnover. The employee knows that the customer has threatened to take its business elsewhere and that the negotiations are not proceeding well. The employee sells his shares in the company, forming the opinion that it is reasonably likely that the customer will take its business elsewhere. Arguably this information is not "precise" enough to be inside information (although it is also arguable that it is).⁷³

⁷³ MAR 1.5.10E

6. Manipulating transactions (Directive provision)

This category of market abuse consists of effecting transactions or orders to trade which give a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more investments or which secure the price of one or more such investments at an abnormal or artificial level.

There is a safe harbour, however, for transactions or orders which are effected "for legitimate reasons and in conformity with accepted market practices on the relevant market".

6.1 FALSE OR MISLEADING IMPRESSIONS

The Code lists the following types of behaviour which are likely to involve the creation of false or misleading impressions:

- buying or selling investments just before a market closes with the effect of misleading investors who act on the basis of closing prices;
- a "wash trade", which is a sale or purchase involving no change in beneficial interest or market risk, or where the change is only between parties acting in concert or collusion;
- "painting the tape" – entering into a series of transactions which are publicly visible on a trading information system for the purpose of giving the impression of activity or price movement in an investment; and

- entering orders into an electronic trading system at prices higher or lower than existing prices but withdrawing the orders before they are executed, in order to give a misleading impression that there is demand at the prices entered.⁷⁴

The Code states that a stock lending/borrowing or repo transaction or other transaction in connection with the provision of collateral does not amount to a wash trade.⁷⁵

6.2 PRICE POSITIONING

The Code also lists types of behaviour which is likely to amount to market abuse consisting of securing the price of an investment at an abnormal or artificial level:

- transactions by a person or persons acting in collusion that secure a dominant position over the supply or demand for an investment and which have the effect of fixing prices directly or indirectly or creating other unfair trading conditions;
- buy and sell orders entered simultaneously or nearly simultaneously at the same price and quantity by the same person, or different colluding persons (but not, for example, crossing trades carried out in accordance with the rules of the relevant trading platform);

⁷⁴ MAR 1.6.2E

⁷⁵ MAR 1.6.3C

- entering small orders into an electronic trading system at prices higher or lower than prevailing prices in order to move the price of the investment concerned;
- an "abusive squeeze" – where a person has a significant influence over the supply of, or demand for, an investment or over the delivery mechanism for a product underlying a derivative contract, or has a position in an investment under which quantities of the investment or product concerned are deliverable and engages in behaviour with the purpose of positioning at a distorted level the price which others have to deliver, take delivery or defer delivery to satisfy obligations in respect of the investment concerned (the purpose must be an actuating purpose if not the sole purpose);
- persons who have been allocated investments in a primary offering colluding to force up the price to an artificial level by undertaking market purchases with a view to selling to third parties attracted by the apparent success of the offering;
- transactions or orders intended to support the price of an investment in order to avoid negative consequences for the issuer of the investment (for example a down grading of its credit rating); and
- trading on one market or trading platform with a view to improperly influencing the price of the same or related investment that is traded on another prescribed market.⁷⁶

⁷⁶ MAR 1.6 4E

6.3 LEGITIMATE REASONS

The Code gives the following cases where behaviour is unlikely to be for "legitimate reasons":

- where an actuating purpose behind the transaction is to induce others to trade in, or to position or move the price of, an investment;
- where, in addition to a legitimate reason, a person has another illegitimate reason for undertaking the transactions or order;
- where a transaction is executed with the purpose of creating a false or misleading impression.⁷⁷

Conversely, the Code states that the following descriptions of behaviour are likely to be for legitimate reasons:

- if the transaction is undertaken pursuant to a prior legal or regulatory obligation owed to a third party;
- if the transaction is executed in a way which takes into account the need for the market as a whole to operate fairly and efficiently;
- the extent to which a transaction opens a new position, so creating an exposure to market risk – as opposed to being one that closes out a position and so removes market risk; and
- if the transaction complies with the rules of the relevant market as to the execution of transactions in a proper way (for example, rules on reporting and executing cross-transactions).⁷⁸

⁷⁷ MAR 1.6.5E

⁷⁸ MAR 1.6.6E

Generally, the Code gives guidance that it is unlikely to be abusive for market users to trade at times and in quantities most beneficial to them (whether for long term investment objectives, risk management or short term speculation) and seeking the maximum profit from their dealings. This behaviour, far from being abusive, improves the liquidity and efficiency of markets.⁷⁹

Nor, states the Code, does it follow from the fact that prices are trading outside their normal range that someone has engaged in price positioning. Price volatility is often the result of the normal interplay of supply and demand.⁸⁰

6.4 FURTHER FACTORS – MANIPULATING TRANSACTIONS

The Code lists a number of market-related factors which may indicate the presence of manipulating behaviour:

- where the relevant transaction or order constitutes a significant proportion of the daily volume in the relevant investment on the market concerned, particularly if the behaviour leads to significant price changes;
- where orders or transactions given or made by a person with a significant buying or selling interest in an investment leads to significant changes in the price of the investment or a related derivative or underlying asset;
- where transactions lead to no change in beneficial ownership (i.e. the "wash trade");
- where a significant proportion of the daily volume of transactions in a particular investment is

represented by a person's buying and selling (or vice versa) within short periods, especially where associated with significant changes in the price of an investment;

- where orders or transactions are concentrated within a short time span within the trading session and lead to a price change which is subsequently reversed;
- where orders lead to changes in the bid or offer prices but are removed before they are executed; and
- where orders or transactions which move prices are undertaken at or around a specific time when reference or settlement prices or valuations are calculated.⁸¹

6.5 FURTHER FACTORS – ABNORMAL OR ARTIFICIAL PRICE LEVELS

The Code gives the following factors which may indicate the presence of behaviour which is abusive:

- the extent to which the person concerned had a direct or indirect interest in the price or value of the investment or related investment;
- the extent to which price, rate or option volatility movements are outside their normal intra-day, daily, weekly or monthly range; and
- whether a person has successfully and consistently increased or decreased his bid or offer or price for an investment.⁸²

⁷⁹ MAR 1.6.7C

⁸⁰ MAR 1.6.8G

⁸¹ MAR 1.6.9E

⁸² MAR 1.6.10E

6.6 FURTHER FACTORS – ABUSIVE SQUEEZES

The Code lists the following factors which are relevant in assessing whether a person has engaged in an abusive squeeze:

- the extent to which the person concerned is willing to relax his control or other influence to help maintain an orderly market and the price at which he is willing to do so (for example it is an indication that behaviour is not abusive if the person is willing to lend the investment in question);
- the extent to which there is, or is a risk of, widespread, “knock-on” settlement default;
- the extent to which prices under the delivery mechanisms of the market in question diverge from the prices for delivery of the investment outside those mechanisms (the greater divergence beyond that to be reasonably expected, the more likely there is to be an abusive squeeze); and
- the extent to which the spot or immediate market compared to the forward market is unusually expensive or inexpensive or the extent to which borrowing rates for the investment are unusually expensive or inexpensive.⁸³

The Code points out that squeezes frequently occur because of the interplay of supply and demand leading to tight markets. This is not of itself abusive. Further, for a person to have a significant influence over supply or demand, through ownership, borrowing or reserving the investment, is not of itself abusive.⁸⁴

The Code also refers to the case where market participants have through their own risk-taking or

failure to observe proper standards put themselves into the position where they are liable to be squeezed. This is especially the case where persons who have adopted the strategy of selling short investments cannot settle their obligation without reliance on holders of the investments concerned lending to them. The Code points out that lenders are under no obligation to lend, even if by declining to do so a squeeze on the holders of short positions results.⁸⁵

6.7 MANIPULATING TRANSACTIONS – EXAMPLES

The Code sets out some illustrations of manipulating transactions:

- A trader holds an option over a certain investment. The settlement value of the option is directly related to the price of the investment. The trader simultaneously buys and sells the investment (that is, trades with himself) at a price outside the normal trading range for the investment. His purpose is to position the price of the investment at a false level, making him a profit or avoiding a loss on the option.
- A trader holds a derivative the settlement value of which depends on the price of a certain commodities future. Just before close of trading he buys a large volume of those futures, with the purpose of positioning the price of the future at a false level in order to make a profit from the derivative’s position.
- A trader holds a short position that will be profitable if a particular investment, which is currently the component of an index, falls out of that index. Whether that is to be the case or not depends on the closing price of the investment. Just before the close of trading, the trader places

⁸³ MAR 1.6.11E

⁸⁴ MAR 1.6.12G

⁸⁵ MAR 1.6.13G

a large sell order in the investment. His purpose is to position the price at a false level so that the investment will drop out of the index.

- A fund manager's quarterly performance (and therefore his remuneration) is dependent on the valuation of his portfolio at the end of the quarter. Just before the close of trading for the quarter, he places a large order to buy liquid investments which are also components of his portfolio. His purpose is to position the price of the investment at a high level, thus boosting the valuation of the portfolio.⁸⁶
- A trader has a long position in bond futures. He buys or borrows bonds and refuses to re-lend these bonds or will only lend to parties he believes will not re-lend to the market. His purpose is to position the price at which those with short positions have to deliver to satisfy their obligations at a materially higher level, making him a profit on his original position.⁸⁷

⁸⁶ MAR 1.6.15E

⁸⁷ MAR 1.6.16E

7. Manipulating devices (Directive provision)

This category of market abuse consists of effecting transactions or orders which employ fictitious devices or any other form of deception or contrivance.

