Shorting Into Offerings: New SEC Prohibition and New Exceptions

2007-08-16

On August 6, 2007, the Securities and Exchange Commission (SEC or Commission) published amendments to Rule 105 of Regulation M to further limit short selling in connection with secondary and follow-on securities offerings.[1] The effective date of the amended rule is October 9, 2007.

Rule 105 is a prophylactic rule[2] designed to prevent manipulative short selling that may affect pricing in a secondary or follow-on securities offering and to facilitate pricing based on natural market forces. Previously, Rule 105 only prohibited "covering" short sales effected during the restricted period with securities purchased in an offering. Amended Rule 105 deletes references to "covering"; instead, the rule generally makes it unlawful for restricted period short sellers to "purchase" securities in the offering. Thus, the Commission hopes the amended rule will provide a bright line of demarcation of prohibited conduct consistent with the prophylactic nature of the rule. The amended rule also includes three new exceptions relating to *bona fide* purchases prior to pricing, activity in separate accounts and activity of registered investment companies and their affiliates.

Section I below highlights significant aspects of the amended rule. Section II discusses the amended rule and its three new exceptions. Section III discusses suggested controls for "buy-side" market participants who may seek to rely on the separate account exception.Finally, Section IV discusses various steps that broker-dealers active in the new issue allocation process may take in order to limit their secondary liability for aiding and abetting violations under amended Rule 105.

I. Highlights of Amended Rule

Some of the highlights of the amended rule and adopting release are:

- Elimination of the covering component and a corresponding expansion of the rule's prohibition to all purchases of offered securities, unless otherwise excepted;
- Clarification that the scope is limited to offerings of "equity" securities for cash;
- Clarification that the rule does not apply to so-called reference securities;

- Addition of a "*bona fide* purchase" exception, which allows a restricted period short seller to participate in an offering if there is a *bona fide* purchase prior to pricing;

- Addition of an exception for restricted period short sales and purchases of offered securities in separate accounts, if decisions regarding each account are made separately and without any coordination or cooperation between accounts; and

- Addition of an exception for registered investment companies, which permits participation in an offering if an affiliated investment company or any series of such investment company sold short during the restricted period.

II. Amended Rule and New Exceptions

A. Expansion of Restricted Activity

As amended, Rule 105 expands the range of restricted activity associated with certain pre-pricing short selling to all purchases in the offering, unless otherwise excepted. The amended rule is intended to combat the use of trading strategies and structures that, in the Commission's view, obfuscated the prohibited covering under former Rule 105, but replicated its economic effect.[3] The Commission's adopting release refers to attempts to "obfuscate," to "hide," to "conceal," to "disguise," as a justification for amending Rule 105. The Commission, however, does not grapple with the more fundamental question of whether the policy objective for restricting short selling activity in the first place is warranted.

Amended Rule 105(a) now states:

> In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A or Form 1-E ("offered securities"), it shall be unlawful for any person to sell short the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") that is the shorter of the period: (1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.

As seen in the rule language, the Commission determined that offerings under Regulation A and Regulation E of the Securities Act of 1933 (Securities Act) should be treated identically under the rule, as both offerings raise the same manipulative concerns at which the rule is directed.

The Commission also took the opportunity to clarify some aspects of the rule. First, the amendments clarify that the scope of the rule is limited to offerings of "equity" securities for cash. The Commission, however, intends to continue to monitor whether trading patterns in debt securities raise manipulative concerns in connection with debt offerings.[4] Second, the Commission clarified that the rule does not apply to reference securities.[5] Therefore, in an offering

of securities convertible into common equity, even though the convertible securities are themselves equity securities, a person may still sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105. The Commission noted that while, for purposes of amended Rule 105, the underlying common equity is not the subject of the convertible securities offering, sellers should be aware that the registration provisions of the Securities Act may still apply to both the convertible security and the underlying equity security at the time of the offering.[6] The amended rule also continues to retain the exception for best efforts offerings.[7]

The Commission cautioned that any transaction or series of transactions, whether or not subject to the provisions of amended Rule 105, continue to be subject to the anti-fraud and anti-manipulation provisions of the federal securities laws. The Commission also reminded market participants intending to purchase offered securities that selling short the same securities prior to the offering continues to be subject to the registration requirements of Section 5 of the Securities Act.[8]

