FINAL NOTICE

To: **Evolution Beeson Gregory Limited**
c/o Jones Day
Solicitors
21 Tudor Street
London EC4Y ODJ

To: **Mr Christopher Potts**
c/o BCL Burton Copeland
Solicitors
51 Lincoln's Inn Fields
London WC2A 3LZ

Date: **12 November 2004**

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives notice about its decision to take the following action

ACTION

1. The FSA gave Evolution Beeson Gregory Limited ("EBG") and Mr Christopher Potts ("Mr Potts") a Further Decision Notice dated 1 November 2004 which notified EBG and Mr Potts that, for the reasons set out below, the FSA had decided to impose financial penalties on EBG in the amount of £500,000 and on Mr Potts in the amount of £75,000 ("the penalties") pursuant to section 123 of the Financial Services and Markets Act 2000 ("the Act"). The penalties were imposed for market abuse as a result of short selling by EBG and Mr Potts, during the period from 25 September 2003 to 21 October 2003, of the shares of Room Service Group plc ("Room Service"), the ordinary share capital of which is and was at the relevant time traded on the Alternative Investment Market ("AIM").

2. The FSA considers that the actions of EBG and Mr Potts were particularly serious and merit a substantial financial penalty in that:

- by 20 October 2003, EBG had established a short position in Room Service shares equal to 252% of the issued share capital;
- EBG had no reasonable settlement plan for meeting its obligations to deliver those shares;
- as a consequence, the market was distorted in that EBG entered into contracts to sell more shares than were within its ability to deliver with the result that the short position could not be settled in a timely fashion;
- the effect of this conduct was that EBG's counterparties and approximately 250 retail investors were adversely affected; and
- as a consequence of EBG's short selling, the suspension of trading of Room Service shares was prolonged when the London Stock Exchange ("LSE") felt it necessary to intervene in order to restore an orderly market.

REASONS FOR THE ACTIONS

The Facts

3. EBG is part of the Evolution Group, a group of companies offering financial services. The companies are authorised by the FSA and based in London. EBG is Evolution Group's investment banking arm. EBG is a registered market maker with the LSE and makes markets in a number of Mid Cap and Small Cap AIM stocks.

4. At all material times, Mr Potts was employed by EBG as its head of market making with overall responsibility for Small Cap and AIM market making operations at EBG. Market making was conducted in approximately 400-500 Small Cap AIM securities during September and October 2003.

5. Mr Potts, as head of market making and as the lead market maker concerned with the relevant book, had direct responsibility for determining and implementing strategies in relation to, and for making the appropriate market in, Room Service shares.

6. In the normal course of business, senior management at EBG would not have been consulted when Mr Potts determined and implemented his strategy unless the strategy breached a cash value trading limit.

7. Room Service is a publicly traded company (now named Azure (Holdings) plc) whose shares are traded on AIM; its shares are a component of AIM's Small Cap Index. AIM is regulated by the LSE.

8. In July 2003, the LSE suspended trading in Room Service shares pending the production of accounts.

9. On 22 September 2003, Room Service issued two announcements via the Regulatory News Service ("RNS"):

   i The first, headed "Preliminary results for the year ended 31 December 2002", stated that Room Service had recorded a loss before taxation of £2.837 million. It went on to state that Chiddingfold Investments Limited ("Chiddingfold") had acquired £119,760 of Room Service's outstanding debt of £216,000. The announcement stated that Chiddingfold would address the majority of this debt through a loan:

   > *"Your directors have agreed that Chiddingfold will enter into arrangements to make a loan of £100,000 to the Company, convertible, subject to shareholder consent, into ordinary shares at 1p per share after the capital reorganisation…"*

   ii The second, headed "Interim Results for the six months ended 30 June 2003", stated that Room Service had effectively not traded in the first half of 2003, that no turnover had been generated, that Room Service had incurred £35,000 of administrative expenses and that Room Service's balance sheet showed a net deficit of £176,000.

