
SEC Proposes to Prohibit Short Selling by Investors Participating in a Securities Offering and Eliminate the “Tick Test” for All Short Sales

2006-12-14

On December 6, 2006, the Securities and Exchange Commission (the Commission) proposed an amendment to Rule 105 of Regulation M under the Securities Exchange Act of 1934 (Exchange Act), as amended, to prohibit conducting certain short selling activities during a specified pre-pricing period in a secondary or follow-on offering.^[i] Further, on December 7, 2006, the Commission proposed to amend Rule 10a-1 under the Exchange Act to remove price restrictions on short sales and prohibit any self-regulatory organization (SRO) from imposing any similar restriction (price tests or price test restrictions).^[ii] In conjunction with the elimination of the price tests, the Commission also proposed to amend Regulation SHO to remove certain order marking requirements.^[iii] For purposes of these pending rule changes, a "short sale" is defined as the "sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."^[iv] The Commission is soliciting comments on all of the proposed amendments, which are due on or before February 12, 2007.

Proposed Amendment to Rule 105 of Regulation M

How the Amendment Would Change Rule 105. Rule 105 currently prohibits a person from **covering** a short sale with securities sold in a securities offering if he or she sold short within five days prior to the pricing of the securities or the period beginning with the filing of the registration statement, whichever is shorter (the restricted period).^[v] In contrast, the proposed amendment would eliminate the prohibition against covering the shorted securities in favor of a broader prohibition against effecting a short sale during the restricted period at all while at the same time purchasing (or entering into a contract for sale for) the same securities in a secondary or follow-on offering. The amended rule would permit (1) investors engaged in short selling **prior to** the restricted period to purchase such security in a secondary or follow-on offering, and (2) other investors to sell short **during** the restricted period, provided they do not purchase, or enter into a contract of sale for, such security in an offering. It should be noted, however, the proposed amendment does not offer an exception permitting those that close out a restricted period short sale, prior to pricing, to participate in the offering.

The proposed amendment is intended to be narrowly tailored to prevent manipulative conduct that impacts the pricing of, and proceeds from, securities offerings; it is not intended to restrict short selling activities in general by market participants.

As with current Rule 105, the primary responsibility for compliance would rest with the person effecting the short sale during the restricted period while seeking to participate in an offering allocation process as an investor. However, broker-dealers (who manage the offering or act as distribution participants) may be held secondarily liable, depending on the facts and circumstances, for aiding and abetting or causing securities law violations by their customers.

Support for the Amendment to Rule 105. Regulation M is intended to protect the independent pricing mechanism of the securities markets so that offering prices result from the natural forces of supply and demand. In furtherance of that goal, Rule 105 addresses the concern that short selling prior to pricing securities in a secondary or follow-on offering artificially depresses market prices, thereby lowering offering proceeds to the issuer. Generally, the offering prices of follow-on and secondary offerings are priced at a discount to a security's closing price (depending on the exchange, the closing transaction price, closing bid price or last sale price) prior to pricing. Accordingly, persons who have a high expectation of receiving securities in an offering may be motivated to capture this discount by aggressively selling short the security just prior to pricing and then covering the short sales with securities received in an allocation at a lower price.^[vi] Such conduct is considered to be in violation of Regulation M.

The Commission appears to be particularly concerned about the numerous recent enforcement actions relating to non-compliance with Rule 105--particularly those trading strategies and structures designed to disguise Rule 105 violations or that accomplish the economic equivalent of activity it seeks to prevent.^[vii] Examples of prohibited activity are as follows:

- Contemporaneous (or nearly contemporaneous) post-offering sales and purchases of the same securities for the same account may be a trading strategy designed to give the appearance that restricted period short sales were not covered with securities obtained through an offering allocation.^[viii] Once the short sale is executed during the restricted period and there is a purchase of, or contract of sale for, the offered securities, the position is economically flat. A contemporaneous or nearly contemporaneous post-offering purchase and sale does not undo the Rule 105 violation.^[ix]
- When a short sale is effected during the restricted period, post-offering limit orders to sell and purchase the offered security at the same price and in the same quantity may be an attempt to mask the fact that the short sale was covered by securities obtained in an offering. Further, the Commission has taken the position that post-offering sales and purchases that have been executed at nearly the same price may be an impermissible strategy. Arguments that a post-allocation secondary market purchase, rather than the shares from the offering allocation, was used to cover the restricted period short sale have been unsuccessful.^[x]
- Maintaining a short position established during the restricted period while simultaneously

maintaining a long position in the security with the shares acquired in a follow-on offering creates a "boxed" position. Offsetting journal entries by a prime broker cancel out the long and short positions, resulting in the economic equivalent to covering the short securities with the long position obtained from an offering allocation.[xi]