B. Exception—Prior *Bona Fide* Purchase

In an attempt to avoid unduly restricting capital formation or short sales, amended Rule 105(b)(1) allows restricted period short sellers to purchase securities in the offering **if** they also make a *bona fide* purchase of the security.[9] To qualify as *bona fide,* the purchase must be:

(1) at least equivalent in quantity to the **entire amount** of the Rule 105 restricted period short sale(s) (e.g., a short sale for 1,000 shares, a purchase of 500 shares prior to pricing, and a purchase of 500 shares in the offering would **not** qualify);

(2) effected during regular trading hours;

(3) reported to an "effective transaction reporting plan;"[10] and

(4) effected **after** the last Rule 105 restricted period short sale, and no later than the business day **prior** to the day of pricing.

The adopting release noted that the timing requirement may make the exception unavailable in a true "overnight deal," when an offering commences after the close of regular trading on the day of pricing. It would not be possible for a *bona fide* purchase to be effected because the last business day prior to the day of pricing would have already occurred. Finally, the person seeking to rely on this exception may not engage in any Rule 105 restricted period short selling activity within the 30 minutes prior to the close of regular trading hours[11] on the business day prior to the day of pricing.

C. Exceptions—Separate Accounts and Investment Companies

Commenters on the proposed rule highlighted difficulties surrounding the rule's application to more complicated structures, such as a fund within a fund complex, each series of a series fund, or each sub-advised portion of a single fund. To help address these concerns, the Commission applied the principles of Rule 200(f) of Regulation SHO concerning aggregation units to amended Rule 105[12], and created two new exceptions for separate accounts and investment companies.

(1) What is an "account"?

The term "account" is not defined in amended Rule 105(b)(2). The Commission noted in the adopting release, however, that it is using the term "account" as a "general term that may encompass the separate accounts that commenters described in many different ways," including "portions of a particular fund," "units," "departments," and "identifiable divisions."[13] The Commission also noted that it is not necessary for the accounts to have separate legal identities and taxpayer identification numbers.[14] This is consistent with the aggregation unit concept in Regulation SHO.[15]

(2) Separate Accounts

Amended Rule 105(b)(2) permits a purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a separate account—even if the accounts are affiliated or otherwise related—as long as the decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts. The adopting release provided a non-exclusive list of indicia of separate accounts:

(a) The accounts have separate and distinct investment and trading strategies and objectives;

(b) Personnel for each account do not coordinate trading among or between the accounts;

(c) Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;

(d) Each account maintains a separate profit and loss statement;

(e) There is no allocation of securities between or among accounts; and

(f) Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, or account owners of multiple accounts do **not**: (i) have authority to execute, or actually execute, trades in individual securities in the accounts; and (ii) have authority to pre-approve, or actually pre-approve, trading decisions for the accounts.[16]

The Commission noted, however, that whether separate accounts meet the exception is a facts and circumstances test. Thus, accounts may fall within the exception even if they do not meet all of the conditions.[17]

Utilizing these principles, the Commission outlined examples of persons eligible for the separate account exception:

- **Individual Investor with Multiple Accounts**: An individual investor who invests capital in two or more accounts and grants full discretionary trading authority to the respective managers of each account, if the individual investor cannot coordinate trading between the accounts

or make investment decisions for the accounts, and the managers do not coordinate trading between the accounts.

- **Adviser That Provides Capital to Multiple Parties**: An adviser that provides capital to two or more advisers or private investment funds, if the funds are separate legal entities, maintain different accounts and separate profit and loss statements, and do not coordinate trading or share information or allocate securities between the accounts.

- **Money Manager That Provides Capital to Separate Advisers**: A money manager that provides capital to two separate advisers, if the funds managed by the advisers are separate legal entities, competitive with one another, maintain different accounts and separate profit and loss statements, and do not coordinate trading or share information or allocate securities.

- **Black Box Trading**: An adviser that operates a black box using a trading algorithm, if the black box is separate from another black box or another trading unit.

