

EXPLANATORY MEMORANDUM TO
THE DEFINITION OF FINANCIAL INSTRUMENT ORDER 2008

2008 No. 3053

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Definition of Financial Instrument Order 2008 amends the definition of "financial instrument" in Part 6 of the Financial Services and Markets Act 2000 (FSMA), inserting a separate definition in section 89F of that Part, and amending the definition applying to the remainder of Part 6. It also amends the definition of "financial instrument" in article 5 of the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Instruments) Order 2001 (S.I. 2001/996).

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 This Order is being made to give further implementation to Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (the Market Abuse Directive), as that Directive has now been modified by Directive 2004/39/EC on markets in financial instruments (MiFID), and to Commission Directive 2007/14/EC of 8 March 2007 (the Commission Directive). The Market Abuse Directive was first implemented by the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005 (S.I. 2005/381). A transposition note setting out how the Market Abuse Directive has been implemented is annexed to the explanatory memorandum to those Regulations. The Commission Directive is being implemented in rules made by the Financial Services Authority (FSA).

4.2 Section 102A of FSMA defines "financial instrument" by reference to the definition in the Market Abuse Directive for the purposes of Part 6 of FSMA. That definition includes "transferable securities" as defined in Directive 93/22/EEC in investment services in the securities field, and has now been modified by Article 69 of Directive 2004/39/EC on markets in financial instruments. Article 69 repealed Directive 93/22/EEC and provided that references to that Directive should be construed as references to MiFID. The resulting definition of "financial instrument" in the Market Abuse Directive as it is now in force is broader than the definition incorporated in section 102A of FSMA. The amendment made by this Order to section 102A is necessary to ensure that provisions in Part 6 of FSMA continue to give full implementation to the Market Abuse Directive.

4.3 The Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 determines which financial instruments are to be considered as "qualifying investments" for the purposes of section 118 of FSMA, which defines "market abuse" in relation to qualifying investments on prescribed markets. Article 5 of

this Order ensures that the definition of “financial instrument” in the 2001 Order is the definition in the market abuse directive as it has now been modified by MiFID.

4.4 Section 89A of FSMA gives the FSA power to make rules for the purposes of Directive 2004/109/EC on the harmonisation of transparency requirements (the Transparency Directive), requiring the disclosure of information in relation to voting rights in respect of shares held by a person. It also gives the FSA power to treat persons holding comparable instruments in respect of voting shares as holding voting rights in those shares and so being liable to disclose the same information (s. 89A(3)(b)). Under s.89F, a person is treated as holding “voting rights” *inter alia* if he or she holds a financial instrument which both results in an entitlement to acquire shares and is an Article 13 instrument (as determined by the European Commission under Article 13.2 of the Transparency Directive). A person is regarded as holding a “comparable instrument” under Article 89F if he or she holds a financial instrument in relation to shares which has similar economic effects to an Article 13 instrument.

4.5 The Commission Directive, which lays down detailed rules for the implementation of a number of provisions of the Transparency Directive, provides that instruments satisfying the MiFID definition of “financial instruments” are to be treated as financial instruments for the purposes of Article 13 of the Transparency Directive, provided that they result in an entitlement to acquire shares to which voting rights are attached. The Order accordingly ensures that the definition of “financial instrument” in section 89F will be the definition in MiFID, rather than the definition in the market abuse directive which applies to the other provisions in Part 6 of FSMA, and which is not as extensive as the MiFID definition.

4.6 The same definition of “financial instrument” is being applied to “comparable instruments” in section 89F(1)(c). This is not strictly required under the Transparency Directive or the Commission Directive. It is however necessary to ensure that parties wishing to acquire control over shares are not able to avoid the disclosure obligations under the transparency obligations directive by acquiring instruments which do not give a legal entitlement to acquire shares but in practice put their holders in an economically similar position so that they are able to exert the same influence over the exercise of the voting rights of such shares.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary Ian Pearson has made the following statement regarding human rights.

“In my view the provisions of the Definition of Financial Instrument Order 2008 are compatible with the Convention rights.”