The Code lists the types of behaviour likely to constitute this form of market abuse:

- using the media to talk up or down an investment or issuer whilst having previously taken an undisclosed position in the investment and profiting subsequently from the market's reaction to the public opinion;
- transactions which are designed to conceal the ownership of an investment, so that disclosure requirements are avoided by holding the qualifying investment in the name of a colluding party, or such that actual disclosures made are misleading in respect of the true underlying ownership;

- "pump and dump" – buying a security, disseminating misleading positive information about it, and selling when the price subsequently rises;
- "trash and cash" – selling an investment short, disseminating misleading negative information to drive down the price and buying to cover the short at a lower price.⁸⁸

Accordingly, the general factors indicating the use of fictitious devices or other forms of deception are:

- the dissemination of false or misleading information by a person who subsequently gives orders to trade or undertakes transactions;
- similarly, where erroneous or biased research is put out by persons who subsequently trade in the investment in question, or by persons affiliated to them.⁸⁹

⁸⁸ MAR 1.7.2E

⁸⁹ MAR 1.7.3E

8. Dissemination of false or misleading information (Directive provision)

This category of market abuse consists of the dissemination of information by any means which gives or is likely to give a false or misleading impression as to a qualifying investment, by a person who knew or could reasonably be expected to have known that the information was false or misleading.

Section 118A(4) of the Act makes special provision for journalists – their conduct is to be assessed taking into account industry codes of practice, unless a journalist derives, directly or indirectly, any advantage or profit from the dissemination of the misleading information.

The Code lists the following types of behaviour as examples of abusive dissemination:

- knowingly or recklessly spreading false or misleading information about a qualifying investment through the media, including in particular through a Regulatory Information Service or similar information channel;
- undertaking a course of conduct in order to give a false or misleading impression about a qualifying investment.⁹⁰

The following factors are relevant, according to the Code:

- If a normal and reasonable person would know or should have known in all the circumstances that the information was false or misleading, that is an indication that the person disseminating the information knew or could reasonably be expected to know that it was false or misleading.⁹¹
- Conversely, if the individuals responsible for the dissemination of information within an organisation could only know that information was false or misleading if they had access to other information held behind a Chinese wall or similar effective barrier, that is an indication that the person did not know or could not reasonably be expected to have known that the information was false or misleading.⁹²

The Code provides the following practical illustrations of dissemination abuse:

- using an Internet bulletin board or chat room to post false or misleading statements about a takeover of a company;
- a person responsible for the content of information submitted to a Regulatory Information Service recklessly submits information which is false or misleading.⁹³

⁹⁰ MAR 1.8.3E

⁹¹ MAR 1.8.4E

⁹² MAR 1.8.5E

⁹³ MAR 1.8.6E

9. Misleading behaviour and distortion (retained provision)

As noted in section 5, the relevance of the retained provision categories of market abuse is likely to be greatest in cases where the alleged abusive behaviour does not involve dealings or transactions in investments, but nevertheless constitutes behaviour affecting investments.

This category of market abuse is subject to the "regular user" test.

Behaviour is caught by this provision only if it is not caught by the Directive provisions relating to manipulating transactions, manipulating devices or dissemination of false or misleading information. The Code indicates that it is of most relevance to the commodity markets and gives two practical examples of abusive behaviour:

- the movement of physical commodity stocks, which might create a misleading impression as to the supply of, or demand for, or price or value of, a commodity subject to a commodity futures contract; and
- the movement of an empty cargo ship, which might create a similar false or misleading impression.⁹⁴

The Code sets out various factors to be taken into account in assessing whether behaviour is likely to give a regular user a false or misleading impression as to the supply of or the demand for or as to the price or value of qualifying or related investments, including the experience and knowledge of market users, the structure of the market and its legal and regulatory requirements,

the identity and position of the person engaging in the behaviour and the extent and nature of its visibility.⁹⁵

The Code lists the following factors which indicate whether or not there has been a failure to meet the standards expected by a regular user:

- whether the transaction is pursuant to a prior legal or regulatory obligation owed to a third party;
- whether the transaction is executed in a way which takes into account the need for the market as a whole to operate fairly and efficiently;
- the characteristics of the market in question, including its users and applicable rules and codes of conduct;
- the standards reasonably to be expected of the person in the light of experience, skill, knowledge and position in relation to the market;
- whether the transaction complied with the rules of the relevant market as to how transactions are to be executed in a proper way;
- whether, in the case of individuals employed within an organisation, they could only know that they created a false or misleading impression if they had had access to information held behind a Chinese wall or similar arrangement.⁹⁶

⁹⁴ MAR 1.9.2E

⁹⁵ MAR 1.9.4E

⁹⁶ MAR 1.9.5E

10. Other exceptions

There are certain general exceptions to the market abuse regime.

10.1 STABILISATION AND BUY-BACK PROGRAMMES

The Stabilisation and Buy-back Regulation (2273/2003/EC) has direct effect throughout the EU. Section 118A(5)(b) provides that behaviour which conforms with the Regulation does not amount to market abuse.

It should be noted, however, that the exception provided for by the Regulation only covers behaviour directly related to the purpose of stabilisation activities. Behaviour which is not so related is not automatically regarded as being abusive but does not have the benefit of the safe harbour.

See section 15 for more detail on stabilisation and buy-back programmes.

10.2 FSA RULES

The Code states that there are no FSA rules which will permit or require a person to behave in a way which amounts to market abuse, although certain FSA rules confirm that behaviour in accordance with the rule does not amount to market abuse, for example:

1. SYSC 10.2.3G provides that the use of a Chinese wall in conformity with the FSA rule on such measures does not amount to market abuse.

Without such a provision, a firm using a Chinese wall could be vulnerable to an allegation of market abuse where information held on one side of the wall would have been relevant to the assessment of behaviour engaged in by persons on the other side of the wall had it been known to them (for example, traders dealing in investments in ignorance of the fact that price sensitive information in relation to those investments is held behind the wall).

2. the rules made under Part VI FSMA (in particular the DTRs) relating to the timing, dissemination or availability, content and standard of care applicable to a disclosure, announcement, communication or release of information.⁹⁷

10.3 TAKEOVER CODE

The Code provides that there are no rules in the Takeover Code which permit or require a person to behave in a way which amounts to market abuse.⁹⁸

A safe harbour is granted by the Code for certain Takeover Code rules about the timing, dissemination or availability, content and standard of care applicable to a disclosure, announcement, communication or release of information if:

- the rule is specified in a table set out in the Code;

⁹⁷ MAR 1.10.2G

⁹⁸ MAR 1.10.3G

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- the behaviour is expressly required or expressly permitted by the rule in question; and
- the behaviour conforms to any General Principle set out in the Takeover Code relevant to the rule in question.⁹⁹

The Code also provides a safe harbour for behaviour conforming with rule 4.2 of the Takeover Code (restrictions on dealings by offerors and concert parties), provided that:

- the behaviour is expressly required or expressly permitted by that rule; and
- it conforms to any General Principle set out in the Takeover Code relevant to the rule.¹⁰⁰

⁹⁹ MAR 1.10.4C

¹⁰⁰ MAR 1.10.6C

11. Accepted market practices

The concept of “accepted market practices” is relevant to the definition of inside information in relation to commodities (being information which would be expected to be disclosed in accordance with accepted market practices on the commodity market concerned) and because it provides a defence for market abuse (manipulating transactions) where a person’s behaviour is for legitimate reasons and in conformity with accepted market practices.

The Code lists the following factors which the FSA will take into account in determining whether to accept a particular market practice:

- the level of transparency of the practice to the market;
- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand;
- the impact on market liquidity and efficiency;
- whether the practice enables market participants to react properly and in a timely manner to the new market situation created by the practice;
- the risk posed to the integrity of related markets in the relevant financial instrument within the EEA;

- the outcome of any investigation by the appropriate authority of the relevant practice, in particular whether it constituted market abuse or breached codes of conduct whether on the market in question or directly or indirectly on related markets within the EEA; and
- the characteristics of the relevant market, including whether it is regulated or not, the types of financial instruments traded and the extent of retail investor participation.¹⁰¹

There are currently no market practices that are specified as accepted by the FSA. Previously, the FSA has specified as an accepted market practice the London Metal Exchange (“LME”) metal market aberrations regime (known as the “Lending Guidance”). At the time the Lending Guidance was only guidance from the LME, but it has since been elevated to the status of LME Rules. This eliminated the need for it to be specified as an accepted market practice since any behaviour in accordance with this practice could potentially be for “legitimate reasons” (i.e. in compliance with rules) under MAR 1.6.6E.

¹⁰¹ MAR 1 Ann 2G2

12. Reporting suspicious transactions

Article 6.9 of the Directive requires that member states "shall require that any person professionally arranging transactions in financial instruments and who reasonably suspects that a transaction might constitute insider dealing or market manipulation shall notify the competent authority without delay".

In the UK, this requirement has been implemented by the FSA in its rules (Supervision manual (SUP) 15.10).

The operative rule is SUP15.10.2R:

"A firm which arranges or executes a transaction with or for a client in a qualifying investment admitted to trading on a prescribed market and which has reasonable grounds to suspect that the transaction might constitute market abuse must notify the FSA without delay."

It is relevant to note that this obligation applies only when a firm arranges or executes a transaction *with or for a client* and so does not apply if, for example, a firm becomes concerned about the behaviour of another firm with which it is trading on a proprietary basis or which is otherwise unrelated to client-serving transactions.

SUP15 Ann 5G sets out indications of possible suspicious transactions which firms should take into account in considering whether a transaction is suspicious. They are neither conclusive nor comprehensive.

