IAN WINTER QC

BANNING THE FUNGIBLE DRUM

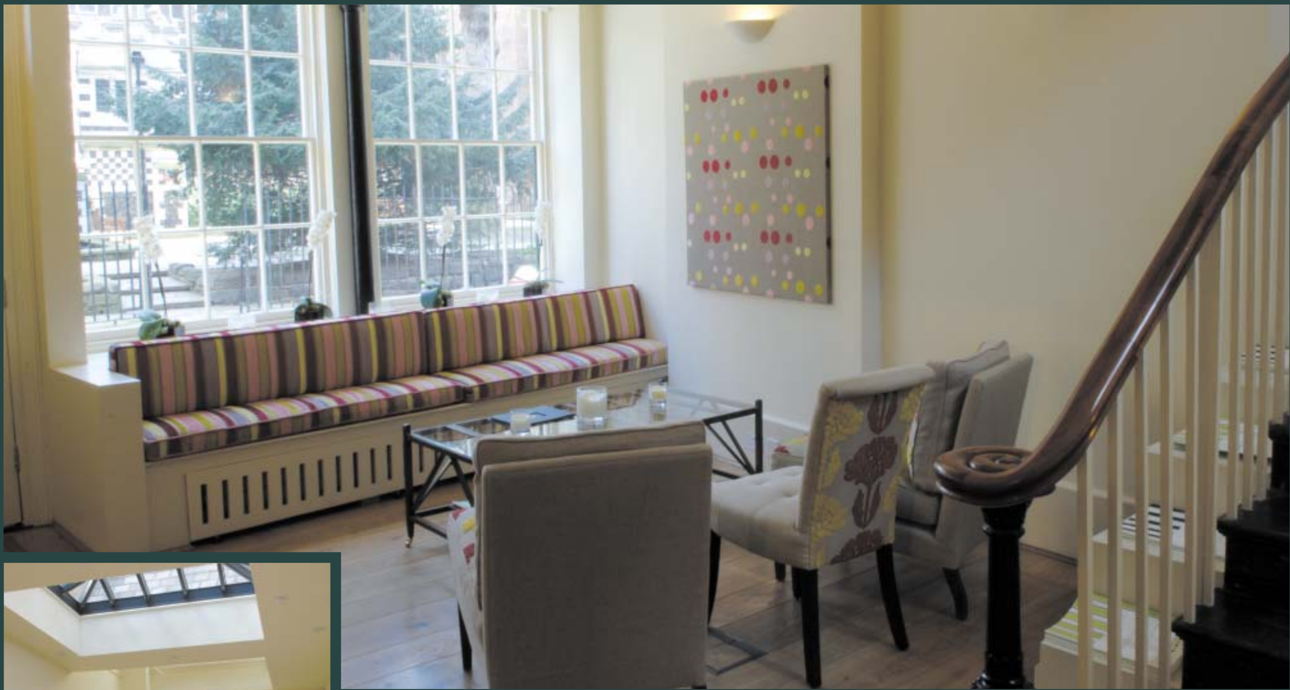
HAS THE FINANCIAL SERVICES AUTHORITY SUCCEEDED WITH ITS INTERIM BAN ON SHORT SELLING?

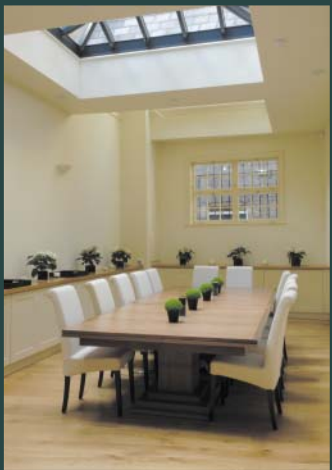
ISSUE SEVEN AUTUMN 2008
PUBLISHED BY

CLOTH FAIR CHAMBERS

CLOTH FAIR CHAMBERS

Nicholas Purnell QC
Julian Bevan QC
Richard Horwell QC
John Kelsey-Fry QC
Timothy Langdale QC
Edmund Lawson QC
Ian Winter QC





Cloth Fair Chambers specialises in fraud and commercial crime, complex and organised crime, regulatory and disciplinary matters, defamation and in broader litigation areas where specialist advocacy and advisory skills are required.

IAN WINTER QC

BANNING THE FUNGIBLE DRUM

HAS THE FINANCIAL SERVICES AUTHORITY SUCCEEDED WITH ITS INTERIM BAN ON SHORT SELLING?