7. Policy Background

7.1 This Order is being made to ensure that the UK remains fully compliant with its obligations under the Market Abuse Directive and the Commission Directive. The

provisions used to implement the UK's obligations under these Directives need to be updated to ensure continued compliance in respect of subsequent amendments. Therefore, changes are being made to sections 102A and 89F of FSMA to ensure the term "financial instrument" is understood by reference to its expanded definition in the Market Abuse Directive and its definition in MiFID respectively.

7.2 This also means that the FSA's powers to make rules for the disclosure of information in relation to financial instruments will now extend to derivative instruments, which, although not giving a legal entitlement to acquire shares, in practice put their holders in an economically similar position. The most common example of this is a Contract for Difference (CfD), which currently falls outside the disclosure rules put in place in respect of obligations under the Transparency Directive. While CfDs are not in effect a substitute for shares on a systematic basis, there are instances in which CfDs are being used in ways that the intention of the current regulatory regime is designed to catch - specifically holders seeking to influence votes and to build up stakes in companies.

7.3 Research commissioned by the FSA found that CfD holders do sometimes approach the party who wrote the CfD, seeking to exert influence on an undisclosed basis, over voting rights attached to the underlying stock held by the CfD writer as hedge against those contracts. The FSA have also looked at situations where it appears that CfDs have been used to help build up significant stakes in companies without any prior disclosure, as would have been required by the Disclosure Rules and Transparency Rules for acquisitions of shares.

7.4 This suggests that parties wishing to acquire control over shares, may in some cases, be able to avoid disclosure obligations by acquiring derivative instruments such as CfDs. It was originally intended that the powers given to the FSA through implementing the Transparency Directive should be sufficiently wide to enable them to require disclosure of such economic interests. It was noted in the explanatory notes to the Companies Act 2006:

1610. Subsection (3)(b) enables the Authority to make rules about disclosure in relation to certain comparable instruments in respect of voting shares. These are instruments that give the holder a level of economic, as opposed to legal, control over votes attached to shares. An example of the type of instrument that the rules could extend to cover is a contract for difference, known as a "CFD".

The change to the definition made by this Order corrects an unforeseen shortcoming in the FSA's powers.

8. Consultation

8.1 The Financial Services and Markets Act 2000 (Market Abuse) Regulations 2004 were subject to full consultation when they were made. The amendments this Order is making to the provisions inserted into FSMA by the 2004 Regulations are minor and do not make a significant change to those provisions.

8.2 As noted above, this Order will make a more significant change to the powers of the FSA to make disclosure rules. In November 2007 the FSA consulted on the specific issue of establishing a disclosure regime for CfDs, focusing on the issues of access to voting rights, corporate control and influence – this consultation contained a full cost benefit analysis of its proposals. Following this consultation the FSA published a policy

update in July 2008, and then a response paper in October 2008 which analysed the feedback from the 2007 consultation and attached draft rules for disclosure. The publication of the response paper is also the start of a further three-month technical consultation on the specific drafting of its disclosure rules.

8.3 Given the nature of these provisions and the extent of the consultation carried out by the FSA, further consultation is not thought necessary.

9. Guidance

9.1 The FSA's Disclosure Rules and Transparency Rules sourcebook will provide guidance on the application of its disclosure regime through amendments made to reflect the operation of the new disclosure regime.

10. Impact

10.1 The impact on business, charities or voluntary bodies is not significant.

10.2 The impact on the public sector is not significant.

10.2 An Impact Assessment is attached to this memorandum.

11. Regulating small business

11.1 It is not anticipated that small businesses, other than (possibly) small firms which specialise in the provision of derivative instruments, will be affected by this legislation. Any such specialist businesses will have been aware of the FSA's round of consultation on this issue and so had a chance to respond.

11.2 Other small businesses are not expected to suffer any impact from this instrument or the requirements to be imposed in FSA rules relating to the disclosure of CfDs. It was determined that the original major shareholding disclosure requirements resulting from the implementation of the Transparency Directive would tend to fall on larger companies; this is expected to remain the case in relation to the disclosure requirements in respect of CfDs

12. Monitoring and review

12.1 The FSA will be responsible for the monitoring and review of the disclosure regime for derivative instruments. It will do so through its Disclosure Rules and Transparency Rules, to which amendments are being made.

