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White Paper

Trading and Compliance Issues Under Rule 105

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One continual source of concern for registered investment advisers and other managers who actively trade in the public equity markets is compliance with Rule 105. Rule 105[1] is part of Regulation M, which is a long-standing set of U.S. Securities and Exchange Commission (the "SEC") rules governing the activities of — among others — underwriters, issuers and selling security holders in connection with offerings of securities.

While Regulation M covers a fairly wide spectrum of activities related to public offerings, Rule 105 is focused on one specific area of potential abuse, namely short selling prior to a follow-on public offering. The rule addresses short selling by traders who seek to cover pre-existing short positions with securities purchased in the public offering. The SEC was concerned that such short sellers, left unchecked, could potentially sell (short) at a higher price than the final offering price and cover the short positions with cheaper shares purchased in the offering, all without assuming significant exposure to market risk in exiting the transaction. The SEC guidance also evidenced derivative and systemic concerns, positing that excessive pre-offering short selling could contribute to a reduction in the offering price for an issuer's securities and a reduction in proceeds realized by issuers.[2]

Understanding Rule 105 is important for investment managers, their in-house legal counsel and compliance officers, and outside counsel to managers. The number of enforcement actions arising from the failure to comply with Rule 105 has risen sharply in recent years and they affect a broad swath of managers, irrespective of domicile or size. A survey of the SEC enforcement activity shows that settlements have been reached with well-known advisers, as well as smaller or less prominent managers, both domestic and foreign. It is also clear that there is no *de minimis* threshold for regulatory scrutiny in this area, with two 2013 cases resulting in a disgorgement amount of less than $10,000.

History and Development of Rule 105

Initial Adoption (1996). As discussed in its 1996 adopting release, Regulation M was "intended to preclude manipulative conduct by persons with an interest in the outcome of an offering."[3] In seeking to carry out that mandate, Regulation M affected a number of practices, including trading restrictions for plans, the stabilizing of transactions and rights offerings.

[1] 17 CFR § 242.105 - Short selling in connection with a public offering.

[2] Securities Exchange Act Release No. 38067 ("Release 34-38067"), Anti-Manipulation Rules Concerning Securities Offerings (December 20, 1996), at text accompanying note 135.

[3] Release 34-38067, at Summary.

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While part of Regulation M's broader mandate, Rule 105 had a narrow focus. In part that was because it was intended to replace an earlier rule, Rule 10b-21,[4] that was specifically targeted at short selling in advance of a registered offering. The new Rule 105, however, differed from the old Rule 10b-21 because it covered only those short sales effected in a restricted period that commenced five business days prior to an offering's pricing and that ended with such pricing. Rule 10b-21, in contrast, contained a restricted period that was defined by reference to the date of the filing of a registration statement or Form 1-A (which could result in a restricted period of variable length).

As initially adopted, Rule 105 did not apply to short sales of derivative securities, because the SEC felt that "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."[5] It also did not expressly prohibit short sellers from "directly or indirectly" covering short sales with securities acquired outside of the offering.[6] Finally, Rule 105 retained an exclusion for shelf-registered offerings (although the SEC noted that it might be necessary to reevaluate that exclusion based on subsequent developments in the availability or frequency of use of shelf registrations).[7]

2007 Amendments. In 2007, the SEC amended Rule 105 "in order to address the proliferation of trading strategies designed to conceal violations of the prior rule and in light of evolving trading strategies."[8]

In particular, the 2007 amendments addressed perceived abuses involving the "covering" of short sales made in the Rule 105 restricted period. The SEC determined that, in the decade following the promulgation of Rule 105, there was an unacceptable level of non-compliance with Rule 105 and, in at least some cases, the development and use of strategies to disguise Rule 105 violations. The SEC characterized these abuses as "attempts to obfuscate the prohibited covering" which contributed to continued violations of the rule, including a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent.[9]

The SEC had proposed to eliminate, and with the adoption of amended Rule 105 did eliminate, the "covering" requirement. Amended Rule 105 made it unlawful to effect a short sale during the Rule 105 restricted period and then purchase the same security in the subsequent offering, effectively repealing the "covering" concept in favor of an economic equivalents test. In other words, subject to certain limited exceptions, the SEC amended Rule 105 to impose a blanket prohibition on participation in a registered firm commitment offering by persons who had effected a short sale in the same securities during the Rule 105 restricted period.

