

Rule 105 update

New round of enforcement highlights SEC approach on short-selling violations

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The Enforcement Division of the U.S. Securities and Exchange Commission (SEC) continued its “Rule 105 initiative” this year, culminating in settlements with six firms that total more than \$2.5 million in monetary sanctions, in addition to other sanctions. These cases highlight important components of the SEC’s approach to Rule 105 enforcement. Fund managers should review their policies with regard to Rule 105, stress test the actual procedures that support those policies, and redouble their surveillance and education efforts to ensure compliance.

Background of Rule 105

Rule 105 is intended to avoid the downward pressure on the price the issuer sets for its offering that may result from short sales soon before the pricing. It is also intended to curtail the ability of firms to unfairly increase their profits by selling short when the security’s price is high and then covering those short sales in the depressed-price offering. Rule 105 of Regulation M applies to:

- Firm-commitment, underwritten offerings
- Of an equity security
- That is offered for cash
- Pursuant to a registration statement

Rule 105 prohibits selling short such a security within the five business days “before the pricing” of an offering and then purchasing securities through that offering. The practical result of the rule is that a fund may sell short in advance of the offering (during the restricted period) or may participate in the offering but must not do both, absent an exception.

While Rule 105 offers certain exceptions, the exceptions are technical and precise and must be strictly followed to provide protection from liability. One exception is the “bona fide purchase” exception, in which the fund initially sold short but then covered all the short sales “no later than the business day prior to the day of pricing” through trades conducted during regular trading hours and reported to “an effective transaction reporting plan.” Other exceptions avoid liability where the short selling and the offering purchases were conducted by independent accounts or investment companies.

SEC Enforcement Activity

Each year, beginning in 2013, the SEC has actively pursued “every Rule 105 violation over a de minimis amount that has come to its attention.” The SEC pursues these violations in annual “rounds,” investigating suspected Rule 105 violations and bringing enforcement actions as it finds warranted.

Rule 105 is a strict liability regulation, meaning that a fund or individual is still liable even if there is no indication of wrongful intent or a conscious strategy to manipulate the market. Further, the SEC has pursued violations even when the trades at issue add up to only a modest amount. Despite the modest amount of the trades, the SEC requires violating firms to not only “disgorge” profits received from the trades but also pay additional sanctions of prejudgment interest and civil monetary penalties. Beyond any monetary penalty, the SEC’s finding that a firm violated the securities laws creates an ongoing obligation for the fund to disclose that violation in certain securities filings and in certain transactions.

The six newly-settled enforcement actions illustrate the broad range of conduct the SEC considers as violating Rule 105:

- Even a single violation is sufficient for the SEC to pursue all the way to an enforcement action (Harvest Capital Strategies LLC; Omega Advisors Inc.).
- Rule 105 covers trading for affiliates, as well as for clients of the party trading (J.P. Morgan Investment Management Inc.).
- The SEC takes an aggressive view in calculating “profits.” Where a firm violates Rule 105 and purchases more securities in the offering than it sold short, the SEC considers the difference between the market price and the offering price to be illicit profit because the offering price is at a “discount” (Sabby Management LLC).
- Transactions can violate Rule 105 even if the offering price is higher than the short-sale price (Auriga Global Investors Sociedad de Valores S.A.).
- Foreign firms are subject to Rule 105 jurisdiction and enforcement actions (Auriga Global Investors Sociedad de Valores S.A.).
- The SEC expects firms to fully cooperate with investigations of Rule 105, including conducting self-reviews of prior trading that may have violated Rule 105. When firms have refused to do so, the SEC has undertaken further investigation and imposed enhanced penalties (War Chest Capital Partners).

Conclusion

The SEC has indicated it will continue to pursue Rule 105 violations to enforce its “zero tolerance” policy. It is incumbent upon fund managers to review their policies and procedures to ensure compliance with Rule 105.

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