- A short sale is effected during the restricted period and covered with offering securities obtained indirectly through an arrangement with a third party who acquired the securities in the offering.[xii]An attempt to do indirectly what one may not do directly nevertheless is a violation of the federal securities laws.
- The linked purchase of securities and a put option to sell an equivalent number of securities may implicate Rule 105 in some respects. This strategy would involve (1) entering into a married put transaction during the restricted period, (2) aggressively selling the underlying securities position as a "long" sale, (3) exercising the puts at the end of the day they are obtained, and (4) using securities obtained in the offering to cover the restricted period sales.[xiii]

The proposed amendment to Rule 105 is the Commission's effort to establish a bright-line rule to prevent non-compliance with Regulation M and to streamline compliance efforts.

Requests for Comment Regarding the Amendment to Rule 105. The Reg M Proposing Release includes numerous areas in which the Commission solicits comments, including the following:

- To determine the net long position, sellers of an equity security must aggregate all of their positions in that security. Under Rule 200(f) of Regulation SHO, however, a registered broker-dealer may establish independent aggregation units amongst its internal trading desks. Should this principle be applied in the context of Rule 105 to non-broker-dealers, including, for example, hedge fund companies? If so, should there be a requirement that the non-broker-dealer be a registered investment adviser or a client of a registered investment adviser for purposes of the excepted transaction?

A Note About Derivatives. Historically, Rule 105 has not been applied to short sales of derivative securities "because an extension of the rule's prohibitions to derivative securities would be inconsistent with the approach of Regulation M, which is to focus on those securities having the greatest manipulative potential." [xv] However, the Commission is interested in receiving comment on how Rule 105 may be implicated in trading strategies involving derivatives that may produce similar effects (e.g., depress the market prices of the underlying equity security and result in lower offering prices) in ways not covered by the current or proposed wording of Rule 105.

Proposed Amendments to Exchange Act Rule 10a-1 and Regulation SHO

Current Exchange Act Rule 10a-1 and Other Price Test Restrictions. Currently, Rule 10a-1(a)(1) under the Exchange Act provides that, subject to certain exceptions, a listed security may be sold short (1) at a price above the price at which the immediately preceding sale was effected (plus tick), or (2) at the last sale price if it is higher than the last different price (zero-plus tick).[xvi] In response to changes in the securities markets since the rule was adopted in 1938,[xvii] the Commission added

various exceptions to Rule 10a-1 and has granted numerous written requests for exemptive relief from its restrictions. Further, because the SROs have been permitted to develop their own price tests, different price tests apply to securities trading in different markets.[xviii]In general, price test restrictions tend to apply only to large or more actively traded securities. The proposed amendments are supported by the increased demand for exemptions from Rule 10a-1 and the concern that they may "create an unlevel playing field among market participants, and allow for regulatory arbitrage."[xix]

Support for the Elimination Short Sale Price Tests. To study the effectiveness of the price tests, the Commission adopted Rule 202T under Regulation SHO to temporarily suspend price tests with respect to certain securities (the Pilot).[xx]Initially, the Pilot ran for one year, during which the provisions of Rule 10a-1(a) and any price test of any SRO for short sales of certain securities were suspended.[xxi]Since then, the Pilot has been extended to April 6, 2007--the date on which temporary Rule 202T of Regulation SHO expires.[xxii]

As a result of the data gathered during the Pilot, the Commission has had the benefit of reviewing extensive economic analyses prior to issuing the proposed amendments. The Commission's Office of Economic Analysis (OEA) produced a staff report regarding the impact of the price tests,[xxiii]and outside researchers provided the Commission with three completed academic studies (Academic Studies).[xxiv]Further, the Commission held a public roundtable focusing on the empirical evidence learned from the Pilot data.[xxv]Based on its review of the Pilot Results, the Commission is proposing to eliminate the tick test under Rule 10a-1 and add Rule 201 under Regulation SHO to further prohibit the development or application of any price test by SROs. The general anti-fraud and anti-manipulation provisions of the federal securities laws, however, would continue to prohibit any short selling activity designed to improperly impact the price of a security.[xxvi]