ISSUE SEVEN AUTUMN 2008
PUBLISHED BY

CLOTH FAIR CHAMBERS

Many people, lawyers included, reacted with surprise to the announcement by the Financial Services Authority (the FSA) in September 2008 that there was to be a ban on the short selling of shares in the UK financial sector. The hedgies and the shorties reacted with consternation, if not outrage, at the summary execution of their favourite pet. How could something that has been a perfectly legal and important part of the securities market for hundreds of years come to be outlawed overnight and without the passing of primary legislation? Words such as "unprecedented" issued forth as the market struggled to come to terms with what the ban might mean. It wasn't long before the struggle moved across to the lawyers to see if there might be a way round the prohibition. The speakeasies in the world of the fungible received their first clients.

A fungible is something whose individual units are capable of mutual substitution. Crude oil is a fungible commodity because when it is bought and sold any individual unit of oil may be substituted for any other. The seller agrees to sell and the buyer agrees to buy units of the commodity mutually substitutable for any other units of the commodity. The same is so for shares in a company. When the buyer contracts to buy shares in a company he does not do so in relation to the actual share certificates with their unique numbers upon them, he just buys shares. The actual shares acquired when the deal is closed are fungible because any of the shares in the company will do.

The fungible nature of shares is critical for the short seller. In a typical short sale transaction the short seller either borrows or rents shares in a company. He then sells those shares to a buyer at a price that is less than the market price on the day of the sale. He does so because he believes that the market price in the shares will fall enabling him to purchase shares to return to the person from whom he borrowed or rented them at a price that is less than that for which he sold them. He sells higher than he subsequently intends to buy. If the shares were not fungible and the lender of the shares required the return of the actual shares lent then short selling would not be possible.

The first recorded incident of short selling was in 1609 when the Dutch trader Isaac Le Maire sold shares in the Vereenigde Oostindische Compagnie, which he did not own. The company had not paid a dividend in seven years and the company's trading ships were under constant threat of attack from the English on the Baltic trade routes. He believed that the price of the company's shares was likely to fall and fall it did enabling him to acquire shares, to satisfy the sale he had agreed, at a lower price. The authorities reacted with outrage leading to the first stock exchange regulations being introduced to ban short selling. The ban was reversed two years later when the essential nature of short selling was determined to be lawful. Those who in September 2008 were howling about the "unprecedented" ban on shorting were four hundred years out of date!

Indeed short selling has been outlawed several times in the four hundred year history of the concept. It was banned outright in England in the eighteenth century when it was shown to have exacerbated the violent stock market down turn following the failure of the Dutch tulip harvest. Short sellers were blamed for the Wall Street crash of 1929 and regulations were introduced in both 1929 and 1940 to prevent shorting. J Edgar Hoover investigated short sellers believing that they had prolonged the Great Depression. In response to the current financial markets downturn Australia, Germany, Ireland, Switzerland, Canada, France, The Netherlands and Belgium have all introduced various forms of bans on short selling.

The essential problem created by the short seller is that the availability of shares, on sale for significantly less than the current market price, tends to undermine the confidence of the market in the value of the share. Shorting only works if that confidence can be sufficiently undermined so as to provoke a collapse in the share price enabling the shorter to acquire the shares he needs at the lower price. Shorters tend therefore to pick on companies who have suffered a misfortune where the confidence of the market is already damaged. This causes people to regard short sellers with suspicion, believing that they are profiting from the misfortune of others.

On the other hand the short seller would say that he is only testing the true value of the share. Warren Buffet is on record as saying that short sellers help the market because they force decisions to be made as to the real value of the share. A short seller can only profit if in fact the current price of the share is higher than it should be, or at least that other investors can be persuaded that that is the case. Short sellers have on several occasions exposed fraud in the price of a company's shares such as in the shorting of Enron and Tyco which occurred several months before their respective financial scandals emerged. The same might well be said about some of the shorting that brought about the current FSA ban.

What is clear however is that short selling on the scale that has recently been seen certainly has the effect of exacerbating a market downturn. In knife edge conditions such as those being experienced at present there are good arguments in favour of curtailing the short seller's profits in favour of the public interest in stabilising the market. The questions therefore are how does one go about prohibiting the activity and is there any way round the ban so that a form of short selling can lawfully continue?