12.1 POSSIBLE SIGNALS OF INSIDER DEALING

SUP15 Ann 5G lists the following as indications of possible insider dealing suspicious transactions:

- a client opening a new account and immediately giving an order to conduct a significant transaction – especially if the client is insistent that the order is carried out very urgently or by a particular time;
- a transaction significantly out of line with the client's previous investment behaviour;
- a client specifically requests immediate execution of an order regardless of the price at which the order would be executed;
- unusual trading in the shares of a company before the announcement of price sensitive information;
- an employee's own account transaction undertaken just before clients' transactions in the same financial instrument.¹⁰²

¹⁰² SUP 15 Ann 5G 2-6

12.2 POSSIBLE SIGNALS OF MARKET MANIPULATION

SUP15 Ann 5G lists as indications of possible market manipulation suspicious transactions:

- an order which, by virtue of its size in relation to the market in the security concerned, will clearly have a significant impact on supply, demand or price – especially such an order placed to be executed near a reference point during the trading day – for example close of trading;
- a transaction which appears to be seeking to modify the valuation of a position whilst not decreasing/increasing its size; and
- a transaction appearing to be seeking to bypass the trading safeguards of the market (for example, as regards volume limits or bid/offer spread parameters).¹⁰³

¹⁰³ SUP 15 Ann 5G.7-9

13. Short selling

13.1 WHAT IS SHORT SELLING?

Short selling is the practice of selling securities, typically shares, without owning them. The seller typically borrows shares from an institutional investor, such as a pension fund or a prime broker, and sells them, with the understanding that an equal number of the same shares must be returned to the lender at the end of the loan. If the price of the stock has fallen by the time the shares are due to be returned to the lender, the borrower/seller can buy the shares in the market to settle the loan, and therefore make a profit with the difference between his original sale price and the current market price of the shares. If, however, the price rises, his short position is "squeezed" and he makes a loss. Short selling positions are taken either as a speculative strategy to make a profit or to hedge a long position.

13.2 BACKGROUND TO MEASURES ADOPTED IN THE FINANCIAL CRISIS

The practice of short selling received unprecedented critical attention following the onset of the financial crisis. In September 2008, due to market volatility and the persistent downward pressure on the prices of financial stocks, the FSA had concerns that short selling carried heightened risks of market abuse and might impact adversely on the orderly functioning of financial markets. Of particular concern was the potential impact of the short selling of stocks in vulnerable financial institutions, mostly banks, which at that time, the FSA feared, could further undermine market confidence in the share prices and stability of the financial services sector.

13.3 EMERGENCY MEASURES

The FSA's first move was, without consultation, to change the Code in June 2008 to require the disclosure of significant short positions in companies undertaking rights issues.¹⁰⁴ Failure to disclose was regarded as "misleading behaviour" which would constitute market abuse.

Then on 18 September 2008, again without prior consultation, the FSA introduced further temporary measures which:

- prohibited the practice of short selling in financial instruments in certain publicly quoted financial institutions; and
- introduced a disclosure obligation for pre-existing net short positions in those companies.

The FSA said that it hoped to calm the financial markets and guard against further market instability. While the temporary restriction on short selling was lifted in January 2009, the short selling disclosure obligations have been modified and extended by the FSA without time limit (see 13.4).

It is important to note that the expiry of the restriction on short selling does not mean that the risk of allegations of short selling-related market abuse has completely disappeared. The FSA is likely to analyse short selling disclosures carefully for signs that they

¹⁰⁴ MAR 1.9.2AE

betray abusive intentions or have abusive effects. The FSA has also reserved the right to reinstate the short selling prohibition should it consider a further ban to be warranted.

13.4 THE DISCLOSURE OBLIGATION

The short selling disclosure obligation is intended to enhance the transparency of the markets and minimise the potential for disorderly markets and market abuse in UK financial sector stocks. The provisions impose ongoing obligations to disclose net short positions in UK financial sector companies that are at, or above, a certain threshold.

A person must now adhere to the following short selling disclosure requirements:

- disclose any new net short position of 0.25% in a UK financial sector company;
- once a disclosure has been made, make additional disclosures if the short position reaches, exceeds or falls below disclosure bands placed every 0.1% above the initial 0.25% threshold (i.e. at 0.35%, 0.45%, 0.55% etc.). Disclosures will also have to be made if a net short position decreases from 0.25%. Disclosure is required to be made by RIS public announcement by 3.30 pm on the business day following the day on which the threshold is reached, exceeded or fallen below. The disclosable position (if any) is that which existed at the end of the relevant business day;
- disclose any net short positions reaching or exceeding 0.25% of undiluted share capital which relates to securities that are the subject of a rights issue. Securities are those which are: (1) admitted to trading on a prescribed market in the UK; or (2) issued by a UK company or a non-UK company

for whom the UK prescribed market is the sole or main venue for trading the securities. Disclosure in the circumstances of a rights issue is required in the same manner as for net short positions in UK financial sector stocks, although the thresholds above 0.25% do not apply. It is important to note that economic interests in share capital that will be issued in the future must be excluded from the calculation. It is therefore not permissible to set off a short position in a company's pre-existing share capital against a long position in nil-paid rights.¹⁰⁵ Similarly, a prospective long position in new rights issue shares arising from an underwriting/sub-underwriting commitment may not be set off against a short position.

13.5 FINANCIAL SERVICES ACT 2010 AND REFORM

There was an inherent legal flaw in the FSA's disclosure regime for short selling, as "misleading behaviour" under section 118(8) FSMA is a type of market abuse under FSMA which requires the hypothetical regular user of the market (see 2.5) to conclude that the non-disclosure of the short position has fallen below acceptable standards. By its own admission, the FSA is not in a position to determine what the "regular user" definitely would or would not think. This could have given rise to problems for the FSA in enforcing the disclosure regime where supposed breaches have occurred. In practice, the FSA may have been hard pressed to establish that a regular user would regard short selling to be market abusive behaviour, at least if the widely-held views of the trading community were indicative of that hypothetical regular user.

For these reasons it was desirable that the FSA's powers in relation to short selling became independent of its powers in relation to market abuse. This was addressed in the Financial Services Act 2010

¹⁰⁵ FINMAR 2.3 7R

which received Royal Assent on 8 April 2010 and which contained a new statutory power for the FSA to make "short selling rules". Reflecting the approach taken with the previous rules made under the market abuse regime, the new powers enable the FSA to prohibit short selling in specified circumstances and to require disclosures about short selling positions.

The FSA subsequently introduced a standalone short selling regime, located in a new Financial Stability and Market Confidence Sourcebook ("FINMAR"), and a new power to impose financial penalties for breaches of the short selling regime. The short selling provisions of FINMAR (described at 13.4 above) were adopted from 6 August 2010 and are in substance the same as the previous rules made under the market abuse regime except that it is now restricted to UK companies and companies for whom a UK prescribed market is the main or sole trading venue for their securities.

The FSA continues to expect its rules to be superseded by the implementation of the pan-European short selling regime (mentioned below), at which stage it will consult further.

13.6 THE EU PERSPECTIVE

In March 2010, the Committee of European Securities Regulators ("CESR") recommended to the European Commission that a pan-European short selling disclosure regime be introduced. Following an earlier consultation, in September 2010 the European Commission published its proposals for such a regime in the form of a draft European Regulation (which will apply directly to Member States without further national enactments).

The intention of the proposed Regulation is to harmonise short selling requirements across the European Union; harmonise the emergency powers of national authorities where there is a serious threat

to financial stability or market confidence; and to ensure greater coordination and consistency between Member States in such emergency situations.

The proposal covers all financial instruments but provides for a proportionate response to the risks that the short selling of different instruments may represent. For instruments such as shares and derivatives relating to shares, sovereign bonds and derivatives relating to sovereign bonds, and CDS relating to sovereign issuers – where concerns are perceived to be higher – transparency requirements and requirements relating to uncovered short selling are applied. Exceptionally (e.g. where there is a serious threat to financial stability or market confidence), measures may be extended on a temporary basis to other financial instruments.

Key features of the proposals are:

- persons entering into uncovered or naked short sales must, at the time of the sale, have borrowed the instruments, entered into an agreement to borrow the instruments or made other arrangements which ensure that the instruments can be borrowed so that settlement can be effected when it is due. This requirement permits legitimate arrangements which are currently used to enter into covered short selling and which ensure that securities will be available for settlement;
- trading venues must ensure that there are arrangements in place for buy-in of shares or sovereign debt where there is a settlement failure, as well as for fines and a prohibition on short selling for late settlement;
- transparency for short positions based on the recommendations of CESR. Short positions in an EU company must be disclosed to the regulator once over 0.2% of the target's share capital and to the market once over 0.5% (where they will

be “marked” as short), with further disclosure at 0.1% intervals. In relation to EU sovereign bonds, only “significant” short positions or CDS in EU sovereign bonds would need to be disclosed to the regulator. The transparency requirements apply not only to short positions created by the trading of shares or sovereign debt on trading venues but also to short positions created by trading outside trading venues (OTC trading) and economic net short positions created by the use of derivatives such as options, futures, contracts for difference and spread bets relating to shares or sovereign debt. There is provision for further technical details to be adopted by the European Commission in delegated acts;

- all short orders should be marked as such to give regulators an idea of volumes, and trading venues should publish a daily summary of the volume of short orders;
- exemptions have been included, broadly, for: (i) shares in a company where the principal market for the shares is outside the European Union; (ii) market making activities (though not for proprietary trading); and (iii) primary market operations performed by dealers in order to assist issuers of sovereign debt or for the purposes of stabilisation schemes under the Market Abuse Directive;
- in the case of adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or in the European Union, competent authorities will have temporary powers (usually up to three months with additional three month extensions possible) to require further transparency, to impose restrictions on short selling and credit default swap transactions or to limit persons from entering into derivative transactions. These powers extend to a wide range of instruments. The European

Securities and Markets Authority (“ESMA”) is required to write an opinion on these proposed measures, and will consider, in particular, whether they are necessary and proportionate;

- a “circuit breaker” power for national authorities to impose a very short restriction on short selling or other transactions where there is a significant fall in the price of a financial instrument (10% for shares; the figure for other instruments is yet to be determined by the Commission);
- ESMA will coordinate cross-border measures where necessary, including taking action itself where a threat to stability has cross-border implications and national authorities have not taken sufficient action to address the threat. Any measure taken by ESMA in such situations would override measures by competent authorities if there is any inconsistency; and
- enforcement powers will be given to competent authorities and ESMA will be given the power to conduct inquiries into specific issues or practices relating to short selling.

The proposal will now pass to the European Parliament and the European Council for consideration. It is intended that, once adopted, the Regulation will apply from 1 July 2012. In the meantime, CESR maintains a document which lists measures adopted by CESR members on short selling, prior to a Regulation coming into force. This document is updated regularly and is available on CESR’s website.