Enforcement Activity. Prior to the 2007 amendments, there was limited publicly-reported enforcement activity surrounding Rule 105; with a very small number of settlements being reported in any given year. Following the 2007 amendments, however, enforcement activity increased markedly and the number of Rule 105 settlements began to rise even more sharply in 2010. From January 2010 to September 2013, the SEC collected over $42 million from disgorgement, civil penalties and pre-judgment interest based on violations of Rule 105.[10]

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[4] Note that a new Rule 10b-21 was adopted in 2008 (in conjunction with Regulation SHO) and which relates to a perceived increase in fails to deliver. *See* Securities Exchange Act Release No. 58774, "Naked" Short Selling Antifraud Rule (October 14, 2008).

[5] Release 34-38067, at text accompanying note 136.

[6] Release 34-38067, at text accompanying note 137.

[7] Release 34-38067, at text following note 137.

[8] U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *National Exam Program Risk Alert: Rule 105 of Regulation M: Short Selling in Connection with a Public Offering* (September 17, 2013) (the "NEP Risk Alert").

[9] Securities Exchange Act Release No. 56206 ("Release 34-56206"), Short Selling in Connection with a Public Offering (August 6, 2007), at text accompanying note 8.

[10] NEP Risk Alert.

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Understanding and Applying Rule 105

As currently in force, Rule 105 prohibits any person from purchasing securities from an underwriter or broker-dealer in a firm commitment equity offering if that person had previously sold short the security that is now the subject of the offering during the Rule 105 restricted period (i.e., the shorter of the period (i) beginning five business days before the pricing of the offered securities and ending at pricing or (ii) beginning at the initial filing of the registration statement and ending at pricing), unless a Rule 105 exception applies.

Identifying Covered Offerings. By its terms, Rule 105 applies only to:

- Firm commitment and underwritten offerings of equity securities.

Identifying a "firm commitment" underwritten offering is therefore essential to Rule 105 compliance. In a firm commitment offering, one or more investment banks agree to act as underwriters and are thereby obligated to purchase a fixed number of securities from the issuer, although they intend to immediately resell all or substantially all of them to the public. This is contrasted with a "best efforts" offering, in which one or more investment banks agree to act as placement agents and do their best to sell the offering to the public; in a best efforts offering, the underwriters are not obligated to purchase or hold unsold securities. (A firm commitment offering that results in the underwriters holding unsold shares of the issuer is referred to as a "sticky" offering.)

However, there is no definition in the rule of what a "firm commitment underwritten offering" is for Rule 105 purposes. Therefore, managers should consider the totality of the specific facts and circumstances of an offering, including situations such as underwriters taking responsibility for specified numbers of shares and the timing and wording of the underwriting agreement.

Compliance Tip:

- In today's capital markets, Compliance Officers should not automatically assume that an offering is a covered "firm commitment" offering. Instead, it is worthwhile to confirm with the selling broker which kind of offering is being conducted (and, ideally, to confirm that answer by referencing the appropriate registration statements on the SEC's EDGAR system).

Rule 105 also applies only to "equity securities." Accordingly, Rule 105 is not applicable to offerings of non-convertible debt, options or other derivatives.

Compliance Tips:

- While non-convertible debt would not fall under Rule 105, convertible debt is itself deemed to be an equity security. Rule 105, however, prohibits only the selling short of the "security that is the subject" of the offering. Managers, however, should consult with legal counsel before participating in an offering of convertible debt if the manager has shorted the related common stock within the Rule 105 restricted period; these actions should be reviewed under the anti-fraud and anti-manipulation provisions of the federal securities laws.

- Similarly, while options and other derivatives are not considered equity securities under the rule, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context.

Identifying Short Sales. Rule 105 makes it unlawful for any person to "sell short," during the Rule 105 restricted period the equity security that is the subject of the firm commitment offering. Rule 105 borrows Regulation SHO's definition of "short sale," i.e., "any 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."[11]

[11] 17 C.F.R § 242.200(a).

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Compliance Tips:

- This can be a subtle point, but the incorporation by reference of the Regulation SHO definition can effectively pull a Manager's "long" and "short" marking procedures into a substantive violation of the federal securities regulations. To ensure Rule 105 compliance, Compliance Officers need to understand, on a granular level, the requirements of Regulation SHO and how the Manager's systems and operations processes calculate long and short exposure and mark orders. This can be quite challenging for more complex managers with multiple products.
- In assessing whether a short sale has been effected, Compliance Officers will want to focus on difficult situations including whether (i) a reduction in a long position is a "long" sale when the portfolio holds a "boxed" short position, (ii) any client portfolios are short uncovered calls that could be exercised within the Rule 105 restricted period, (iii) an existing short position could experience a stock dividend during the Rule 105 restricted period, (iv) rebalancing could be interpreted as a short sale during the Rule 105 restricted period.