10. On 25 September 2003, the LSE announced the restoration of trading in Room Service shares.

11. Following the announcements on 22 September 2003, Mr Potts spoke to Chiddingfold and established that the capital reorganisation would be likely to be similar to a previous transaction of August 2003 in which Chiddingfold, EBG and Mr Potts had been involved. In that transaction, involving shares in Underwriting and Subscription plc, Chiddingfold represented a consortium of investors of which EBG was a part. The consortium was involved in a refinancing option which involved a placing in which 7 million ordinary shares were subscribed for at 1p each. The inference drawn by the FSA is that Mr Potts understood that a similar re-financing option together with a similar issue of shares would arise in respect of Room Service.

12. At some point before 20 October 2003, Mr Potts asked EBG's compliance department whether there were any LSE or FSA limits on the size of short positions. At the time, he did not seek specific advice nor did he discuss his proposed short selling strategy with EBG's compliance department. In addition, EBG's compliance department stated that there were no limits on short positions under the FSA or LSE Rules, but failed to ask Mr Potts for any further details in respect of his request.

13. From 25 September to 21 October 2003 EBG conducted 350 trades in Room Service. A total of 334 (95.4%) were booked as sales and 16 (4.6%) as buy orders. During this period, EBG traded a total of 344,468,855 Room Service shares; at this time there were approximately 124 million Room Service shares in issue. This equates to a net position of -312,867,860 ordinary shares when trading was suspended or a short position equal to 252% of Room Service's issued share capital. The average price of the sale transactions, in this period, was 0.9p with a total net consideration of £247,888.

14. EBG began to short sell Room Service shares on 25 September 2003. By the close of trading on 14 October 2003, 30% of the issued share capital of Room Service had been short sold by EBG. EBG aggressively short sold the stock on 15, 16 and 17 October 2003. Of the total 350 transactions booked by EBG from 25 September 2003 to 21 October 2003, 239 or 68% were booked during those three days, of which 42% were due for settlement in 3 days' time (i.e. T+3). Between 15 and 17 October 2003, Mr Potts responded to and then encouraged

substantial buying interest from retail investors by lowering EBG's sale price for Room Service shares. By 15 October 2003 EBG's short position exceeded 100% of the issued share capital of Room Service. Mr Potts and EBG continued selling shares short in Room Service, despite EBG being asked by the LSE on 20 October 2003 how it proposed to close its open position, until the stock was suspended, at the request of Room Service on the morning of 22 October 2003.

15. EBG and Mr Potts were relying on the passing of resolutions at the Room Service annual general meeting ("AGM") on 20 October 2003 and the issue of new Room Service shares immediately after the AGM to cover EBG's short positions. Alternatively, they were relying on Room Service to go into insolvency and for investors to walk away from their share entitlements in such eventuality. The size of the short position did not trigger any internal controls at EBG because the controls in place at the time based upon cash limits were not breached. As a result it was possible for such a large short position to be built up without reference to its senior management. EBG took no steps to inquire of Mr Potts how he proposed to settle the position until EBG was prompted by an inquiry from the LSE on 17 October 2003.

16. All of EBG's counterparties to these transactions were professional broking companies who took the majority of their orders from retail investors. EBG classed these brokers as market counterparties.

17. Room Service held its AGM on 20 October 2003. At the AGM all the capital reorganisation resolutions were passed, reducing the number of issued shares by a factor of 100 and approving the potential non-pre-emptive issue of up to 2,514% of the original share capital. At the time of EBG's short selling, it was not known whether the capital reorganisation resolutions to be put to Room Service's AGM would be passed. Even after the resolutions had been passed at the AGM it was not known when, if at all, any new shares authorised to be issued at the AGM would in fact be issued by the Company. In addition, approval was given for the Company's name to be changed to Azure (Holdings) plc.

18. However, the proposed equity for debt transaction did not take place and on 22 October 2003 at 07:30hrs, Room Service released the following statement:

> *"The Chairman's statement contained in the preliminary announcement of the results for the year ended 31st December 2002, referred to a convertible loan of £100,000 from Chiddingfold Investments Limited. That loan will now not take place and alternative proposals for refinancing the Company are being considered."*

19. Also on 22 October 2003 at 07:30hrs, trading in Room Service shares was suspended by the LSE at Room Service's request.