It should be noted that the European Securities Markets Expert Group (“ESME”) has reported that supervisory authorities from at least 25 major equity markets reacted to the stock market crash in mid-September 2008 by implementing short selling rules such as those seen in the UK, but noted that the effectiveness of the short selling restrictions had not

been borne out by the evidence¹⁰⁶. ESME published studies which showed that during the period of the restrictions, volatility increased and spreads widened when contrasted with unrestricted stocks.

Nevertheless, as a result of recent turbulence in the financial markets, and the sovereign debt markets in particular, there has been increased political pressure on the European Commission to introduce a short selling regime as soon as possible.¹⁰⁷

¹⁰⁶ Paper: ESME on Short Selling, 19 March 2009

¹⁰⁷ For example, a letter dated 8 June 2010 from President Sarkozy and Chancellor Merkel to the Commission calling for a ban on naked short selling

14. Fining procedure and appeals

14.1 FINES AND PUBLIC STATEMENTS

Under the Act the FSA may impose an unlimited fine on any person (including an individual or a company not authorised under the Act) that is engaging or has engaged in market abuse, or has required or encouraged another person to do so.¹⁰⁸ Further, where the FSA applies to the court under the Act for an injunction or a restitution order where market abuse has occurred it may additionally request the court to consider whether a penalty should be imposed on the person to whom the application relates.¹⁰⁹ This enables the FSA to apply to the court to impose a fine at the same time as seeking other remedies for market abuse.

As an alternative to imposing a fine, the FSA may publish a statement to the effect that a person has engaged in market abuse.¹¹⁰ The rationale behind this is that in some cases the publication of a finding that a person has committed market abuse will in itself be sufficient deterrence and punishment.

14.2 DUE DILIGENCE DEFENCE

Under the Act, the FSA may not impose a penalty on a person if, having considered any representations made by him in response to a warning notice, there are reasonable grounds for the FSA to be satisfied that:

- (1) he believed, on reasonable grounds, that his behaviour did not amount to market abuse; or
- (2) he took all reasonable precautions and exercised all due diligence to avoid engaging in market abuse.¹¹¹

This provides a defence to the imposition of a fine (but not to an informal warning or to disciplinary proceedings). The defence only applies where the FSA has commenced an investigation for market abuse and has issued a warning notice (see below) setting out its intention to impose a fine. The person must then make representations to the FSA stating why, although he may have committed market abuse, no fine should be imposed on him. Following such representations, the FSA must then be satisfied that the person believed on reasonable grounds that his behaviour did not amount to market abuse or that he took all reasonable precautions and exercised all due diligence to avoid committing market abuse.

There are three points on this defence. First, the grounds on which the person believed that he was not engaging in market abuse must be objectively reasonable¹¹². In this context, compliance with the Code, and reliance on legal advice, should assist in discharging the burden of proof, although neither will be conclusive. Secondly, the person must show that he took *all* reasonable precautions, and exercised *all* due

¹⁰⁸ Section 123(1) FSMA

¹⁰⁹ Section 129 FSMA

¹¹⁰ Section 123(3) FSMA

¹¹¹ Section 123(2) FSMA

¹¹² Confirmed by the Upper Tribunal in *David Massey v The Financial Services Authority* (FIN 2009/0024). It is not enough to show only that a belief is understandable or not irrational.

diligence. This sets a high standard and any lack of care on his part may exclude the defence. Thirdly, for the alternative there must be sufficient evidence that the person did in fact believe that he was not committing market abuse and had exercised the requisite level of diligence.

If the defence is established then the FSA is precluded from publishing a statement that the person has engaged in market abuse.¹¹³

14.3 STATEMENTS OF FINING POLICY

Under the Act, the FSA is required to prepare and issue a statement of its policy with respect to the imposition and level of fines.¹¹⁴ In determining its policy, the FSA is required to have regard to:

- (1) whether the behaviour had an adverse effect on the market in question and, if it did, how serious that effect was;
- (2) the extent to which that behaviour was deliberate or reckless; and
- (3) whether the person on whom the penalty is to be imposed is an individual.

The FSA may at any time alter or replace a statement of fining policy.¹¹⁵ The Act sets out the procedure for consultation on statements of fining policy. Broadly, the FSA is required to publish a draft statement and invite representations. Following the consultation exercise, it must then publish a summary of the

representations made and its response to the consultation.¹¹⁶

In exercising its power to fine, the FSA is required to "have regard" to any published statement in force at the time that the behaviour took place.¹¹⁷ It follows that the FSA must take such statements into account in determining the appropriate level of the penalty. However, it will be able to depart from its policy where it considers it appropriate to do so. In doing so the FSA will be required to comply with public law standards of fairness which may place limits on the ability of the FSA to depart from previously published policy with retrospective effect.

The statement of fining policy is currently set out in Chapter 6 of the FSA's Decision Procedure and Penalties Manual (DEPP).

14.4 FINING PROCEDURE

Where the FSA intends to impose a fine, or make a public statement that a person has committed market abuse, it must first serve a warning notice on the person stating the amount of the penalty.¹¹⁸ If the FSA does not consider that a fine or a public statement is necessary it may instead issue a private warning to the person. Following the issuing of a warning notice the person may make representations that he has not engaged in market abuse, or that no penalty should be imposed on him. If, having considered the representations, the FSA decides to impose a fine it must then issue a decision notice setting out the amount of the fine,¹¹⁹ which may differ from that in the warning notice.

¹¹³ The ability to publish a statement under section 123(3) is conditional on the FSA being entitled to impose a penalty. If the defence is established, there is no power to impose a penalty.

¹¹⁴ Section 124(1) FSMA

¹¹⁵ Section 124(4) FSMA

¹¹⁶ Section 125 FSMA

¹¹⁷ Section 124(6) FSMA

¹¹⁸ Section 126(1) FSMA

¹¹⁹ Section 127(1) and (2) FSMA

The person may then refer the case to the Tribunal which will consider whether market abuse has occurred as well as the imposition and, if relevant, the level of any fine. There is a further right of appeal (with leave) to the Court of Appeal on a point of law. However, given the nature of the definition of market abuse, and the regular user test, it remains unclear whether a finding that particular conduct amounts to market abuse will be held to be a question of law or of fact. If it is treated as a factual matter (which seems more likely) then the scope of any right of appeal will be considerably narrowed.

The effect of a referral to the Tribunal is to suspend payment of the fine.¹²⁰

14.5 STIFFER FINANCIAL PENALTIES FOR INDIVIDUALS

The FSA has recently demonstrated greater willingness to impose significant financial penalties in cases of market abuse by individuals.¹²¹ Demonstrating the FSA's commitment to its policy of credible deterrence, in March 2010 new FSA rules on enforcement penalties came into effect.¹²² For market abuse cases

¹²⁰ Section 133(9). The Government explained "it is not our intention that the FSA should be able to demand payment of penalties or restitution, or make public statements, during the period when the person concerned has a right to refer the matter to the tribunal. The FSA cannot give effect to a decision contained in a decision notice pending a reference to the tribunal, or appeal from the tribunal to the higher courts, or while a decision remains open to such a reference being made. Once the review process is complete, action will be given effect to by a final notice" House of Lords Debates, Session 1999-2000, 18th April 2000 col. 691.

¹²¹ For example, in May 2010, the FSA fined Simon Eagle £2.8m and made a prohibition order against him for deliberate market abuse. He was the instigator of a prolonged and complex share-ramping scheme that resulted in the market maker Winterflood Securities Limited, and two of its traders, being fined £4m, £200,000 and £50,000 respectively in April 2010, following a decision of the Court of Appeal. The fine imposed on Simon Eagle consisted of a disgorgement of £1.3m profit and a penalty of £1.5m, and is the FSA's largest fine to date for an individual.

¹²² DEPP 6

against individuals, the minimum fine will be the greater of:

- 40% of the individual's total gross employment benefits (if the breach is referable to the individual's employment), in the 12 months preceding the market abuse;
- twice the profit made or loss avoided as a direct result of the market abuse; and
- £100,000.

Therefore, the starting point for a fine for an individual who has committed market abuse will now be £100,000, and serves to underpin Hector Sants' oft-repeated assertion that people should 'fear' the FSA as it pursues its enforcement objectives.

14.6 FINING FIRMS

The FSA may also fine firms under the civil market abuse regime, and has done so especially where firms are perceived not to have exercised appropriate checks against the trading activities of their employees. The FSA recently fined a leading market-making firm £4 million, after the company failed to take adequate steps to ensure unusual share trades which evidenced a clear risk of market manipulation were genuine.¹²³ While the employees involved were also heavily fined, it is worth noting the importance of the case in emphasising the need for firms to apply adequate systems and controls to avoid a market abuse action from the FSA. The FSA has stated that it will pursue individuals, rather than the firm, where the firm can show it has good systems and controls and has been complying with them appropriately.¹²⁴ The firm in the

¹²³ *Winterflood Securities Limited, Sotiriou & Robins v Financial Services Authority*, FSMT Decision 66, March 2009

¹²⁴ The FSA's Market Abuse Strategy: Prevention & Cure – Speech by Margaret Cole, Director of Enforcement, FSA – 29 June 2007

above mentioned case was also penalised despite the FSA's finding that the misconduct in question was not deliberate, as the market abuse regime under the Act does not include a requirement for intent.¹²⁵

It should be noted, as part of firms' compliance with the FSA's expectation of adequate systems and controls, that SUP 15.10.2R and Article 6(9) of the Market Abuse Directive also require firms to report suspicious transactions connected to client activity to the FSA without delay (see section 12 above) in order to avoid enforcement action.