'And that's, basically, how short-selling works'

The Daily Telegraph

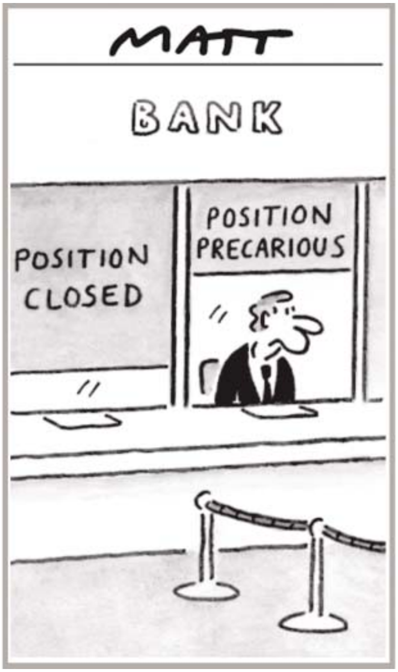
The FSA first acted on 12 June 2008 when it published the Short Selling Instrument requiring any person who had reached or exceeded a short position in a company that amounted to 0.25% of the issued capital of a company to make disclosure of that position by filing a Regulatory Information Service announcement to that effect. This, it was hoped, would calm the market by informing it that any significant drop in the price of shares was due to a single short seller's position rather than because of a general lack of confidence in the price. It did not succeed and when the significant shorting of a major English bank occurred in early September the FSA took the final decision to ban shorting. On 18 September 2008 the FSA issued the Short Selling (No.2) Instrument (the Instrument). The legal framework to that Instrument is as follows:

The Financial Services and Markets Act 2000 (the Act) gave the power to the FSA to control market abuse by imposing penalties upon those responsible. The FSA may impose an unlimited fine or may publish a statement to the effect that the person in question has been involved in market abuse. In 2005 the Act was substantially amended by the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005. The Act, as amended, creates seven forms of market abuse covering various forms of insider dealing, trading otherwise than for legitimate reasons, employing fictitious devices or other forms of deception, disseminating misleading information or impressions to the market and engaging in behaviour that affects the value of qualifying investments, known as *"misleading behaviour"*. It is this last head of market abuse that is relevant to the short seller.

Section 118(a) and (b) state that where behaviour *"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 would be, or would be likely to 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"*, it will amount to market abuse.

An investment qualifies under the Act if it is admitted, or for which a request for admission has been made, to trading on a prescribed market, which includes all UK recognised investment exchanges and OFEX, all UK regulated markets and all prescribed markets that are accessible electronically in the UK. In short virtually all investments admitted to virtually all markets are covered by the Act. Behaviour in relation to those qualifying investments is covered by the Act if it occurs in the UK or the electronic access to the market upon which the qualifying investment is traded occurs in the UK.

The Act required the FSA to publish a code that would contain appropriate guidance so that persons affected by the Act would be able to determine whether or not behaviour amounted to market abuse. The FSA did so and published the Code of Market Conduct which at Chapter 1.9 sets out s.118 of the Act, as amended, with guidance as to what the FSA regards as market abuse. The Code was amended by the Instrument so as to include the prohibition on short selling. The manner therefore in which the FSA has acted to prevent short selling is to widen the definition given to market abuse so as to include short selling. This is why the FSA was able to issue the prohibition without needing to resort to primary legislation. One important question, to which this article returns, is whether the Instrument falls within the scope of the Act or whether it is broader in scope and therefore possibly ultra vires the primary legislation.



The Daily Telegraph

The Instrument states as follows, *"A person who enters into a transaction that (whether by itself or in conjunction with other transactions) has the effect of: (a) creating a net short position in a UK financial sector company: or (b) increasing any net short position in a UK financial sector company that the person had immediately before 19 September 2008: is in the opinion of the FSA, engaging in behaviour that is market abuse (misleading behaviour)"*.

A *"net short position"* is defined by the Instrument as a position which *"gives rise to an economic exposure to the issued share capital of a company. Calculation of whether a person has a short position must take account of any form of economic interest in the* *shares of the company". "Economic exposure"* is understood to mean any exposure, whether direct or indirect to the issued share capital of a company.

A UK financial sector company is defined as a UK bank or insurance company of the UK incorporated parent undertaking of such a bank or insurance company.

The Instrument also makes it necessary for a person to make disclosure of a net short position that was held prior to 19 September 2008 if that position represented 0.25% or more of the issued capital of a company. This restated the position as set out in the 12 June 2008 Instrument. The Instrument restated that a failure to make disclosure of such a net short position would amount to market abuse in the opinion of the FSA. The Instrument specifically excludes from the ambit of the prohibition persons acting in the capacity of a market maker. As the FSA website makes clear this exemption applies only to market makers when they are acting as such and is therefore specific to each transaction conducted by such persons. The FSA does not expect market makers to hold significant short positions other than for brief periods and will scrutinise such positions by market makers to ensure that the underlying purpose of the transaction was in line with genuine market making. The Instrument will expire on 16 January 2009 when it will no longer be market abuse for a person to engage in short selling.