Non-U.S. Activity. Rule 105 applies to multinational offerings of securities occurring in part in the United States and to all distribution participants and their affiliated purchasers, wherever they are located or effect transactions. Rule 105 may also apply to foreign short sales effected during the Rule 105 restricted period by a participant in a U.S. offering.

However, in an entirely foreign distribution of a security that has no market in the United States, but whose reference security does have a market in the United States, the foreign distribution is not subject to Regulation M. For example, Rule 105 does not prohibit a short sale of common stock during the Rule 105 restricted period and participation in an offering for ADRs, because they are not the same subject security. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws apply to any transaction effected in the United States.

Compliance Tip:

- Compliance Officers should carefully review multinational offerings and any foreign trading activity during the Rule 105 restricted period before approving participation in any follow-on public offering.

Identifying and Isolating the Restricted Period. As noted above, the "Rule 105 restricted period" is defined as the *shorter* of the period:

- Beginning five business days before the pricing of the offered securities and ending at pricing; or beginning at the initial filing of the registration statement and ending at pricing.

A "business day" under Rule 105 is defined as a 24-hour period determined with reference to the principal market for the securities to be distributed, which includes a complete trading session for the market in question.

Compliance Tip:

- Compliance Officers should have an effective source of *information* about the issuer of the security in order to confirm the "principal market" for the offered securities. This will usually be self-evident, but is worth confirming for a multinational. The source of information can be a direct query at a Bloomberg terminal or it can be in the form of an email from an employee in the operations group or on the trading desk.

The "business day" definition continues to be misunderstood by many market participants, sometimes resulting in inadvertent violations of the rule. The business day on which pricing occurs is the determinant of the time frame, irrespective of whether the market is open at that time; even if pricing occurs after the principal market closes, that day is the day of pricing and, therefore, is included in the Rule 105 restricted period.

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Compliance Tips:

- Compliance Officers should be careful not to assume that "overnight deals" price the next morning; follow-on offerings can price late in the evening, even if the market is closed.
- Calculating the five-day period can be difficult, particularly if the assessment is done after trading hours and with one or more of the affected personnel being out of the office. Some Compliance Officers will utilize a default *six* business day period to segregate situations that need additional consideration.

If the principal market is closed for a holiday, however, that day will not count as a business day within the five business day period; this is because, while a "business day" under Rule 105 is generally defined as a 24-hour period, it must include a complete trading session for the market in question.

Compliance Tip:

- Remember to double check holidays that affect the *principal market* for the issued securities. These could lengthen the restricted period.

For managers utilizing a shorter restricted period that begins with the initial filing of the registration statement or notification on Form 1–A or Form 1–E, other considerations come into play. For example, prospectus supplements containing specific information with respect to the offering that are filed immediately before the offering are not necessarily considered to be the relevant registration statements. In these cases, the *original prospectus,* which might have been filed years before the secondary offering, is considered the registration statement and, therefore, the five business day period preceding the pricing of the offered security would be the shorter of the two periods.

However, Well-Known Seasoned Issuers (the so-called "WKSIs") qualify for automatic shelf registration. Managers must pay special attention to a WKSI's initial filing date, because an automatic shelf registration may be filed immediately before the offering and result in a Rule 105 restricted period that is shorter than a five business day period.

Compliance Tip:

- Any reliance on the shorter "beginning with the initial filing of such registration statement or notification" option needs to be carefully reviewed by counsel (whether in-house or external) experienced in securities offerings. Such counsel should confirm whether the applicable filing is a qualifying "registration or notification" that will trigger a shorter restricted period.

Rule 105 Exceptions

There are three exceptions under Rule 105. These include the "bona fide purchase" provision, an exception for separate accounts, and an exception for investment companies.

Bona fide purchases. The bona fide purchase exception provides that even if a person has shorted during the Rule 105 restricted period, the person can still participate in the offering if a bona fide purchase of the subject security effectively reversed the effects of the short sales.

To qualify as a bona fide purchase, the person must show:

- A purchase of, or purchases that total to, a number of securities at least equal to the number of securities shorted during the restricted period;
- During regular trading hours;
- That is (are) reported; and
- That is (are) effected after all short sales that occurred during the Rule 105 restricted period and no later than the business day prior to the day of pricing.