Requests for Comment Regarding the Elimination of Short Sale Price Tests. The Tick Test Proposing Release includes numerous areas in which the Commission solicits comments, including the following:

Conclusion

Both proposing releases seek to reduce the compliance burdens of broker-dealers by streamlining or eliminating regulatory requirements. Given the pending complete rollout of Regulation NMS in May 2007, it would be important for market participants to provide timely feedback to the Commission to the extent that final guidance is expected to have material implications for their trading technology platforms.

For more information on this or other securities issues, please contact the authors listed above.

[i]See *Short Selling in Connection with a Public Offering*, Exchange Act Rel. No. 54,888 (Dec. 6, 2006), 71 Fed. Reg. 75,002-01 (Dec. 13, 2006) ("[Reg M Proposing Release](#)"). Rule 105 also covers all registered public offerings, including shelf offerings. *Id.* at n.30.

[ii]*Amendments to Regulation SHO and Rule 10a-1*, Exchange Act Rel. No. 54,891 (Dec. 7, 2006), 71 Fed. Reg. 75,068 (Dec. 13, 2006) ("Tick Test Proposing Release"). The operation of the

provisions under Rule 10a-1(a) is commonly described as the "tick test."

[iii]/*Id.* at *66-69.

[iv] 17 CFR 242.200(a); *see also* Reg M Proposing Release, *supra* note 1, at n.3.

[v] Currently, Rule 105 provides that "it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the shorter of: (1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) The period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with such pricing." 17 CFR 242.105.

[vi] Conversely, some persons may effect short sales prior to pricing because they believe the security is overpriced—a true price discovery mechanism for the market and one that should be encouraged. Persons capitalizing on the possibility that the security is overpriced, however, likely are less concerned with the potential to cover the short positions with offering securities at lower prices.

[vii] *See* Reg M Proposing Release, *supra* note 1, at n.18 (listing the following enforcement actions as examples of recent violations of Rule 105 under Regulation M: SEC v. Solar Group S.A. and James J. Todd, No. 06-CV-12936 (S.D.N.Y. Nov. 6, 2006), Litigation Rel. No. 19,899 (Nov. 6, 2006); SEC v. Graycort Financial, LLC, No. C 06-6033 (N.D.CA Sep. 28, 2006), Litigation Rel. No. 19,851 (Sep. 28, 2006); SEC v. Compania Internacional Financiera SA and Yomi Rodrig, No. 05-CV-10634 (S.D.N.Y. Dec. 20, 2005), Litigation Rel. No. 19,501 (Dec. 20, 2005); SEC v. Galleon Management, L.P., Litigation Rel. No. 19,228 (May 19, 2005); DB Investment Managers, Inc., Exchange Act Rel. No. 51,707 (May 19, 2005); Oaktree Capital Management LLC, Exchange Act Rel. No. 51,709 (May 19, 2005); SEC v. Joseph X. Crivelli, Exchange Act Rel. No. 50,092 (Jul. 27, 2004); Ascend Capital, LLC, Exchange Act Rel. No. 48,188 (Jul. 17, 2003); and SEC v. Ethan H. Weitz and Robert R. Altman, Litigation Rel. No. 18,121 (Apr. 30, 2003)).

[viii] The Commission gave the following example: "a person (1) effects a short sale of 5,000 shares during a Rule 105 restricted period, (2) purchases, including enters into a contract of sale for, 5,000 shares of the security in the offering, (3) following the purchase, or entry into the contract of sale, sells 5,000 shares and (4) contemporaneously or nearly contemporaneously purchases 5,000 shares. *Id.* at *14-15. Under this scenario, the violation of Rule 105 may be complete with the purchase of (or execution of sales contract for) securities in the offering at step number 2.

[ix]/*Id.*

Id. at *16.

[xi]/*Id.* at *17.

[xii]/*Id.* at *18 (*quoting* 15 U.S.C. 78t(b)).

[xiii]/*Id.* at n.29 (discussing *Commission Guidance on Rule 3b-3 and Married Put Transactions*, Exchange Act Rel. No. 48795 (Nov. 17, 2003), 68 Fed. Reg. 65820 (Nov. 21, 2003)).