The interim nature of this ban accordingly exposes the utilitarianism of the FSA's approach. By defining market abuse as including short selling when ordinarily the FSA regards the activity as *"a legitimate technique which assists liquidity and is not itself abusive"* (see the FSA website), the FSA is indicating that what may or may not amount to market abuse will be for the FSA to decide against the particular backdrop of instant market conditions. This may be useful in avoiding the need for primary legislation but damages the need for certainty over what amounts to market abuse. More importantly, in relation to the question of the vires or otherwise of this secondary legislation, does the Instrument lawfully categorise short selling as market abuse (in that it amounts to misleading behaviour) when prior to 19 September 2008 and after 16 January 2009 exactly the same behaviour did not and will not amount to misleading behaviour?

As is clear from the wording of the Instrument it is the creation or increasing of a *"net short position"* that is prohibited. A *"net position"* is one that is calculated against a gross position. It appears to be the case therefore that if a person holds a long position in relation to a company's shares he will be able to establish a short position in relation to those shares so long as the net result of the long and the short positions is neutral or favours the long position. In the answers to Frequently Asked Questions published by the FSA, the FSA states that *"It also means that it is possible to short a UK financial sector company post 19 September, provided that the person can offset the short position with an equivalent long position in relation to that same company".*

The use of the word *"equivalent"* in that answer is understood to mean that the total quantum of difference from the open market price of the long position at the time that the short position is transacted must not be less than the total quantum of difference from the open market price of the short position. In other words if you add up the value of all the shares that have been acquired in excess of the market price that figure must be at least the same as the total value of those shares sold at less than the market price. The only alternative interpretation would be simply to add up the numbers of shares in the long position as opposed to the number in the short position. Such an interpretation would permit a short seller to net off his position by buying long but only fractionally above the market price and then shorting the same number of shares but significantly below the market price. This cannot have been the intention of the Instrument.

In practice resort to the net position is unlikely to be of assistance to the short seller. Long positions are unusual outside of futures deals since even if one is confident in the long term value of a share one still prefers to acquire it at the lowest value, normally the market price. The net position is calculated on the basis of the person's "*economic exposure*" to the shares in the company. It would be difficult to argue that possession of long positions in futures deals created a current economic exposure to the shares of the company. It doesn't, it creates a future economic exposure and an exposure that can be hedged or avoided by subsequent transactions. It is difficult to see how a short seller could engineer a current long position in the shares that he wishes to short so that he can establish a neutral net position and still profit from the shorting.

The Instrument has been careful to focus upon the "*effect*" of the transaction rather than the mechanics of it. This is because of the myriad instruments and derivatives available to traders, any one of which may be constructed in significantly different ways. By focusing upon the consequences of the transaction it is unnecessary to examine the mechanics of the deal so long as the effect is to establish or increase a net short position. This means that the use of contracts for differences, spread betting, options, futures, depository receipts, convertible bonds, dual line stocks or derivatives is unlikely to prevent the transaction from creating or increasing a net short position if that is the underlying effect of the deal.

On the face of it therefore the Instrument has been effective in prohibiting short selling during the period 19 September 2008 to 16 January 2009 with only the following caveat. The Act defines the seventh head of market abuse as being behaviour that is likely to give a regular user of the market a misleading impression as to the supply of, demand for or price or value of qualifying investments or which would distort or would be likely to distort the market in such a manner *and* which behaviour is likely to be regarded by a regular market user as a failure to observe the standard of behaviour reasonably to be expected.

Before this head amounts to market abuse therefore the behaviour in question must give a misleading impression or distort the market in such a way as to be regarded as behaviour that is below the reasonable standards normally experienced by a regular user of the market. Given that prior to the prohibition short selling was a centuries old, widely practised technique and one regarded by the FSA itselves as "*legitimate*" it would be very difficult to assert that it suddenly became something that misleads or distorts the market in an unreasonable way.

The Instrument does not address this issue. It does not prohibit the creation or increasing of a net short position in circumstances that are likely to give a regular user of the market a misleading impression as to the price or value of shares or which distorts the market and which was misleading and/or distorting in a manner that fell below standards reasonably to be expected. The Instrument merely prohibits the creating or increasing of a net short position. The manner in which the Instrument achieves the prohibition is to call such creation or increasing of a net short position "*market abuse*". The FSA, through the Instrument, has therefore defined market abuse in a manner that is fundamentally different from the definition contained in the Act, the primary legislation.