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This requires that all purchases of the security must be made after the short sale. For example, if pricing occurs on Wednesday after the close of regular trading, the bona fide purchase could not have been made during regular trading on Wednesday. Instead, to qualify as a bona fide purchase, it must have been made during regular trading on Tuesday.

Furthermore, a person relying on the bona fide purchase exception cannot have effected a short sale within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing. Thus, if pricing occurs on a Wednesday after the close of regular trading, the bona fide purchaser could not have shorted in the last half-hour of trading on Tuesday.

Compliance Tip:

- Complying with the bona fide purchase exemption is highly technical. Compliance Officers seeking the protection of this exemption should consider carefully memorializing that she or he obtained written documentary support *for each separate element* of the requirement.

Separate Accounts. The second exception is the separate account exception, which permits the purchase of the offered securities if the person sold short during the Rule 105 restricted period in a separate account. A separate account is defined as an account that operates without coordination of trading and coordination among or between the accounts.[12] The SEC has recognized the following as indicia of separateness:

- Having separate and distinct investment and trading strategies and objectives from the other accounts under management;
- Personnel for each account do not coordinate trading among or between the accounts;
- Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;
- Each account maintains separate profit and loss statements;
- There is no allocation of securities between or among accounts; and
- Persons with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entity do not have authority to execute trades in individual securities of the accounts and do not have the authority to pre-approve trading decisions for the accounts.

An advisor that operates a so-called “black box” trading algorithm can have separate accounts if the black box is separate from another black box or another trading unit.

Compliance Tip:

- The separate account exception is highly dependent on a facts and circumstances analysis and is an area where there are few examples of “safe harbor” guidance from the SEC. Managers that intend to rely on this exemption should assume that the SEC will be very assertive in challenging it and should seek legal counsel prior to its implementation.

Registered Investment Companies. The final exception is the investment company exception, which allows a registered fund to participate in an offering, even if another series of the registered fund or an affiliated registered fund sold short during the restricted period.[13]

No Scienter Requirement; Rule 105 Penalties

Rule 105 does not have a knowledge or scienter requirement. As a result, a person can be liable under Rule 105 even if the person was unaware of a violation of the rule. As long as the SEC can show the person sold short during the restricted time period, that person can be found to have violated Rule 105 (unless a Rule

[12] NEP Risk Alert.

[13] NEP Risk Alert.

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105 exception applies).[14] This even extends to reliance on erroneous legal advice and remedial efforts taken by the investment advisor upon discovery of the rule violation, neither of which will necessarily exculpate the short seller from Rule 105 penalties.[15]

A violation of Rule 105 can result in disgorgement of profits, prejudgment interest and a civil penalty/fine. A survey of the 2013 SEC enforcement actions confirms that Rule 105 violations that result in small disgorgement amounts (e.g., less than $10,000) can still carry hefty civil penalties. For instance, two firms with short sale profits of $4,091 and $8,402, respectively, were each fined $65,000.[16]

Need for Policies and Procedures

Rule 105 violations can occur in any kind of structure, but managers with more complex businesses run higher risks of an inadvertent violation. Unfortunately, there is no “one size fits all” policy that will work for every market participant, but it is clear that successful policies will share at least some of the following attributes:

- Effective and frequent training on Rule 105 with portfolio management staff, trading desk personnel and the compliance team;
- Periodic review and testing of Rule 105 procedures; and
- A multi-disciplinary, real time sign-off procedure for participation in follow-on offerings (and one which is flexible enough to accommodate after-hours decision making but still provides access to the manager’s trading history).

As with all targeted initiatives, the Rule 105 compliance effort should not take place in a vacuum. Compliance officers should, given its multiple dimensions, instead seek to utilize it as a mechanism to promote a broad sense of ownership in the firm-wide compliance effort.

[14] A willful violation of the securities law means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

[15] *See, e.g.,* Vollero Beach Capital Partners LLC, Exchange Act Release No. 34-70408, 2013 WL 5203264 (Sept. 16, 2013) ("Prior to its violation in connection with that offering, Vollero Beach Capital consulted its then-outside counsel and received erroneous advice that Rule 105 did not apply to the type of registration form on which the offering was filed with the Commission").

[16] Credentia Grp., LLC., Exchange Act Release No. 34-70394, 2013 WL 5203250 (Sept. 16, 2013); Merus Capital Partners, LLC, Exchange Act Release No. 34-70405, 2013 WL 5203261 (Sept. 16, 2013).

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