[xiv] 17 CFR 242.200(c).

[xv] Reg M Proposing Release, *supra* note 1, at *23 (quoting *Anti-manipulation Rules Concerning Securities Offerings*, Exchange Act Rel. No. 38067 (Dec. 20, 1996), 62 Fed. Reg. 520, 538 (Jan. 3, 1997)).

[xvi] See 17 CFR 240.10a-1(a); Tick Test Proposing Release, *supra* note 2, at *17.

[xvii] See *Rules for the Regulation of Short Selling*, Exchange Act Rel. No. 1548 (Jan. 24, 1938), 3 Fed. Reg. 213 (Jan. 26, 1938).

[xviii] See, e.g., Nasdaq Rule 3350, New York Stock Exchange Rule 440B, American Stock Exchange Rule 7. Nasdaq Rule 3350 differs from other SRO rules governing the prices at which short sales may be executed on an exchange--Rule 3350 prohibits short sales in Nasdaq Global Market securities at or below the current best (inside) bid displayed in the National Market System when the current best (inside) bid is below the preceding best (inside) bid in the security (commonly known as the "bid test").

[xix] Tick Test Proposing Release, *supra* note 2, at *4.

[xx] See 17 CFR 242.202T; *Short Sales*, Exchange Act Rel. No. 50,103 (Jul. 28, 2004), 69 Fed. Reg. 48,008 (Aug. 6, 2004).

[xxi] *Securities Exchange Act of 1934; Order Suspending the Operation of Short Sale Price Provisions for Designated Securities and Time Periods*, Exchange Act Rel. No. 50,104 (Jul. 28, 2004), 69 Fed. Reg. 48,032 (Aug. 6, 2004); *but see Securities Exchange Act of 1934; Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions*, Exchange Act Rel. No. 50,747 (Nov. 29, 2004), 69 Fed. Reg. 70,480 (Dec. 6, 2004) (order resetting the pilot to commence on May 2, 2005 and end on April 28, 2006, to give market participants additional time to make systems changes necessary to comply with the Pilot).

[xxii] *Order Extending Term of Short Sale Pilot*, Exchange Act Rel. No. 53,684 (Apr. 20, 2006), 71 Fed. Reg. 24,765 (Apr. 26, 2006).

[xxiii] See Office of Economic Analysis, U.S. Securities and Exchange Commission, *Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot* (Sep. 14, 2006), available at http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf. "In summary, OEA found little empirical justification for maintaining price test restrictions, especially for large securities. Despite changes in the displayed liquidity, all securities in the study had about the same realized liquidity and pricing efficiency whether or not price test restrictions apply. When OEA examined the differences between large and small securities, the most interesting pattern showed that price test restrictions actually amplify volatility in large securities while dampening it in small securities." Tick Test Proposing Release, *supra* note 2, at *40-41.

[xxiv] See Karl Diether, Kuan Hui Lee and Ingrid M. Werner, *It's SHO Time! Short-Sale Price-Tests and Market Quality* (Jun. 20, 2006); Gordon J. Alexander and Mark A. Peterson, *(How) Do Price Tests Affect Short Selling?* (May 23, 2006); J. Julie Wu, *Uptick Rule, Short Selling and Price Efficiency*

(Aug. 14, 2006). "The results of the Academic Studies on volatility and price efficiency were largely consistent with the results in the OEA Staff's Draft Summary Pilot Report. However, the conclusions regarding liquidity differed. For example, some of the Academic Studies found that price test restrictions result in narrower spreads than if these restrictions did not apply. Similarly, some Academic Studies found that bid and ask depths are greater when short sale price test restrictions apply. Thus, according to some of the Academic Studies the Commission received, the Pilot results indicate that removal of price test restrictions may result in a decrease in liquidity. Several panelists at the Regulation SHO Roundtable questioned whether this result, that is, the decrease in liquidity after the removal of price test restrictions, is economically meaningful." Tick Test Proposing Release, *supra* note 2, at *42-43; *see also infra* note 25 below.

[xxv]A transcript from the roundtable, *available at* <http://www.sec.gov/about/economic/shopilottrans091506.pdf>. The OEA staff's report, the Academic Studies and the public roundtable, collectively, are hereinafter referred to as, the "Pilot Results."

[xxvi]Tick Test Proposing Release, *supra* note 2, at *53-54.