14.7 CRIMINAL SANCTIONS – A SHIFT IN EMPHASIS

In recent years, there has also been a significant shift in the emphasis of the FSA's enforcement policies for market abuse and insider dealing. As part of the FSA's strategy to deliver on its long-term objectives for credible deterrence, the enforcement division has increasingly looked to bring criminal enforcement action against those who are alleged to have been involved in insider dealing and market abuse,¹²⁶ believing that the threat of a custodial sentence is a greater deterrent than civil sanctions through fines or public censure. The FSA has been expanding its enforcement team to meet these broader objectives. In March 2009 the FSA successfully prosecuted individuals for insider dealing, the first successful prosecution of its kind by the FSA and one of a "steady stream" of cases which has been pursued by the regulator since then.

The FSA has also gained additional powers to help it secure results in its criminal investigations of insider dealing. These include:

- Amendment of the Serious Organised Crime and Police Act 2005 to include the FSA, from 6 April 2010, in the list of special prosecutors capable of granting witnesses immunity from prosecution. This gives the FSA power (with the consent of the Attorney General) to grant immunity to witnesses who fully assist the FSA in their investigations but would otherwise be exposed to the risk of prosecution.¹²⁷
- A "leniency provision", to provide suspects with a greater incentive to cooperate with FSA enquiries, which was introduced to the FSA Enforcement Guide at the end of 2008. Where misconduct is carried out by two or more individuals acting together, and one of the individuals provides information and gives full assistance in the FSA's prosecution against the other(s), the leniency provision allows the FSA to take this cooperation into account when deciding whether to proceed against the individual who has assisted.¹²⁸ However, depending on the facts of the case, a suspect could still receive a public censure or have a financial penalty imposed against him in spite of his cooperation with the FSA.

¹²⁵ Subsequently confirmed by the Court of Appeal in *Winterlood Securities Ltd & Ors v FSA* [2010] EWCA Civ 423, 22 April 2010

¹²⁶ Infringement of the Criminal Justice Act 1993 or the criminal offence of misleading statements and market manipulation (s 397) in FSMA 2000 are both criminal breaches that could lead to prosecution by the FSA.

¹²⁷ Section 71 Serious Organised Crime and Police Act 2005

¹²⁸ FSA Enforcement Guide 12 B (12A)

15. Buy-back and stabilisation regulation

15.1 SHARE BUY-BACK PROGRAMMES

The Market Abuse Directive (Article 8), as implemented in section 118A(5)(b) of the Act, provides a safe harbour from the market abuse provisions for conduct in conformity with the Buy-back and Stabilisation Regulation (the "Regulation").¹²⁹

The share buy-back safe harbour does not cover all share purchases made by an issuer with shares admitted to trading on a regulated market, but only those with one of the following objectives (Article 3):

- a reduction in capital;
- a purchase of shares to meet obligations under convertible or exchangeable debt instruments; or
- a purchase of shares to meet obligations under an employee share option programme or other granting of shares to employees of the issuer or of an associate company.

Any other purpose means that the purchase of shares by or on behalf of an issuer falls to be assessed under the general market abuse regime. An example might be purchases made by or on behalf of an investment trust to reduce the discount of the share price to net asset value.

It is a pre-condition of the safe harbour that applicable company law is complied with and that

there is adequate public disclosure of the intention to implement the programme in all Member States in which the issuer has requested admission of its shares to trading on a regulated market.

The issuer must also have in place mechanisms to report all transactions to the competent authority of the regulated market concerned; and within seven trading days of any transaction there must be public disclosure (disclosure through a Regulatory Information Service is acceptable to the FSA).¹³⁰

The following conditions apply to purchases conducted within the safe harbour:

- any purchase price must not exceed the higher of the last independent trade and the highest current independent bid on the relevant trading venue(s). In the case of a venue which is not a regulated market, reference prices/bids shall be taken from a regulated market in the Member State concerned. Where an issuer executes a trade by means of a derivative instrument (such as an option) the foregoing condition is applied to the exercise price of the derivative;
- the issuer must not purchase more than 25% of the average daily volume of the shares in any one day on the regulated market concerned, such average daily volume calculated by reference to formulas specified in the Regulation. Where there is extreme low liquidity on the relevant market,

¹²⁹ Commission Regulation 2273/2003/EC

¹³⁰ Article 4

the issuer may exceed the 25% limit provided that the relevant competent authority is informed, adequate public disclosure is made and the issuer does not exceed 50% of the average daily volume.¹³¹

"Extreme low liquidity" is not defined. Issuers are advised to contact the FSA for guidance.¹³²

The safe harbour is subject to important restrictions:

- an issuer may not sell its own shares during the life of the programme;
- no purchases may take place during a closed period; and
- no purchases may take place when an issuer has decided to delay the public disclosure of inside information in circumstances permitted by the DTRs.¹³³

These restrictions are in turn subject to important exceptions for investment firms and credit institutions:

- the prohibition on selling shares does not apply if there is a Chinese wall between those handling inside information relating to the issuer and those responsible for trading decisions; and
- the prohibition on trading in closed periods or where there is a delay in disclosure of inside information does not apply to trading on behalf of clients if there is a Chinese wall between those handling inside information (including trading decisions under the programme) and those who trade issuer shares on behalf of clients.¹³⁴

¹³¹ Article 5

¹³² MAR 1 Ann 1.1 IIG

¹³³ Article 6.1

¹³⁴ Article 6.2

In the case of any issuer, the restrictions do not apply:

- where the dates and quantities of securities to be traded during the period of the programme are set out at the time the programme is publicly disclosed; or
- in the case where all trading decisions have been delegated to an investment firm or credit institution which acts independently and not subject to influence by the issuer with regard to the timing of purchases.¹³⁵

15.2 STABILISATION – INTRODUCTION

The Regulation brought about significant changes to the stabilisation regime in the UK.

Before 1 July 2005, the FSA's price stabilising rules provided a safe harbour from the criminal insider dealing provisions of the Criminal Justice Act 1993, the criminal provisions of section 397 of FSMA (misleading statements and practices) and the market abuse regime in Part VIII of FSMA.

The Regulation has direct effect throughout the EU and supplants the FSA's previous rules in the area which it covers.

As a result of the Market Abuse Directive and the Regulation, the only stabilisation safe harbour for the new market abuse provisions derived from the Directive is provided by the Regulation. The Directive covers market abuse on "regulated markets"; correspondingly, the Regulation provides a stabilisation safe harbour in respect only of regulated markets.

Although the Directive applies to regulated markets only, the UK has chosen to implement the Directive

¹³⁵ Article 6.3

so that the provisions derived from it apply to a wider category of "prescribed markets", which includes all UK markets whether regulated or not.

Although the Regulation limits the powers of the FSA in respect of stabilisation activities on regulated markets, the FSA continues to make its own stabilisation rules which apply to non-regulated markets. This is an important issue, as both AIM and the PSM of the LSE are non-regulated markets.

15.3 STABILISATION – MAIN FEATURES OF THE REGULATION

The Regulation, which has been adopted wholesale as FSA rules (this has the effect of extending the regulated markets safe harbour to the criminal law provisions mentioned above), sets out a relatively streamlined set of provisions for securities admitted to, or the subject of an application for admission to, trading on a regulated market. It covers:

- The definition of stabilisation. It means any purchase or offer to purchase "relevant securities" (the securities the subject of the offer) or any transaction in associated instruments equivalent to the relevant securities, by investment firms or credit institutions, which is undertaken in the context of a significant distribution (see below) exclusively for supporting the market price of those relevant securities for a pre-determined period of time, due to a selling pressure in the market for the securities.¹³⁶
- The associated instruments which may be dealt in. These include contracts or rights to subscribe for, acquire or dispose of the relevant securities; financial derivatives on the relevant securities; the securities into which convertible or exchangeable

relevant securities may be converted or exchanged; instruments which are issued or guaranteed by the Issuer or Guarantor of the relevant securities and whose market price is likely to influence materially the price of the relevant securities, or vice versa. Associated instruments need not be admitted to trading on a regulated market.¹³⁷

- Price limits. For equity offers, the stabilisation of the relevant securities may not be executed above the offering price. Stabilisation of equity into which relevant debt securities are convertible or exchangeable may not exceed the market price for the equity at the time of the public disclosure of the final terms of the offer. It follows from this that transactions in associated instruments, although not the subject of any specific price rules, may not have the effect of raising the price of relevant securities above the offer price.¹³⁸
- The commencement and termination of the stabilisation period for various kinds of instruments. For new issues of equity the period is 30 days after public disclosure of the price. For secondary offers the period begins at the same time and ends 30 days after the date of allotment.¹³⁹
- "Adequate public disclosure" of stabilisation. This concept is not defined, but the FSA's guidance says that disclosure in accordance with the DTRs or in accordance with market rules would be adequate. In practice, a prospectus stabilisation legend is likely to continue to feature as part of adequate disclosure.¹⁴⁰

¹³⁶ Article 2

¹³⁷ Article 2
¹³⁸ Article 10
¹³⁹ Article 8
¹⁴⁰ Article 9

- Subsequent public/FSA disclosure of the fact and extent of stabilisation action having taken place.¹⁴¹
- Notification to the FSA of stabilising transactions.¹⁴²
- The record which must be kept of stabilising orders and transactions.¹⁴³
- Over-allotments – which may not exceed the cover provided by the “greenshoe option” by more than 5% of the original offer.¹⁴⁴
- The greenshoe option – which may only be exercised to the extent there have been over-allotments.¹⁴⁵
- The greenshoe – which may not amount to more than 15% of the original offer.¹⁴⁶
- A point of contact for the FSA’s enquiries if there is more than one investment firm/bank involved in stabilisation. Otherwise there is no limit on the number of stabilisation managers.¹⁴⁷

Short selling (other than over-allotting) is not permitted by the Regulation.

Stabilising may only take place in the context of a “significant distribution”, which means an initial or secondary offer of securities to be admitted to trading on a regulated market, publicly announced and distinct from ordinary trading both in terms of the amount in value of the securities offered and the selling methods employed.¹⁴⁸ This concept does not include a block trade.

