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Alert

SEC Enforcement Division Increases the Pace of Rule 105 Investigations

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The Enforcement Division of the Securities and Exchange Commission ("SEC") recently increased the pace of investigations of potential violations of Rule 105 of Regulation M under the Securities Exchange Act of 1934. Rule 105 makes it unlawful for any person during the "Rule 105 restricted period" to "sell short" an equity security that is being offered for cash pursuant to a registration statement in a firm-commitment, underwritten offering and purchase the offered securities. Hedge fund managers should review their compliance with the Rule.

Background of Rule 105

Rule 105 charges involving hedge fund managers have increased since 2007 when the Rule was amended to make it easier for the SEC to prove a violation. Prior to the amendment, Rule 105 prohibited a manager from selling short ahead of an offering and then using the shares purchased in the offering to cover the short position. The 2007 amendments made the rule simpler — now, a manager may either short within the restricted period, or participate in the offering, but may not do both.

There are limited exceptions to Rule 105 that may apply: (1) a "bona fide purchase" exception if the manager covers the restricted period shorts no later than one business day prior to the day of pricing of the offering; and (2) a "separate accounts" exception if the manager is advising separate accounts, where one sells short and the other participates in the offering. A critical note for both exceptions, and the Rule generally, is that the requirements are technical and precise — the Rule and related guidance must be carefully analyzed to assure compliance.

The SEC views Rule 105 as a prophylactic rule which does not require any showing that the manager intended to manipulate the price of the securities sold short, or that the short selling had that effect or even could have had that effect in the circumstances. Charges against fund managers have been brought even where there was a single offering at issue and where the number of shares traded was relatively modest.

Enforcement's New Approach

The SEC's Enforcement Division has recently sought information from a number of hedge fund managers related to potential Rule 105 violations. The staff of the Enforcement Division appears to be taking a more uniform and streamlined approach in these instances. Specifically, the request from the SEC typically focuses on a small number of offerings in which funds or accounts managed by the adviser participated, after having recently sold short. The information sought by the staff with respect to the particular trades at issue may be more detailed, and the request may be for it to be produced in a standardized chart or spreadsheet format, at least initially. Information about the personnel involved in the relevant trading, and applicable compliance policies and procedures may be requested. The staff may also in its initial request ask the manager to review its trading in all securities for a period of years for potential Rule 105 violations. Finally, the request may indicate that the manager may include a narrative description as to why charges are not appropriate or if there are mitigating circumstances.

To be prepared for this type of letter from the SEC's Enforcement Division, hedge fund managers should review their compliance with Rule 105 and take any appropriate steps to improve their compliance with the Rule.

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