20. On 2 December 2003, Room Service announced an alternative capital reorganisation which resulted in Chiddingfold and its associates acquiring over 80% of Room Service's shares through a debt for equity refinancing and a placing of 19.5 million shares and that Chiddingfold had incurred an obligation under Rule 9 of the City Code on Takeovers and Mergers ("Rule 9") to make a mandatory offer for Room Service. Room Service then announced details of an open offer to existing shareholders:

"The Directors wish to offer existing shareholders the opportunity to participate in the overall refinancing of the Company at the same price as the Placing and the Debt Conversion. Accordingly, shareholders will be invited to subscribe for new ordinary shares by way of an open offer of 12,422,500 new ordinary shares on the basis of ten new ordinary shares for each existing ordinary share held ("Open Offer") at a price of 1p per new ordinary share."

21. The LSE also released a statement to the market on 2 December 2003 outlining the possible impact of the Open Offer on a large number of unsettled positions that had resulted from EBG's short selling of Room Service's shares:

    "The Exchange is fully aware of concerns in the market about the possible impact of the settlement backlog, which is likely to affect the delivery of entitlements to participate in the open offer that the Company has announced. The trading rules of the Exchange govern its member firms' settlement responsibilities and the Exchange is currently working with market participants to resolve this situation in an orderly manner."

22. Room Service's Open Offer led to it being necessary for the LSE to issue a direction to EBG to make a cash offer to purchasers of Room Service shares whose share purchase transactions had not settled and who, accordingly, were precluded from participating in the Open Offer.

23. On exchange trading in Room Services' shares resumed on Friday 30 January 2004.

Relevant statutory provisions and guidance

24. Section 118(1) of the Act defines "market abuse" as "*behaviour… which…*

    (a) occurs in relation to qualifying investments traded on a market to which this section applies;

    (b) satisfies any one or more of the conditions set out in subsection (2); and

    (c) is likely to be regarded by a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market."

25. The relevant condition is that set out in section 118(2)(c) of the Act:

    "a regular user would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question."

26. Shares in Room Service, being traded on AIM, are qualifying investments and dealing in such shares is behaviour occurring in relation to such investments for the purposes of section 118(1) of the Act.

27. The term "regular user", in relation to a particular market, means *"a reasonable person who regularly deals on that market in investments of the kind in question"* (section 118(10) of the Act).

28. Under section 119 of the Act the FSA has issued the Code of Market Conduct ("the Code"), which contains guidance as to whether or not behaviour amounts to market abuse. Under section 122 of the Act, the Code may be relied on so far as it indicates whether or not particular behaviour should be taken to amount to market abuse. In respect of this Final Notice, the FSA has had regard to MAR 1.2 of the Code which sets out guidance on the regular user.

29. Under section 123(1) of the Act the FSA may impose a financial penalty of such amount as it considers appropriate if the FSA is satisfied that a person has engaged in market abuse.

30. Under section 123(2) of the Act the FSA may not impose a financial penalty for marker abuse against a person if there are reasonable grounds for it to be satisfied that the person believed on reasonable grounds that his behaviour did not amount to market abuse.

EBG and Mr Potts engaged in market abuse

31. The FSA considers that the market in Room Service shares was distorted and that market abuse within the meaning of that expression in section 118(2)(c) of the Act occurred.

32. The behaviour of EBG and Mr Potts considered by the FSA to amount to market abuse is:

   i EBG offered to sell, and sold, Room Service shares, beyond the level for which EBG had a reasonable settlement plan, thereby distorting the supply side of the market;

   ii EBG continued to offer the lowest price for Room Service shares in the market for the majority of the period 15 to 17 October 2003; and

   iii EBG's naked short selling of the equivalent of 252% of the issued share capital of Room Service.