¹⁴¹ Article 9
¹⁴² Article 9
¹⁴³ Article 9
¹⁴⁴ Article 11
¹⁴⁵ Article 11
¹⁴⁶ Article 11
¹⁴⁷ Article 9
¹⁴⁸ Article 2

15.4 STABILISATION OTHERWISE THAN ON A REGULATED MARKET

The FSA’s own rules cover stabilisation on markets which are not regulated markets. A list of the markets covered is contained in MAR 2 Annex 1R. It includes any market “prescribed” for the purposes of the UK’s market abuse regime but which is not a regulated market. This would include AIM and the PSM. Also included is any recognised overseas investment exchange (such as EUREX, ICE Futures, the CME and NASDAQ) and certain other named non-EEA exchanges (such as NYSE, Tokyo Stock Exchange and Hong Kong Stock Exchange).

The FSA stabilising rules also cover securities which are or may be traded under the rules of the International Securities Markets Association.¹⁴⁹

Behaviour which is in conformity with the FSA’s stabilisation rules does not amount to market abuse and is also exempted from the criminal provisions of the Criminal Justice Act 1993 and section 397 FSMA.¹⁵⁰

Although it was open to the FSA to retain the approach of the pre-Directive stabilisation rules, it has opted to follow the Stabilisation Regulation fairly closely. However, the FSA has made the following significant modifications to the provisions of the Regulation when adapting it for the purposes of its own rules:

- the previous disclosure requirements are retained: a prescribed form of wording for the prospectus or similar document, the rubric “stabilisation/ FSA” for screens and a reference to the possibility of stabilisation taking place in a public

¹⁴⁹ MAR 2.2.1R(2)(c)
¹⁵⁰ Schedule 1 paragraph 5 of the Criminal Justice Act 1993 and section 397(4) FSMA

announcement before the opening of the offer period;

- there is no requirement to make transaction reports to the FSA;
- there is no requirement to make public disclosure of the details of any stabilisation activity;
- there is a requirement to keep a record of stabilising transactions but not stabilising orders;
- there is no limit on the size of any over-allotment position not covered by a greenshoe option;
- there is no limit on the size of the greenshoe option.¹⁵¹

In theory, there is a gap in the coverage of the two sets of stabilisation provisions. In respect of all markets, whether regulated or not, the UK has chosen to retain certain features of the Act's original market abuse regime which are not derived from the Directive. The Regulation in its terms does not provide a safe harbour against possible contravention of these provisions; to the extent that a safe harbour is necessary for conduct on a regulated market, it would have to be provided by the FSA's own rules. However, the application of the FSA's stabilisation rules does not extend to conduct on a regulated market. The reason for this is presumably that the retained provisions can only apply in certain very limited circumstances, almost certainly not involving transactions in securities but concerning behaviour in relation to commodities underlying commodity futures markets. Stabilisation activity by definition involves transactions in securities; therefore it seems that it is not necessary to extend the safe harbour to cover the theoretical gap.

15.5 OVERSEAS STABILISATION RULES

The FSA's stabilisation rules have traditionally recognised that international stabilisation in accordance with US, Japanese and Hong Kong laws and regulations should be afforded recognition.

This accommodation is continued, but only for the purposes of the FSA's own stabilisation rules.¹⁵² As the FSA is powerless to modify the Regulation, and the Regulation does not recognise any non-EEA rules, the effect of the safe harbour for overseas stabilisation does not extend to any security admitted to trading on a regulated market, or the subject of a request for such admission. Nevertheless, the safe harbour will, for example, be available for international stabilisation in respect of bond issues admitted to the PSM.

¹⁵¹ MAR 2.4.4R

¹⁵² MAR 2.5

16. Future of the super-equivalent provisions

As already explained, the UK's market abuse regime is wider in scope than required by the Directive. The two principal limbs of "super-equivalence" (see sections 5 and 9 above) are the following two categories of market abuse:

- Misuse of information contrary to the standards of the regular user (section 118(4) FSMA).
- Behaviour that leads to a false or misleading market impression or market distortion and is also contrary to the standards of the regular user (section 118(8) FSMA).

These provisions were made subject to a "sunset clause" at the time of the Directive's implementation, meaning that they would be removed from the UK's market abuse regime after a fixed term. The sunset clause specified 30 June 2008 as the end date, but this was extended to 31 December 2009 pending an EU review of the market abuse regime. The use of section 118 to impose emergency short selling

restrictions in September 2008 (see section 13 above) led to a further extension of the sunset period until 31 December 2011 to allow the FSA to continue imposing emergency or other short selling restrictions if necessary, and to give the Government time to provide the FSA with independent express powers under the Act to make rules regarding short selling, for example by implementing any EU and G20 global standards that are eventually agreed upon. Although the FSA now has a new statutory power to make "short selling rules", provided by the Financial Services Act 2010 (see section 13.5), the Government has extended the sunset period until 31 December 2014¹⁵³. This reflects the Government's intention, following the EU review of the Directive (on which, see section 17), to align the UK market abuse standards with those imposed by the new Market Abuse Regulation, and to avoid two sets of changes to the UK regime in a short period of time. The Government anticipates that 31 December 2014 is when the Regulation will likely take effect.

¹⁵³ SI 2011/2928

17. The European Commission's proposals for the revision of the Directive

In June 2010, the European Commission launched a public consultation on the review of the Directive. Its objective was to consult financial market participants, governments, competent authorities and other stakeholders on the modifications to the Directive that the Commission was considering for its forthcoming legislative proposal. The consultation period closed on 23 July 2010.

Subsequently, on 20 October 2011, the European Commission proposed a new Market Abuse Regulation and a new Market Abuse Directive on criminal sanctions. The proposals aim to update and strengthen the framework provided by the existing Directive.

Amongst other things, the proposed Regulation:

- extends the scope of existing EU legislation to financial instruments traded on multilateral trading facilities (MTFs), other organised trading facilities (OTFs) and OTC so that trading on all platforms and of all financial instruments which can impact them will now be covered by market abuse legislation. It also extends the regime's scope to market abuse occurring across both commodity and related derivative markets;
- clarifies which high frequency trading (HFT) strategies constitute prohibited market manipulation;
- extends the current reporting of suspicious transactions to suspicious unexecuted orders and suspicious OTC transactions;
- grants regulators increased powers to obtain access to the information they need to detect market abuse;
- requires Member States to provide for the protection of whistleblowers and sets common rules where incentives are offered for reporting information about market abuse;
- creates a new offence of 'attempted market manipulation';
- proposes common penalty principles (e.g. that fines should not be less than the profit made from market abuse where this can be determined, and that the maximum fine should not be less than two times any such profit);
- reduces the administrative burdens on SME issuers, who will be exempt from the requirement to draw up lists of insiders, unless the supervisor demands otherwise; and
- raises the threshold for the reporting of managers' transactions.

The proposed Directive requires Member States to make the offences of insider dealing and market manipulation subject to criminal sanctions. Member States will, in addition, be required to impose criminal sanctions for inciting, aiding and abetting market abuse, as well as for attempts to commit such offences.

The proposals are with the European Parliament and the Council for negotiation and adoption. Once adopted, the Regulation will apply two years after its entry into force. Member States will have two years to transpose the Directive into national law.

REVIEW OF MIFID

The Commission's legislative proposal on the Markets in Financial Instruments Directive (MiFID) was also published on 20 October 2011. The proposed Directive and Regulation on market abuse use definitions provided in the MiFID proposals, and so the market abuse proposals cannot take effect before the MiFID proposals.

Important Note:

This Memorandum is intended to provide an overview of the market abuse regime. It should not be relied upon as a substitute for legal advice which should be sought as required.

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**OPERATING ARRANGEMENTS BETWEEN
THE FINANCIAL SERVICES AUTHORITY
AND
THE RECOGNISED INVESTMENT EXCHANGES
ON MARKET MISCONDUCT**

1. The FSA has agreed operating arrangements with the London Stock Exchange, Virt-X, Jiway, Coredeal, LIFFE, the International Petroleum Exchange, the London Metal Exchange and OM London Exchange ("the Exchanges") to deal with cases of suspected market misconduct. It has always been the objective of the FSA and the Exchanges to protect the integrity of the markets of the Exchanges and to prevent market misconduct. The new market abuse regime reinforces the need for the FSA and the Exchanges to ensure that they have in place effective arrangements for co-ordinating enforcement action in tackling possible or apparent market misconduct. Hence, the FSA and the Exchanges have agreed these operating arrangements.
2. FSA will be responsible for the application of the new market abuse regime introduced under the Financial Services and Markets Act 2000 and the investigation and prosecution of the criminal offences of market manipulation and insider dealing. The Exchanges wish to maintain fair and transparent markets that are attractive to market participants.
3. The FSA and the Exchanges recognise the desirability of avoiding undue duplication of investigation and enforcement work and a multiplicity of enforcement actions arising out of the same matter.
4. The FSA and the Exchanges will therefore maintain a close working relationship to deal with relevant enforcement issues arising in respect of possible or apparent market misconduct on the Exchanges' markets. The FSA and the Exchanges will discuss matters as and when they arise and will hold regular meetings to liaise on issues of mutual interest to both parties.
5. The FSA and the Exchanges will have regard to the principle that persons should not be subject to more than one investigation or set of enforcement proceedings for the same misconduct. It may, however, be appropriate for the FSA and the Exchanges to exercise different powers in relation to that person or the two sets of investigations or proceedings relate to different aspects of the suspected misconduct. In cases of joint interest either the FSA or the relevant Exchange will have lead responsibility, keeping the other informed.
6. The FSA and the Exchanges recognise that there are areas in which they have an overlapping remit in terms of their functions and powers in relation to market misconduct. The FSA and the Exchanges will therefore endeavour to ensure that only the party or parties with the most appropriate functions and powers will commence investigations and take enforcement action.
7. The FSA and the Exchanges will consider cases of suspected market misconduct on a case-by-case basis as they arise. Where the suspected misconduct appears to amount to a breach of provisions that both the FSA and the relevant Exchange have powers to enforce the FSA and the relevant Exchange will determine which of them should take action. Relevant considerations in this context include the seriousness of the suspected misconduct, the jurisdiction of the FSA and the Exchanges and the range of powers available to the FSA and the Exchange. The FSA's expectation is that in

circumstances where the market misconduct is limited to the Exchange, the perpetrators are all members of the Exchange and the enforcement powers of the Exchange are sufficient to deal with the misconduct, the FSA would expect the Exchange to investigate and to take enforcement action rather than the FSA. The FSA and the relevant Exchange will continue to liaise as appropriate during the course of an investigation and any subsequent enforcement action.