The primary legislation requires that the conduct, whatever it is, in this case short selling, is misleading to or distorting of the market in a manner that falls below standards reasonably to be expected, before it amounts to market abuse. The Instrument makes the same conduct market abuse however clear, non-distorting and reasonable it might have been. In this critical regard the Instrument significantly extends the definition of market abuse beyond the ambit of the primary legislation. This makes the Instrument susceptible of an argument that the Instrument, in this regard, is ultra vires and accordingly unenforceable to the extent that it exceeds the primary legislation.

'This is capitalism working'

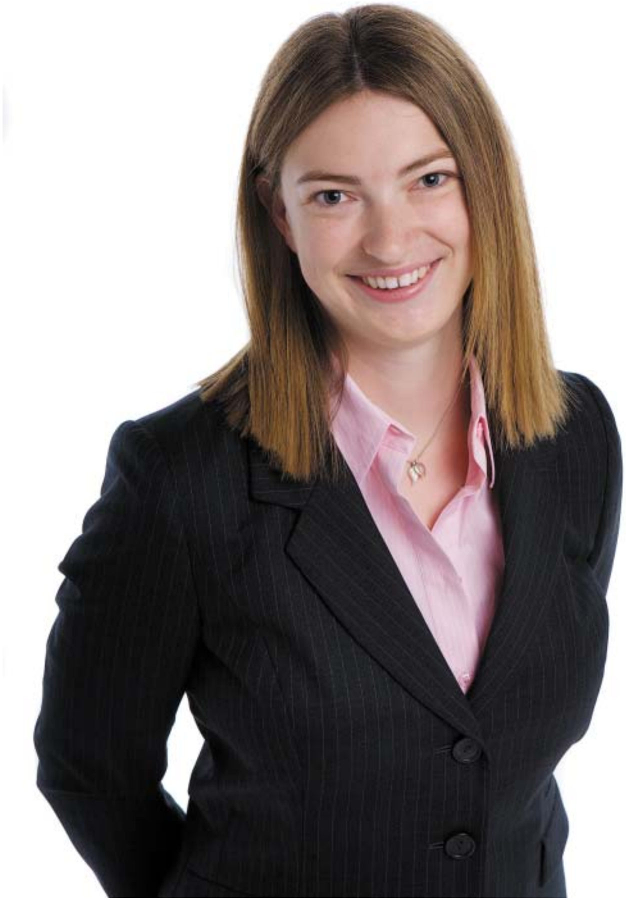
The Daily Telegraph

Secondary legislation is only vires if it is authorised by the primary legislation. The secondary legislation must therefore fall within the scope or ambit of the primary legislation to have the legitimacy of that primary legislation. It appears that the Instrument, because it is wider in scope than the primary legislation could be struck down to the extent that it might be construed to be lawful only if the additional and limiting words of the Statute are read into the Instrument. This would convert the ban on creating or increasing net short positions into a ban on creating or increasing net short positions in a way that 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 which distorts or is likely to distort the market and which short selling is likely to be regarded by the user of the market as short selling that fell below the standard of behaviour reasonably expected of short sellers.

The fundamental difference between the Instrument as it is drafted and the Instrument as it would read if s.118(a) and (b) were read into it is obvious. The prohibition would suddenly become very much more limited and would depend upon the manner in which the short position was acquired and whether that behaviour was misleading or distorted the market and whether it was unreasonable. It appears to be the case therefore that a bold short seller could take the view that the Instrument as drafted is ultra vires the Act and could establish short positions so long as he did not mislead or distort the market and as long as he behaved in accordance with reasonably expected standards. It is stressed that such a course would be bold indeed, since the FSA would undoubtedly disagree that the Instrument is ultra vires the Act. The FSA would argue that once the ban is in place the regular market user would assume that no short selling was taking place and would therefore be misled by conduct that breached the ban.The regular market user would consider a failure to observe the ban as a failure to observe reasonable standards of behaviour. Since such a user would think that short selling was not occurring the fact of short selling would be likely to mislead or distort the market. This however could be countered by informing the purchaser of shares that the short seller considered the ban to be ultra vires and was continuing to short sell. That would remove any chance of the market being misled or distorted and might well prevent the FSA from enforcing the ban or of penalising those who did not comply with it. Bold indeed, but then again, fortune favours the brave. Such a bold short seller might find himself asking the same question that Tommy, the dodgy boxing promoter in Guy Ritchie's film *Snatch* found himself asking, *"Have you got the minerals?"*!