- **Multiple Sub-Advisers Subject to Primary Adviser's Supervision**: If there are multiple sub-advisers to a registered investment company that are subject to the supervision of a single, primary investment adviser, each sub-advised portion of that fund or series of fund may be able to rely on the exception if: (i) the sub-advisers meet the elements of Rule 17a-10(a)(1)-(2) under the Investment Company Act of 1940 (Investment Company Act); and (ii) the primary investment adviser for the fund or series neither executes trades in individual securities nor pre-approves trading decisions for the sub-advised portions.

The adopting release noted that a fund that invests in multiple funds and owns shares of each fund, rather than shares of each fund's underlying investments, will likely not need to rely on this exception (e.g., a hedge fund that invests in other unaffiliated hedge funds and does not coordinate trading activity of the funds). In such cases, the shares of each fund are different securities from the underlying securities.

(3) Investment Companies

Section 17(d) and Rule 17d-1 of the Investment Company Act generally prohibit concerted action between funds in a complex and between different series of the same fund. Because these provisions help prevent persons from engaging in activities that Rule 105 seeks to prohibit, the Commission adopted a new exception for registered investment companies. Under amended Rule 105(b)(3), an investment company[18] registered under Section 8 of the Investment Company Act or a series of such company may purchase a security in an offering where any of the following sold the offered security short during the Rule 105 restricted period: (i) an affiliated investment company or any series of such company; or (ii) a separate series of the investment company.

III. Suggested "Buy-Side" Controls for Separate Account Exception

Buy-side market participants intending to rely on the separate account exception may consider adopting a number of internal controls and procedures, including the following, in order to ensure compliance with amended Rule 105:

- Draft a written plan of organization that documents the separate and distinct investment and trading strategies of the accounts;
- Implement system-based access limitations to prevent sharing of position and pending order information across separate accounts;
- Prohibit or carefully monitor the journaling of positions between accounts;
- Employ separate personnel with decision-making authority regarding trading activity in different accounts and provide them with appropriate training;
- Restrict personnel with management or oversight responsibility from: (i) executing trades in separate accounts; (ii) pre-approving trading decisions for the accounts; and (iii) allocating securities between or among accounts;
- Develop surveillance procedures or exception reports that detect potential red flags involving coordinated trading strategy between accounts; and
- Conduct periodic reviews of the controls, including reviewing for evidence of coordination or cooperation between accounts and for trading activity that appears to be inconsistent with the stated strategy or objectives of the account, and appropriately document any such reviews.

As previously noted, however, the Commission has repeatedly stated that technical compliance with the rule is insufficient if the transaction has the economic effect of the activity Rule 105 is designed to prevent in the Commission's view.[19] A *bona fide* economic purpose test is difficult to apply in hindsight. But, in order to meet the Commission's standards, firms will need to develop robust mechanisms to identify potential parallel economic effects that may violate the amended rule.

IV. Suggested "Sell-Side" Controls to Help Avoid "Aiding and Abetting" Liability

In the proposing release, the Commission noted that, while compliance with Rule 105 rests with the restricted period short seller, "broker-dealers may be charged, depending on the facts and circumstances, for aiding and abetting or causing securities law violations by their customers."[20] The Commission did not elaborate on this point in adopting the rule amendments.

The brighter line of demarcation under amended Rule 105 should make it easier for firms to surveil for potential violations. To that end, firms may consider adopting the following internal controls and procedures:

- For broker-dealers who are active in the allocation process, obtain a representation from

customers that any short sales and subsequent purchases of securities in secondary and follow-on offerings will comply with Rule 105.[21]

- Surveil for failures to deliver securities on purported "long sales," which could indicate false marking activity in order to disguise restricted period short selling; and

- Develop surveillance procedures or exception reports for accounts that receive offered securities through multiple accounts with patterns of journaling between or among such accounts.

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

---

[1] The Commission voted to amend Rule 105 on June 20, 2007, but the release was not published until August 6, 2007. *See* SEC Pres Release No. 2007-120 (June 21, 2007); Exchange Act Release No. 56,206 (Aug. 6, 2007), 72 Fed. Reg. 45,094 (Aug. 10, 2007) (adopting release). The amended rule was published for comment on December 6, 2006. *See* Exchange Act Release No. 54,888 (Dec. 6, 2006), 71 FR 75,002 (Dec. 13, 2006) (proposing release).