8. The Exchanges will continue to give guidance on their rules and the FSA will give guidance on the Code of Market Conduct. Such guidance and the extent to which it has been complied with will be relevant in assessing whether market misconduct has occurred. The Exchanges and the FSA will communicate closely on such issues.

Article 51(3) of the MiFID Implementing Directive- List of Minimum Records

Note: This is the list of record-keeping requirements in the FSA Handbook modules which has been produced to satisfy the requirement under Article 51(3) of the MiFID Implementing Directive. Article 51(3) requires us to create a list of minimum records which must be kept by investment firms under MiFID and its implementing measures. Firms should note that the details of the requirements are contained in the Handbook rules referred to. The list itself contains no substantive requirements.

As we set out in CP06/19, in the long term we may decide to fulfil this obligation through our existing practice of maintaining a list of explicit record-keeping requirements, within the schedules to the Handbook modules. However, CESR issued a consultation paper in October 2006 and we are awaiting their recommendations before finalising our proposal.

List of Minimum Records required under MiFID and Implementing Measures (FSA Rules)

Handbook reference and relevant MiFID references	Subject of record	Contents of record	When record must be made	Retention period
SYSC				
SYSC 9.1.1R Art. 13(6) MiFID and Art 5(1)(f) MiFID Implementing Directive	Record-keeping requirement	A firm's business and internal organisation, including all services and transactions	Ongoing	5 years
SYSC 10.1.6R Art. 13(6) MiFID and Art. 23 MiFID Implementing Directive	Conflict of interest	Details of the kinds of services and activities carried out by the firm in which a conflict has arisen or may arise	Ongoing	5 years

Handbook reference and relevant MiFID references	Subject of record	Contents of record	When record must be made	Retention period
COBS				
COBS 2.3.17R(1) Art.19(1) MiFID and Art.26 MiFID Implementing Directive	Fee, commission or non-monetary benefit under COBS 2.3.1R(2)	Each fee, commission or non-monetary benefit	When benefit is given	5 years
COBS 3.8.2R(1) Art.19(3) MiFID and Art.29 MiFID Implementing Directive	Standard form notice to clients and agreements under COBS 3	Each standard form notice and agreement	From when standard form is first used	Relevant period from when the firm ceases to carry on business with clients under that standard form (COBS 3.8.2R (3))
COBS 3.8.2R(2) Art.19(3) MiFID and Art. 28 MiFID Implementing Directive	Client categorisation	Client categorisation and supporting information, evidence of dispatch to client of any notice (the notice itself where this differs from standard form) and a copy of any agreement entered into	From time of categorisation	From when the firm ceases to carry on business with or for that client: Indefinitely (pension transfer, pension opt-out or FSAVC) 5 years (life policy or pension contract) 5 years (MiFID business or the equivalent business of a third country investment firm). 3 years (any other case)
COBS 5.8.1R Art.19(3) MiFID and Art. 29(8) MiFID Implementing Directive	Financial promotion	Financial promotions communicated or approved	When communicated or approved	See COBS 5.8.1R (3)
COBS 9.1.4R Art.19(1) MiFID and (7) Art.39 MiFID Implementing Directive	Client agreements	Documents setting out rights and obligations between the firm and the client	From date of agreement	From whichever is the longer of 5 years or the duration of the relationship with the client. Records relating to a pension transfer, pension opt-out or FSAVC must be retained indefinitely.
COBS 12.7.4R(3) Art.13(2) MiFID and Art.12 (2)c) MiFID Implementing Directive	Personal transaction	Details of the personal transaction notified to the firm	From date of notification	5 years

Handbook reference and relevant MiFID references	Subject of record	Contents of record	When record must be made	Retention period
COBS				
COBS 17.2.7R Art.19(8) MiFID and Art. 40 MiFID Implementing Directive	Confirmation to clients	Copy of a confirmation	From date of despatch to client	5 years (MiFID business or the equivalent business of a third country investment firm) 3 years (Other business)
COBS 17.3.10R Art.19(8) MiFID and Art. 41 MiFID Implementing Directive	Periodic Statements	A copy of a periodic statement sent to a client	From date of despatch to client	5 years (MiFID business or the equivalent business of a third country investment firm) 3 years (Other business)
CASS				
CASS 6.4.5R Art.19(2) MiFID	Securities financing transactions	Details of the client on whose instructions the use of financial instruments has been effected and the number	When a firm uses financial instruments in accordance with CASS 6.4	5 years
CASS 6.5.1R Art. 13(7) and (8) MiFID and Art. 16(1)(a) MiFID Implementing Directive	Safeguarding of client assets	Records and accounts to enable the firm to distinguish financial instruments held for one client from those held for another and the firm's own	Ongoing	5 years
CASS 6.5.2R Art. 13(7) and (8) MiFID and Art. 16(1)(b) MiFID Implementing Directive	Safeguarding of client assets	As above	As above	5 years
SUP				
SUP 17.4.6 Art.25(2) MiFID	Data retention	Data relating to transactions in financial instruments, including the identity of the client and information required under the money laundering directive	Ongoing	5 years
DISP				
DISP 1.5.1R Art. 13(2) MiFID and Art.10 MiFID Implementing Directive	Complaints	Details of each complaint received by a firm and the measures taken for its resolution	Ongoing	5 years (MiFID business) 3 years (Other business)

List of Minimum Records under MiFID and Implementing Measures (the MiFID Regulation)

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
COBS				
COBS 12.5.1EU Art.13(6) MiFID and Art:7 MiFID Regulation	Client orders	Details of orders received from clients or decisions to deal	Immediately on reception of order from client or the decision to deal	5 years
COBS 12.5.2EU Art.13(6) MiFID and Art.8 MiFID Regulation	Client orders	Details of orders executed for clients	Immediately after executing a client order or receiving confirmation that an order has been executed	5 years
COBS 12.5.3EU Art.13(6) MiFID and Art.8 MiFID Regulation	Client orders	Details of orders transmitted for execution	Immediately after transmitting the order for execution	5 years
MAR				
MAR 6.7.2(b)EU Art.27(1) MiFID and Art.24 MiFID Regulation	Systematic internalisers	Records of its quoted prices	Ongoing	12 months or such period as appropriate

Supervision

Chapter 19

Commodity Futures Trading Commission Part 30 exemption

19

PAGE
1



19.1 Application

19.1.1

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01.12.01/001

This chapter applies to a *firm*:

- (1) whose *permission* includes:
 - (a) the *regulated activities* of *dealing in investments as principal, dealing in investments as agent, arranging (bringing about) deals in investments or managing investments*; and
 - (b) the *specified investments of options or futures*;
- (2) which carries on those activities from an establishment maintained by the *firm* in the *United Kingdom*;
- (3) which intends to trade on behalf of US customers on non-US futures and options exchanges; and
- (4) which wishes to seek exemption under Part 30 of the General Regulations of the US Commodity Exchange Act.



19.2 Purpose

19.2.1

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01.12.01/001

Section 30.3 of Part 30 of the General Regulations under the US Commodity Exchange Act ('CFTC Part 30') makes it unlawful for any person to trade on behalf of US customers on non-US futures and options exchanges unless the trade is transacted by or through a US-registered futures commission merchant on a fully disclosed basis. However, these regulations allow the CFTC to grant an exemption from this registration requirement on a jurisdiction by jurisdiction basis. The CFTC operates an exemption system for firms regulated by the FSA.

19.2.2

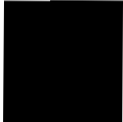
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The FSA sponsors applications for exemption from *firms* to the CFTC in line with the terms of the agreement between the *United Kingdom* and US regulators. This *guidance* is to help *firms* understand why an application may be required and to explain which *rules* apply as a result of an exemption.



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19.3 Exemption under CFTC Part 30

19.3.1

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01.12.01/001

The *CFTC* can exempt from certain *CFTC* rules and obligations a non-US firm that solicits or accepts orders for non-US futures and option transactions from customers located in the United States. The *CFTC* receives this power from *CFTC* Part 30. The exempted rules and obligations include registration and financial requirements. The firm has to comply with comparable regulatory requirements imposed by its home country regulator instead.

19.3.2

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01.12.01/001

The scope of the exemption is limited to firms trading in non-US futures and options on behalf of US customers on non-US futures and options exchanges other than a contract market designated as such under section 5 of the US Commodity Exchange Act.

19.3.3

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01.12.01/001

Registration is not required if a firm is trading for US customers through a futures commission merchant on an omnibus basis. Trading on an omnibus basis means the customers' identities are not revealed to the firm and all orders are given by the US futures commission merchant, so preventing the firm from having any contact with the US customers.

19.4 Applicable rules for firms under CFTC Part 30 exemption

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- 19.4.1** **G** 01.12.01/001 A *firm* that has a *Part 30 exemption order* must continue to comply with the applicable requirements and standards under the *regulatory system* including *COB*. However, it becomes subject to a number of additional US rules. The *FSA* is responsible for the supervision of the *firm* and its adherence to the *UK* requirements and standards and additional US requirements.
- 19.4.2** **G** 01.12.01/001 *CFTC* rules generally require US customers to be offered segregation in accordance with the *client money rules*. This is also an *FSA* requirement for a *firm* with a *Part 30 exemption order* (see ■ *COB 9.3.141R* to ■ *COB 9.3.144R*).
- 19.4.3** **G** 01.12.01/001 *Firms* should note that, although supervision rests with the *FSA*, the *CFTC* may be allowed access to relevant documents if it requests, under the terms of the *Part 30 exemption order*.
- 19.4.4** **G** 01.12.01/001 As well as the *FSA*'s requirements on risk warnings, a *firm* obtaining an exemption must meet the following US documentation requirements:
- (1) general risk disclosure for foreign futures and options;
 - (2) options disclosure; and
 - (3) particular additional risk disclosure and explanatory statement to London Metal Exchange customers.