CLOTH FAIR KALISHER SCHOLARSHIP 2008

The Kalisher Trust was set up in 1996 in memory of the late Michael Kalisher QC and is a unique charity which has funded one talented student through the Bar Vocational Course each year. In 2007 Cloth Fair Chambers undertook to fund a second scholarship each year and Deborah Smithies is the second Cloth Fair Kalisher Scholar. The scholarship is to be awarded to her by The Hon Mr Justice Penry-Davy at the annual Kalisher Lecture on 21 October 2008 at the Old Bailey.



DEBORAH SMITHIES

I decided upon a career in the law comparatively late. As an undergraduate, I read PPE at Magdalen College, Oxford, and at first I intended to pursue an economics-related career. I considered a career in banking or management consultancy, and to that end I took up an Easter internship with Goldman Sachs in my first year. However, over the course of that internship I came to realise that a City career wasn't right for me. I considered the opportunity to do further study in the field of development economics, but in truth I didn't think I was suited to the life of an academic either. Just before my final year, I became interested in the Bar as a career; and the more I thought about it, the more I came to realise that the Bar offered everything that I was looking for: intellectually challenging work in which I could use my communication skills on a daily basis and be ultimately responsible for my own decisions.

I organised a mini-pupillage in Leeds, shadowing a barrister acting for the defendant in a murder trial. I loved the sense of drama in the courtroom, watching with interest as the barristers cornered the witnesses in carefully constructed cross-examinations. I did three further mini-pupillages quite soon after that one, including one with a junior criminal barrister in London. I thoroughly enjoyed all of them, and was by that point certain that I wanted to pursue a career at the Bar.

I was accepted onto the Graduate Diploma in Law course at Nottingham Law School, and stayed on there for the Bar Vocational Course. The GDL in particular was demanding, due to the sheer amount of law to be memorised in a comparatively short space of time; but for the same reason, it was extremely satisfying. The kind of law that really interested me was that which had a tangible human element. For this reason I was drawn towards criminal law to a greater extent than Land Law or Equity and Trusts.

I found that that initial instinct was confirmed on the BVC. I loved the thrice-weekly criminal advocacy sessions: having been a keen debater and drama student in my school days, I was comfortable addressing an audience, structuring an argument and delivering it persuasively. I knew that I wanted my career at the Bar to involve as much advocacy as possible. I also enjoyed the conferencing aspect of the course, dealing sensitively with lay clients and explaining situations in an accessible way. I very much enjoyed the Family and Immigration electives, but was determined by the end of the year that I wanted to forge a career for myself at the Criminal Bar.

I am eagerly looking forward to starting my pupillage this month at KBW Chambers in Leeds. I was of course absolutely delighted to be awarded the Cloth Fair Scholarship this summer. The award is a much appreciated vote of confidence in my abilities as a criminal barrister, and I am determined to demonstrate over the course of my career that the Kalisher Trustees' faith has not been misplaced.

NEW STAFF

ADRIAN CHAPMAN

We are delighted to announce that Adrian Chapman has joined our clerking team as First Junior Clerk in direct support to Nick Newman, our Senior Clerk.

Adrian brings ten years of clerking experience with him, having worked his way to the First Junior post at QEB Hollis Whiteman Chambers. Adrian will help provide a very strong middle order to our Clerks' Room, bridging the gap in experience between Nick and Ben O'Neill, our Junior Clerk.

The success of Cloth Fair and the increased demand this has made on the administrative team, has led Chambers to recognise that, in order to provide the highest possible level of service to our clients, an investment in this position is required.

We are sure that Adrian will prove to be a very successful appointment and we welcome him to the fold.

Commercial Director:
Charlotte Bircher
charlottebircher@clothfairchambers.com
020 7710 6445

Senior Clerk:
Nick Newman
nicknewman@clothfairchambers.com

First Junior Clerk:
Adrian Chapman
adrianchapman@clothfairchambers.com

Consultant:
Michael Greenaway
michaelgreenaway@clothfairchambers.com

CLOTH FAIR CHAMBERS

39-40 Cloth Fair London EC1A 7NT
tel: 020 7710 6444
fax: 020 7710 6446
tel: (out of office hours) 07875 012444
dx: 321 Chancery Lane/London
email@clothfairchambers.com
www.clothfairchambers.com