13. Contact

Andrew Donald at Her Majesty's Treasury Tel: 020-7270 4725 or e-mail: Andrew.donald@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

Summary: Intervention & Options

Department /Agency:
HM Treasury

Title:
Impact Assessment of Definition of Financial Instrument Order 2008

Stage: Implementation

Version: 1

Date: **24 November 2008**

Related Publications: HMT consultation on implementation of the Transparency Directive, March 2005; FSA consultation on disclosure of Contracts for Difference, November 2007.

Available to view or download at:

<http://www.hm-treasury.gov.uk>

Contact for enquiries: Andy Donald

Telephone: 020 7270 4725

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

The UK is no longer giving full effect to its obligations under the Market Abuse Directive as it has been modified by Markets in Financial Instruments Directive, or to its obligations under Commission Directive 2007/14/EC.

Furthermore the rule-making powers of the FSA, granted when implementing the Transparency Directive, need to be clarified so that disclosure obligations cannot be avoided through the use of certain derivative instruments.

What are the policy objectives and the intended effects?

To ensure that the UK continues to give full effect to its obligations under the Directives listed above.

To clarify that the FSA's rule-making powers in relation to disclosure of major shareholdings cover derivative instruments, such as Contracts for Difference (CfD). Although not giving a legal entitlement to acquire shares there are instances where CfDs are being used in ways the regulatory regime is designed to catch - specifically holders seeking to influence votes and build up stakes in companies on an undisclosed basis.

What policy options have been considered? Please justify any preferred option.

1. Do nothing.
2. Make an Order to update the UK's position in relation to the Directive listed above and clarify the rule-making powers of the FSA in regard to disclosure of CfDs.

The second option is preferred to ensure that the UK remains fully compliant with EU directives and clarifies the FSA's rule-making powers.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The FSA have published their revised cost benefit analysis. The FSA will be responsible for monitoring ongoing compliance with their disclosure regime.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

.....Date:

Summary: Analysis & Evidence

Policy Option: 2	Description: Make an Order to update the UK's position in relation to the Market Abuse Directive and the Commission Directive.
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' These costs relate to the FSA implementing a general disclosure regime for CfDs, coupled with aggregation of CfDs and shareholdings and an exemption for authorised firms writing financial instruments in a client serving capacity		
	One-off (Transition) Yrs			
	£ £5.8m - £16.8m			
	Average Annual Cost (excluding one-off)			
	£ £1.5m - £3.1m		Total Cost (PV)	£
Other key non-monetised costs by 'main affected groups'				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Ensuring the UK remains fully compliant with EU directives. Also a disclosure regime will help increase market certainty on the levels of ownership, influence and voting practices.		
	One-off Yrs			
	£ N/A			
	Average Annual Benefit (excluding one-off)			
	£ N/A		Total Benefit (PV)	£
Other key non-monetised benefits by 'main affected groups'				

Key Assumptions/Sensitivities/Risks
 The FSA's costs in relation to a disclosure regime are based on research carried out for them, dialogues with market participants and data from their own system.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £ N/A	NET BENEFIT (NPV Best estimate) £ N/A
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What is the geographic coverage of the policy/option?	UK wide					
On what date will the policy be implemented?	FSA rules in Sep 2009					
Which organisation(s) will enforce the policy?	FSA					
What is the total annual cost of enforcement for these organisations?	£ 25-50k p.a.					
Does enforcement comply with Hampton principles?	Yes					
Will implementation go beyond minimum EU requirements?	Yes					
What is the value of the proposed offsetting measure per year?	£ N/A					
What is the value of changes in greenhouse gas emissions?	£ N/A					
Will the proposal have a significant impact on competition?	No					
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border: none;"> <tr> <td style="width: 25%;"></td> <td style="width: 12.5%; text-align: center;">Micro</td> <td style="width: 12.5%; text-align: center;">Small</td> <td style="width: 12.5%; text-align: center;">Medium</td> <td style="width: 12.5%; text-align: center;">Large</td> </tr> </table>		Micro	Small	Medium	Large
	Micro	Small	Medium	Large		
Are any of these organisations exempt?	<table style="width: 100%; border: none;"> <tr> <td style="width: 25%;"></td> <td style="width: 12.5%; text-align: center;">No</td> <td style="width: 12.5%; text-align: center;">No</td> <td style="width: 12.5%; text-align: center;">N/A</td> <td style="width: 12.5%; text-align: center;">N/A</td> </tr> </table>		No	No	N/A	N/A
	No	No	N/A	N/A		

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of	£ N/A	Decrease of	£ N/A
Net Impact			£ N/A

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

PURPOSE

This Order is being made to give further implementation to Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (the Market Abuse Directive), as that Directive has now been modified by Directive 2004/39/EC on markets in financial instruments (MiFID), and to Commission Directive 2007/14/EC of 8 March 2007 (the Commission Directive). Amendments are being made to the Financial Services and Markets Act 2000 and the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Instruments) Order 2001.

