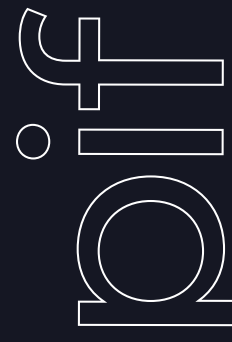
Common Brokerage and Trading Issues



Schulte Roth&Zabel

29TH ANNUAL PRIVATE INVESTMENT FUNDS SEMINAR

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Prior to entering private practice, Derek was an auditor, risk consultant and member of the in-house counsel team at a bulge bracket investment bank. Derek earned his J.D. from the University of Virginia School of Law and his B.S. in accounting from the University of Delaware.

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Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Hon. Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written and spoken about enforcement trends in the private fund space and other industry-related topics. Most recently, he was interviewed for the article "Execution Enforcement Actions Escalate," published in *The Hedge Fund Journal*. Craig earned his J.D., *cum laude*, from the Benjamin N. Cardozo School of Law and his B.A. from the University of Michigan.

Common Brokerage and Trading Issues

I. Short Selling Considerations: Regulation SHO and Regulation M, Rule 105

A. Introduction: Regulation SHO ("Reg SHO") and Regulation M, Rule 105

1. Generally: What Is Reg SHO?

(a) Reg SHO was adopted to address concerns regarding failures to deliver securities sold short, and potentially abusive naked short selling. There are several portions of Reg SHO that impact fund managers.

(b) 17 CFR 242.200(g) defines a "short sale" as "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."

(c) Order Marking and Locates

(i) Reg SHO imposes on short sales of equity securities a marking requirement and a locate requirement. The marking requirement means that sell orders must be marked long or short, and the long or short marking must reflect the net position of the seller. 17 CFR 242.200(g)(1). The locate requirement means that short orders must indicate where the shares sold can be obtained in order to settle the transaction. 17 CFR 242.203.

2. Generally: What Is Regulation M, Rule 105?

(a) Rule 105 makes it unlawful for any person to "sell short," during the "Rule 105 restricted period," 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 in the offering.

B. How Does Reg SHO Apply to Fund Managers?

1. Order Marking and Locates

(a) Reg SHO's order marking and locate rules apply only to broker-dealers, not their customers. But fund managers can still be impacted.

(b) The industry practice for complying with Rule 200(g) in the prime brokerage context "is for an executing broker to reasonably rely on a customer's representation of a 'long' sale, in that the customer's positions are held away at the prime broker." Similarly, broker-dealers are permitted to rely on a customer representation that a short sale is supported by a locate from another source, provided that such reliance is reasonable.[1]

(c) In recent years, the SEC has also looked at the conduct of fund managers transmitting orders to broker-dealers, and whether those fund managers have provided accurate information regarding their net long or short positions in the security, or the availability of a locate, to the broker-dealers handling their orders. Where advisers have inaccurately calculated net aggregate and short positions, and thus misidentified short sales as long, the SEC has charged them with derivatively causing the brokers' Reg SHO violations. The SEC can also bring charges under Rule 10b-21, which makes it a "manipulative or deceptive device or contrivance" to submit an order that deceives a broker-dealer, a participant of a registered clearing agency, such as a prime broker, or a purchaser about its intention or ability to deliver the security on or before the settlement date. *See* 17 CFR § 240.10b-21.

(i) For the purpose of order marking, the SEC has consistently maintained that sellers must aggregate all long and short positions to determine its net position in the security. In order to mark an order "long" the seller must either own, or be in possession of, (through a borrow, for example) the

[1] *See* Q&A 4.3 Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO ("Reg SHO FAQs").

shares sold.

(ii) The SEC has identified three principal ways sellers can violate the order marking or locate rules:

(1) A short seller misrepresents to an executing broker that a "locate" has been obtained from a specific source (who did not actually provide a locate); or

(2) A seller misrepresents to an executing broker that they are "long" the securities being sold (but actually do not own the shares being sold); and

(3) The seller fails to deliver the securities sold on settlement date.[2]

2. How to Comply with Reg SHO

(a) What constitutes "owning" a security for purposes of 17 CFR 242.200?

(i) Exchange Act Rules 200(b)-(f) set out when a person is "deemed to own" a security for purposes of Reg SHO under the Exchange Act. Specifically, a person is deemed to own a security if:

(1) It or its agent has title to it;

(2) The person has purchased, or entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it;

(3) Owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange;

(4) Has an option to purchase or acquired it and has exercised such option;

(5) Has rights or warrants to subscribe to it and has exercised such rights or warrants; or

(6) Holds a security or futures contract to purchase it, has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.

(ii) In addition, Exchange Act Rule 200(c) states that a person is only deemed to own a security to the extent that they have a net long position. For purposes of determining the net long position for persons other than broker-dealers, the person must aggregate all of its positions in the security attributable to the same legal entity (i.e., at the individual fund level) and, pursuant to guidance issued by the SEC's Trading and Markets staff, a seller must generally decrement for all unexecuted sell orders but cannot increase the net long position for unexecuted buy orders.