33. By reference to the three required elements under section 118(1) of the Act (which makes reference to section 118(2)), the behaviour of EBG and Mr Potts, as described in the preceding paragraph, amounted to market abuse in that the behaviour:

   i occurred in relation to Room Service shares, which are qualifying investments, being traded on AIM which is a prescribed market for the purposes of the regime;

   ii is likely to be regarded by a regular user of AIM as that which would, or would be likely to, distort AIM; and

   iii is likely to be regarded by a regular user of AIM as a failure on the part of EBG to observe the standards of behaviour reasonably expected of an authorised firm in relation to the market and as a failure on the part of Mr Potts to observe the standards of behaviour reasonably expected of the head of market making at an authorised firm in relation to the market.

34. Section 118(2)(c) of the Act concerns behaviour which would, or would be likely to, distort the market in the investment in question. The Code explains this in the following terms:

> *"A person may not engage in behaviour that interferes with the proper operation of market forces and so with the interplay of proper supply and demand and so has a distorting effect. Distortion undermines confidence in the prescribed markets and damages efficiency to the detriment of market users, including investors"* (MAR 1.6.3).

35. The Code provides no examples of distortion involving short selling, but it does not purport to be an exhaustive list of all types of behaviour which may or may not amount to market abuse. In this regard, the FSA considers that distortion is not limited to behaviour for the purpose of price positioning or abusive squeezes (the examples given at MAR 1.6.9E and 1.6.13E).

36. The FSA notes also the generic guidance at MAR 1.2.3(5) which states that a regular user is likely to consider:

> "*the need for market users to conduct their affairs in a manner that does not compromise the fair and efficient operation of the market as a whole or unfairly damage the interests of investors".*

37. The FSA regards the behaviour described above as having led to market distortion because the normal market forces of supply, including sellers taking short positions, depends upon the reasonable expectation of market users that the selling party will be in a position to settle transactions in a timely fashion. If sellers cannot settle transactions in a timely fashion, or at all, because they have short sold beyond the level for which they have a reasonable settlement plan, then this will inevitably distort the market for those shares at the point of sale because the expectation of timely delivery on the part of investors who enter into that market and contract to buy shares will not be met. The distortion is subsequently evidenced by the disruption to settlement so that investors are denied delivery, in a timely fashion or at all.

38. EBG did not have a reasonable settlement plan to cover its short position of 252%, when it relied upon either a possible future issue of shares or a possible insolvency of Room Service.

39. Investors in Room Service contracted to buy many more shares than were in fact in issue. The distorted nature of the market was only generally appreciated when the settlement problems arose. (Room Service's Nominated Adviser alerted the LSE to the potential settlement problem on 17 October, having observed the volume of trading in Room Service shares.)

40. In their conduct, EBG and Mr Potts failed to consider the need for market users to conduct their affairs in a manner that does not compromise the fair and efficient operation of the market as a whole or unfairly damage the interests of investors.

41. The FSA considers that the regular user in this case should be given the attributes of the average investor in AIM. The FSA is of the view that the regular user would expect his share transactions to be settled in a timely manner. This is fundamental to the way markets operate. Accordingly, the regular user in these circumstances would not expect the non–settlement of shares for which he had contracted and would not consider it reasonable that a market maker had sold short more shares then were in fact in issue and in respect of which there was no reasonable settlement plan.

42. The FSA therefore is of the view that such behaviour would be deemed by the regular user to have fallen below the standards expected of a firm in EBG's position and to have fallen below the standards expected of a person in Mr Potts' position.

43. The FSA is also of the view that there are no reasonable grounds for it to be satisfied that Mr Potts believed on reasonable grounds that his behaviour did not amount to market abuse.

Penalty

44. In determining the appropriate level of penalty in this case, the FSA has had regard to Chapter 14 of the Enforcement Manual ("ENF 14"), headed *Sanctions for Market Abuse*.

45. In enforcing the market abuse regime, the FSA's priority is to protect prescribed markets from any damage to their efficiency caused by distortion to the market. The effective and appropriate use of the power to impose penalties for market abuse will help to maintain confidence in the UK financial system by demonstrating that high standards of market conduct are appropriately enforced in the UK financial markets. The public enforcement of these standards also furthers the public awareness of the FSA's protection of consumers' objective, deterring future market abuse (ENF 14.1.3).