New special administration regime for investment banks.

Executive summary

A new special administration procedure for investment banks has been created by the introduction of The Investment Bank Special Administration Regulations 2011 (the “**Regulations**”). An administrator appointed under the Regulations will have new special administration objectives which include:

- to return client property as soon as reasonably practicable; and
- to co-operate with the markets in resolving failed trades.

Other key changes introduced by the Regulations are:

- administrators will be able to set a bar date for asset claims;
- the rules governing losses for shortfalls of client securities are clarified; and
- suppliers of key services are obliged to continue to supply them to the administrator.

This briefing examines the Regulations and how, if at all, they may impact on the law and practice of administering a failed investment bank.

Background to the Regulations

The Regulations came into effect on the 8th February 2011 and provide for a new special administration regime to apply to insolvent investment banks.

Following the collapse of Lehman Brothers and the ensuing financial crisis, the regulators became acutely aware that the insolvency regime applicable to investment banks would need to be carefully reviewed to ensure that it was fit for purpose. There were views expressed that the UK regime compared unfavourably with those in other jurisdictions, particularly when dealing with protection of client assets and money. At the same time, other views were expressed that hasty reform could be both unwise and counter-productive. As a result it was decided not to include any specific reform addressing investment banks in the Banking Act 2009 (the “**Banking Act**”) but instead to provide an enabling power to pass new regulations to apply to insolvent investment banks within 2 years. The 2 years expired in February 2011.

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Extensive consultation has taken place with the industry, professional advisors and users of investment banking services. Linklaters participated in these consultations through the government's Investment Banking Liaison Panel of industry experts. HM Treasury produced a series of consultation papers inviting submissions during which thinking evolved significantly and the Regulations reflect the outcome of those consultations. The focus has been to ensure that the UK remains an attractive place for investment banking business and that customers can continue to deal with UK investment banks with confidence.

The principal area of concern has been overcoming difficulties with dealing with the return of property and money held for clients. In practice, as it has turned out in the case of Lehman Brothers, through the use of non-insolvency based arrangements such as the contractual Claims Resolution Agreement, the UK has managed to address some of the more challenging aspects of the return of securities held for clients reasonably effectively and, in some respects, rather better than in some of the other jurisdictions where client assets are held. Linklaters acted for the administrators of Lehman Brothers International (Europe) ("**Lehman UK**") in the creation of the Claims Resolution Agreement. However, such arrangements may not always be available in future and the Lehman Brothers insolvency did reveal a number of areas where the law could be improved, often by incorporating into law ideas first advanced in the Claims Resolution Agreement. That is what the Regulations seek to address.

What is an investment bank?

The Regulations apply to investment banks which are defined in the Banking Act as institutions which:

- have permission under Part 4 of the Financial Services and Markets Act 2000 to carry on at least one of the following regulated activities:
 - safeguarding and administering investments;
 - dealing in investments as principal; or
 - dealing in investments as agent;
- hold client assets (whether or not on trust); and
- are incorporated or formed in the UK (so this would include partnerships).

At the same time as the Regulations came into force, The Investment Bank (Amendment of Definition) Order 2011 clarified that, for these purposes, client assets include client money. They also clarified that the Regulations do not apply to insurance intermediaries.

The special administration regime

The Regulations create a new procedure called "special administration" which can apply to investment banks. The special administration regime ("**SAR**")

creates three special administration objectives which administrators will have a duty to follow:

- Objective 1 is for the administrator to ensure the return of client money or assets as soon as is reasonably practicable;
- Objective 2 is for the administrator to ensure timely engagement with market infrastructure bodies and the authorities; and
- Objective 3 is for the administrator to either rescue the investment bank as a going concern or wind it up in the best interests of the creditors.

The administrator has flexibility to prioritise these objectives as appropriate, so the administrator will not be required to return all client assets before addressing unsecured creditors. In many respects, it could be argued that this statement of objectives is little more than a statement of the pre-existing law of what the administrator of an investment bank should do anyway but it is perhaps a helpful clarification. The FSA does have the power, having consulted with the Treasury and the Bank of England, to direct the administrator to prioritise certain objectives over the others, if that is necessary to maintain public confidence in the stability of the UK financial markets. This may be helpful to the administrators in providing them with a defence to undertaking (or failing to undertake) certain actions which might otherwise expose them to personal liability.

Objective 1 – the return of client assets

Objective 1 relates to the return of property after discharge of claims on those assets. In reality, it is the customer's net equity that must be returned. Without more, an administrator would face difficulties in returning client assets before all claims to those assets have been asserted. Accordingly, the Regulations allow the administrators to set a "bar date" for claims to assets to help speed up the return process. Although under the ordinary administration procedure a bar date may also be set for client asset claims (one was set in Lehman's UK administration for example), the risk remains that late claimants could seek to recover from their recipients assets which had been distributed to them by the administrator. The Regulations remove this risk and make the bar date more effective. Claims made after the bar date will not be able to upset the returns of assets already made (other than where bad faith is present). There are a number of safeguards to the process that have been built in including timing, publicity and a requirement for creditor committee and court approval.

Objective 1 also addresses an issue which was troubling in Lehman about the allocation of losses arising from shortfalls of securities if it should turn out that there are more claims to assets than actual assets held by the investment bank. Under general trust law, there are a number of possible alternative theories which might apply to allocate the loss and each produces a different result. The Regulations provide that loss will be ascertained for each particular type of stock (by CUSIP or ISIN) and borne pro rata by all claimants to securities of that kind. If there is a shortfall after that allocation then that will

give rise to an unsecured claim (based on the value of the securities on the date the special administration commenced). This is the same mechanism that Lehman UK used in the Claims Resolution Agreement and the Regulations give it statutory effect. It should be noted that this rule does not apply to client money claims which continue to be allocated and dealt with under the FSA's client money rules as set out in CASS. Those continue to be the source of some dispute and are under review. The client money rules are imminently to be subject to revisions and it was felt not appropriate to address them in these Regulations.

Objective 2 – working with the markets

Objective 2 requires the administrator to work with market infrastructure bodies in applying their default rules and resolving unsettled trades or settlement instructions. In the Lehman UK insolvency, one particular area of concern in the markets was the time and complexity of resolving failed trades. The Regulations attempt to address this by providing a specific special administration objective. The Lehman UK insolvency showed that there was scope for improvement in these arrangements so as to minimise disruption.

Continuity of supply

The Regulations also seek to ensure that suppliers of key services needed for the special administration objectives cannot withdraw their services until the administrator has had time to make suitable alternative arrangements. The Lehman UK insolvency showed that disruption in the supply of key data and services could severely delay the return of client property and disrupt the activities of the administrators. The Regulations require continuity of supply of IT and other key services. When an investment bank goes into special administration, the supplier cannot make it a condition of the supply, or do anything that would have the effect of imposing that condition, that any of the outstanding charges owed by the firm to the supplier and incurred before the date of administration are paid. Suppliers of the following are covered:

- computer hardware or software or other hardware used by the investment bank in connection with the trading of securities or derivatives;
- financial data;
- infrastructure permitting electronic communication services;
- data processing;
- secured data networks provided by an accredited network provider; or
- access to a relevant system by a sponsoring system participant.

The supplier can stop providing supply if charges since the date of commencement of the special administration are unpaid for more than 28 days, or with consent of the administrator or leave of the court. Court permission will be given if the supplier can show that continuing the supply

will cause him hardship. Similar rules governing continuity of supply of utilities already apply under the Insolvency Act 1986.

Banks that are also investment banks

Many of the institutions to which the Regulations apply will also be UK banks falling within the operation of the Banking Act. Under the Banking Act, the regulators may apply the Special Resolution Regime under Parts 2 and 3 of that Act to a bank which is also an investment bank. Much of the detail of the Regulations addresses how they will operate for a bank which is also an investment bank. Regrettably, this results in the creation of yet two more new insolvency regimes:

- Special Administration (Bank Insolvency) – this is an alternative to “bank insolvency” (as set out in part 2 of the Banking Act) where the investment bank is also a deposit taking bank. It is substantively the same as the investment bank special administration procedure but modifies it to give priority to the administrator to work with the Financial Services Compensation Scheme in connection with the transfer of deposits to another financial institution; and
- Special Administration (Bank Administration) – this is an alternative to “bank administration” (as set out in Part 3 of the Banking Act) where part of the business of the deposit taking bank is sold to a commercial purchaser or transferred to a bridge bank. It is substantively the same as the investment bank special administration procedure but modifies it to give priority to the administrator to provide support to the purchaser.

Future developments

Much of the detail of the Regulations will be in the form of new insolvency rules for the SAR. These are not yet in place and will, we are told, be introduced shortly to come into force as soon as possible. They will provide for the mechanics of creditors meetings, the creditors committee and bar date procedures. They will also provide that the costs of returning client assets will be paid for out of the client assets. That reflects the rule in *Re Berkeley Applegate* but is helpful clarification for administrators and unsecured creditors. Of course, without rules being in place the Regulations are only partially effective at the moment.

Under the Banking Act, the Treasury is required to review the operation of the Regulations within 2 years of their coming into effect (i.e. before 8 February 2013). The review must consider how far the Regulations are achieving their objectives as set out in the Banking Act and whether the Regulations should continue to have effect. In the absence of another investment bank failure over that period it is likely that any review will concentrate on what impact, if any, the Regulations have had on maintaining confidence in the UK as a good place to conduct investment banking business. There are many factors (of which these Regulations may be only a small one) which could impact that.

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