LEGAL COLUMN

Plumbing new depths

This month saw the costs decision in the market abuse proceedings brought by the FSA against Paul Davidson and others. It resulted – for the first time – in the Financial Services & Markets Tribunal making a costs award against the FSA. While the decision is embarrassing for the FSA, does it have any significant implications for the future conduct of market abuse cases? Ed Sautter, finance and regulatory dispute partner at Mayer Brown Rowe & Maw, looks at the case.

The proceedings in the case concerning allegations of market abuse against three individuals – Paul Davidson, Ashley Tatham and Nigel Howe – arose out of a spread bet taken out ahead of the flotation of biotech firm Cyprotex, in 2002. Howe, who was the broker in charge of the placing, placed a large spread bet on behalf of Davidson with City Index, of which Tatham was the executive director for trading.

It was alleged that Davidson, Howe and Tatham had colluded with each other in respect of the spread bet. City Index would, as was the usual practice, hedge the bet by entering into a contract for differences, in this case with Dresdner, which would in turn hedge its position by subscribing for a tranche of physical Cyprotex stock. In this way, it was asserted, Davidson ensured that the minimum subscription condition to the placing was achieved.

Significantly, it was also said that the alleged true reason for these actions was not disclosed to those involved in advising Cyprotex or to the market generally through the relevant prospectus.

Davidson and Tatham succeeded in rebutting these allegations before the Tribunal. In particular, the Tribunal rejected much of the evidence of Howe, upon which the FSA had placed significant reliance.

Davidson's and Tatham's claim for costs was based upon paragraphs 13(1) and (2) of Schedule 13 of FSMA 2000, which provides that the Tribunal can: a) order a party to any proceedings on a reference to the Tribunal to pay costs to another party if it has acted "vexatiously, frivolously or unreasonably"; and (b) order the FSA to pay costs if the Tribunal considers "that a decision of the Authority which is the subject of the reference was unreasonable".

The Applicants had three lines of attack – the FSA's approach to the evidence; its approach to the law; and the penalties imposed in the relevant Notice.

The Tribunal criticised the Regulatory Decisions Committee (RDC) for failing to consider whether the FSA should interview Davidson under its compulsory powers (which it had failed to do) and for not making every possible effort to obtain the fullest telephone records when it was quite clear that the existence of such records would be crucial in determining the credibility of the evidence of Howe.

The Tribunal also noted that the FSA had obtained the advice of leading counsel to the effect that the issue of the Decision Notice should be deferred pending the receipt of certain outstanding information but there was no indication that the information had been received.

The Tribunal also noted that, notwithstanding that the Notice referred to collusion and concealment, there was a complete lack of direct evidence of this. In fact, the evidence was that Davidson had not sought to conceal the relevant strategy from anyone, and that it was Howe, the broker, who had failed to comply with his duty to ensure that reference to the spread bet was made in the relevant prospectus.

The Tribunal was also critical of the RDC's inadequate exploration of what was, at that time, very new law concerning market abuse and, in particular, the concept of regular user and the application of the relevant AIM Rules and Code of Market Conduct. Expert evidence put before the Tribunal at the substantive hearing was to the effect that a regular user would not have regarded the actions of Davidson or Tatham as market abuse if they had been disclosed to the market in the prospectus.

The Tribunal was also critical of the penalties imposed by the RDC and the approach taken to fixing the level of those penalties.

The Tribunal explained that the RDC was not in the same position as a prosecutor in a criminal case because a prosecutor does not make any binding decision and imposes no penalty. The Tribunal clearly considered that the RDC had taken the wrong approach and had not based its decision upon sufficiently cogent evidence.

The FSA was not found to have acted vexatiously, frivolously or unreasonably in connection with the proceedings.

Implications for the FSA

The Tribunal noted that the matters that it had identified as being unreasonable were unlikely to recur in the future, as the Decision Notice in this case was issued before the numerous changes made to the FSA's enforcement process as a result of the review of 2005.

These reforms included a legal review before reference to the RDC by lawyers in the Authority's enforcement division who are not part of the investigation team; and a dedicated legal function to assist the RDC in its decision-making.

The FSA will no doubt emphasise the Tribunal's acknowledgement that this case took place under the unreformed procedures. But it is clearly a positive development for those caught up in market abuse investigations that the lessons of this case and the effect of the 2005 reforms should result in the FSA ensuring that a rigorous review of the law and evidence is conducted in each case. The timely reminder of the role that the RDC performs as part of the enforcement process further confirms the need for this rigorous approach.

Those dealing with the FSA will no doubt use this decision and the reforms to the enforcement process to ensure that the FSA tests rigorously the legal and evidential basis of the allegations made.