46. In accordance with the FSA's published policy (ENF 14.4) in determining whether to take action in respect of market abuse, and in determining the level of any proposed penalty, the FSA has regard to all the circumstances, including the nature and seriousness of the abuse, the persons' conduct following the abuse, the nature of the market that has been abused, the likelihood of abuse of the same type being repeated and the need to deter such abuse, and the previous history of the persons concerned.

47. This is the first case in which the FSA has imposed a financial penalty in respect of market distortion amounting to market abuse.

48. The FSA has taken all the relevant circumstances into account in deciding that it is appropriate to impose a financial penalty in this case and that the level of the penalty is proportionate. The FSA has particular regard to the guidance set out in ENF 14.4, 14.6 and 14.7 and to the following considerations:

    i the total net consideration from the trading was approximately £247,000. EBG's actual approximate gross profit from its trading was £80,000. The FSA would normally seek to impose a penalty that at a minimum deprived EBG and Mr Potts of any benefits that they gained from the market abuse. The FSA has also taken into account the fact that EBG has paid out approximately £151,568 in respect of the settlement plan;

    ii investors in the Small Cap AIM market, as with any investors in shares traded on regulated markets, need to have confidence in the integrity of the processes by which shares are traded on the market. Mr Potts and EBG did not give appropriate regard to the timely settlement of the short positions nor to the interests of buyers of Room Service shares. The FSA therefore considers it essential that the penalty imposed should be such as not only to deprive EBG and Mr Potts of any gains arising from the abusive behaviour but also to act as a powerful incentive to others to refrain from such abuse;

iii the market impact of the distortion has been considered by reference to the market capitalization of Room Service at the time of the short selling which was approximately £100,000. In relation to this relatively small market capitalization, the FSA considers that the distortion had a significant market impact on the market in that approximately 250 investors did not receive their shares in a timely manner;

iv the behaviour of EBG and Mr Potts was unreasonable: the short selling was carried out under the supervision of an experienced market maker who was head of market making and was an approved person at an authorised firm. The FSA considers that a reasonable person in such a position would have guaranteed a source of stock borrowing in relation to a short position of even a fraction of a company's issued share capital. However, Mr Potts failed to borrow any Room Service stock and did not give appropriate regard to whether or not the short positions could be settled in a timely fashion;

v the seriousness of the market abuse is aggravated by the fact that market making firms and individual market makers are at the heart of share trading on regulated markets. Distortive practices by market makers undermine investors' confidence in markets such as AIM as well as undermining their efficiency and orderliness. Therefore the levels of penalty are designed in part to deter future conduct of this nature and to register the FSA's view of the seriousness of this conduct;

vi in fixing the penalty in relation to Mr Potts, the FSA has taken into account that the abusive behaviour could have been avoided if EBG's controls had prevented a short position of the size that occurred in this case being built up without reference to senior management (such a limit has now been introduced.) Similarly, if inquiries had been made of Mr Potts about his proposed trading, at the time he sought advice on the existence of limits on short selling, the risk of market abuse might have been identified;

vii EBG has no previous findings of misconduct made against it. After its initial unsatisfactory reaction to the LSE's concerns, and since it realised the seriousness of the situation, EBG has cooperated fully with the FSA's investigation and extensively with the LSE to fully safeguard the entitlements of Room Service shareholders; and

viii Mr Potts is an approved person but has no previous history of regulatory misconduct.

IMPORTANT NOTICES

This Final Notice is given to EBG and Mr Potts in accordance with section 390 of the Act.

Manner of payment

The penalties must be paid to the FSA in full.

Time for payment

EBG and Mr Potts must pay to the FSA by no later than 26 November 2004 the full amounts of the respective penalties specified above.

If the penalties are not paid

If all or any part of the penalties are outstanding after the required date of payment, the FSA may recover the outstanding amount as a debt due to the FSA.

Publicity

Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Final Notice relates. Under those provisions, the FSA must publish such information about the matter to which this Final Notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to EBG or Mr Potts or prejudicial to the interests of consumers.

The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

For more information concerning this matter generally, please contact David Blunt at the FSA (direct line: 020 7066 1608 fax: 020 7066 1609).

Carlos Conceicao
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FSA Enforcement Division