Collectively these changes ensure the UK remains compliant with the EU Directives and gives the FSA the legislative power to implement its disclosure regime in relation to derivative instruments such as Contracts for Difference (CfD), which currently fall outside the disclosure and transparency rules put in place in respect of obligations under the Transparency Directive.

COSTS AND BENEFITS

The initial intention in implementing the Transparency Directive was that the FSA would have the power to ensure that parties wishing to acquire control over shares could not avoid their disclosure obligations by acquiring derivative instruments such as CfDs. This can be seen in the explanatory notes to the Companies Act 2006, which states:

1610. Subsection (3)(b) enables the Authority to make rules about disclosure in relation to certain comparable instruments in respect of voting shares. These are instruments that give the holder a level of economic, as opposed to legal, control over votes attached to shares. An example of the type of instrument that the rules could extend to cover is a contract for difference, known as a "CFD".

In extending the FSA's rule making powers, these Regulations correct an unintended shortcoming in the FSA's powers. The FSA has published its response to its November 2007 consultation on putting in place a disclosure regime for CfDs and is now engaging in a consultation period on the technical aspects of those rules. In response to the feedback received the FSA has changed their recommendation from a targeted disclosure regime to a general disclosure regime. This regime would require the disclosure of institution's gross long positions (i.e. the aggregation of shareholdings and CfD holdings), coupled with an exemption for authorised firms writing financial instruments in a client serving capacity (e.g. where a CfD writer writes a short CfD for a client, it effectively takes a long CfD position itself.)

COSTS

The FSA have concluded that their general disclosure regime will lead to the following costs being incurred: one-off costs of £5.8m - £16.8m and on-going costs of £1.5m - £3.1m per annum.

Compliance costs to firms and issuers are the most significant aspect of the figures derived at. The compliance costs fall into two broad categories: up front costs involved in setting up or updating systems; and, the costs of processing additional disclosures and notifications.

Following feedback on their consultation paper the FSA is introducing an exemption for investment firms and credit institutions that write CfDs. This means that smaller system changes will be needed compared to their original proposals, and the upfront costs have been reduced. The proposed exemption will also reduce the number of disclosures and therefore the level of ongoing costs.

BENEFITS

Benefits of this nature are hard to quantify, however, benefits accrue from increased market transparency; the transparency of control of major shareholdings being important to the efficient functioning of equity markets. Disclosure may therefore help allay market rumour and speculation and promote market confidence.

There is support for the FSA creating a disclosure regime and the thrust of the discussion has been on getting the right regime in place.

There is a further benefit in that making the Order ensures that the UK remains fully compliant with its obligations under the Market Abuse Directive and the Commission Directive; however, this is a qualitative rather than a quantitative benefit.

SMALL FIRMS IMPACT TEST

Smaller firms are not expected to suffer a disproportionate impact from the requirements. It was determined that the original major shareholding disclosure requirements would tend to fall on larger companies; this is expected to remain the case in relation to the disclosure requirements in respect of CfDs.

COMPETITION ASSESSMENT

The Order is not expected to diminish or distort competition in the market or to have a disproportionate impact on particular groups.

ENFORCEMENTS, SANCTIONS AND MONITORING

The FSA will be responsible for monitoring compliance.

IMPLEMENTATION AND DELIVERY PLAN

This Order is being made under the negative resolution procedure.

The FSA has published a response to consultation paper setting out its policy in relation to a general disclosure regime for CfDs. It is now engaging in a technical consultation period on how to implement the rules. They propose to finalise and make the rules in February 2009 with them coming into force in September 2009, subject to being granted the necessary statutory powers.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

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