[2] The Commission notes that the rule is "prophylactic" apparently in order to avoid potential scienter-based defenses and implicitly justify its "bright-line" test rather than presenting a rigorous cost-benefit analysis to justify the mechanical line drawing.

[3] The Commission specifically pointed out that derivatives have been used to conceal, in its view, Rule 105 violations by attempting to disguise a short sale as a long sale. Accordingly, the Commission stated that it will continue to monitor for the use of derivative strategies that may replicate the economic effect of the activity the rule is designed to prevent. *See* 72 Fed. Reg. at 45,102.

[4] *See* 72 Fed. Reg. at 45,101.

[5] Reference security means a security into which a security that is the subject of a distribution (subject security) may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security. *See* 17 C.F.R. § 242.100(b).

[6] *See* 72 Fed. Reg. at 45,101.

[7] The adopting release specifically noted that PIPE offerings not conducted on a firm commitment basis continue to be excepted from Rule 105. *See* 72 Fed. Reg. at 45,096, fn. 41.

[8] *See* 72 Fed. Reg. at 40,596; *see also*,e.g., *SEC v. Joseph J. Spiegel*, Civil Action No. 1:07CV00008 (RCL) (D.D.C.).

[9] In the adopting release, the SEC reminds market participants that, regardless of technical compliance with the exception's requirements, any transaction that is part of a plan or scheme to

evade the rule would not be considered *bona fide* (e.g.,a transaction that does not include the economic elements of risk associated with a purchase for value). *See* 72 Fed. Reg. at 45,097.

[10] An “effective transaction reporting plan” is defined in Rule 600(b)(22) of Regulation NMS.

[11] The term “regular trading hours” is defined in Rule 600(b)(64) of Regulation NMS.

[12] Currently, only broker-dealers may utilize independent aggregation units in determining their net position under Regulation SHO. Broker-dealers that have aggregation units should review their existing policies and procedures to ensure they are consistent with the factors outlined in the adopting release.

[13] *See* 72 Fed. Reg. at 45,098, fn. 64.

[14] *See id.* at 45,099.

[15] *See* Letter regarding Bear, Stearns & Co. Inc., *et. al*. (November 23, 1998), 1998 SEC No-Act LEXIS 1038 (granting exemptive relief to aggregation units comprised of separate, identifiable trading units or trading desks).

[16] The Commission noted that, in some circumstances, a manager allocating offering shares to an account that has a restricted period short sale would be in violation of Amended Rule 105. Thus, if the allocation is effected by a formula or predetermined basis, an account that has a restricted period short sale **must not** receive the offering shares. *See* 72 Fed. Reg. at 45,099.

[17] The Commission noted that it will consider specific requests for exemptive relief on case-by-case basis.

[18] An “investment company” is defined in Section 3 of the Investment Company Act.

[19] *See also*, Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48,008 (Aug. 6, 2004) (stating that “where the transaction is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk, that transaction may be a sham transaction that violates Rule 105.”); Securities Exchange Act Release No. 48795 (Nov. 17, 2003), 68 Fed. Reg. 65,820 (Nov. 21, 2003) (providing guidance concerning the use of married puts as part of an attempt to create a "long" position for the purpose of circumventing Rules 10a-1 and 105 of the Exchange Act).

[20] *See* 71 Fed. Reg. 75,002, 75,005.

[21] In the proposing release, the SEC asked whether potential investors in an offering should be required to "give an underwriter a certification that they have not effected and will not effect a short sale during the Rule 105 restricted period." SIFMA and other commenters objected to the certification on a deal-by-deal basis because, among other things, it may implicitly shift the burden of complying with the rule to underwriters, and it would impose significant delays on the allocation process. *See*, e.g., Letter from Securities Industry and Financial Markets Association (Feb. 13, 2007). Nevertheless, obtaining a prospective representation from customers as part of its policies

and procedures may help protect a firm from secondary liability in this uncertain arena.