(b) Order Marking Practical Considerations

(i) Carefully structure and comply with prime brokerage agreements regarding what position and trade information must be supplied to the prime brokers regarding positions.

(ii) Ensure that any trade files provided for the purpose of calculating net positions are accurate and complete.

(iii) Recognize that any short or long designation on an order must reflect the net position of the entity. Ensure long positions with a particular prime broker are netted against any short positions held elsewhere.

(iv) Where multiple prime brokers are used, ensure that trade files produced to each prime broker include all trading activity across all brokers.

(v) In multi-prime arrangements where the seller is net long, arrangements should be made with the relevant prime brokers to ensure free of payment deliveries are made to ensure that orders

[2] 17 CFR 242.200(g) defines a "short sale" as "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.*" (emphasis added).

marked long are not consummated with the delivery of borrowed shares.

(c) Locates

(i) As a best practice, responsibility for locates should be allocated to prime brokers.

(ii) If the manager is responsible for finding locates for any short sales, the locate must be found prior to the entering each short sale order. Standing instruction letters or blanket assurances do not qualify.

(iii) If the manager relies on an "easy to borrow" list to satisfy locate requirement, that list must be current and not stale.

C. How Does Rule 105 of Regulation M Apply to Fund Managers?

1. Protecting the Pricing Mechanisms of the Securities Markets

(a) According to the SEC, "[a] fundamental goal of Rule 105 of Regulation M is protecting the independent pricing mechanisms of the securities markets so that offering prices result from the natural forces of supply and demand unencumbered by artificial forces. The Rule is particularly concerned with short selling that could artificially depress market prices. Generally, the offering prices of follow-on and secondary offerings are set at a discount to a stock's closing price just prior to pricing. A person who expects to receive offering shares may attempt to profit by aggressively short-selling the security just prior to the pricing of the offering, thereby depressing the offering price, and then purchasing lower-priced securities in the offering."[3]

The main text of the rule is as follows.

(i) In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A (§ 239.90 of this chapter) or Form 1-E (§ 239.200 of this chapter) filed under the Securities Act of 1933 ("offered securities"), it shall be unlawful for any person to sell short (as defined in § 242.200(a)) 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.

D. 17 CFR § 240.105

1. Strict Liability

(a) As evident from the text of the rule, Rule 105 is a strict liability rule. If you are participating in a public offering of securities and sell short in the restricted period, a violation has occurred. There is no requirement of any knowledge, let alone scienter to make out a violation. Compliance with Rule 105 is crucial for Fund Managers for a number of reasons.

2. Consequences of Violations

(a) Even a single violation can lead to charges; Rule 105 is not intended to catch only systematic "scams."

(b) Charges can be brought for even trivial amounts, but penalties can be sought in excess of the overall disgorgement.

(c) Rule 105 violations are also required to be reported in certain filings (e.g., 13D, ADV), and Rule 105

[3] *See* OCIE Risk Alert Rule 105 of Regulation M: Short Selling in Connection with a Public Offering, available here.

violations fall under the category of "market manipulation" and can also lead to censure, suspension or a lifetime ban of being associated with an investment advisor or broker-dealer, all of which can cause investor concern and affect your ability to keep and/or raise capital for your funds.

3. Understanding Rule 105 to Avoid Violations

   (a) Rule 105 applies to <u>firm commitment</u> underwritten offerings of equity securities for cash.

   (b) Firm Commitment vs. Best Efforts Offerings

      (i) *Firm Commitment Underwritten Offering*. One or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public.

      (ii) *Best Efforts Offering*. An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities.

   (c) What is the "subject equity security"?

      (i) Rule 105 only applies to equity securities. Thus, an offering on non-convertible debt would not fall under the rule. An offering of convertible debt would fall under the rule as convertible debt is itself an equity security. However, the rule prohibits only the selling short of the "security that is the subject" of the offering, therefore a short sale of the underlying common stock would not prohibit participation in an offering of the convertible debt. However, be careful, the anti-fraud and anti-manipulation provisions of the federal securities laws still apply.

      (ii) Options and other derivatives are not considered the same as the subject equity securities with respect to an offering of common stock under the rule. However, again, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context.

   (d) What is the Rule 105 Restricted Period?

      (i) The shorter of the period:

         (1) Beginning five business days before the pricing of the offered securities and ending at pricing; and

         (2) Beginning at the initial filing of the registration statement and ending at pricing.

      (ii) How do you calculate the five business day period?

         (1) "Business day" refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market.

         (2) If pricing occurs after the principal market closes, then the day of pricing is included in the five-business day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday and end at pricing on the following Thursday.

         (3) *Problems with holidays.* If the principal market is closed for a holiday, then such date will not count as a business day within the five-business day period.

   (e) How do you calculate the period beginning from the initial filing of the registration statement?

      (i) Start with the issuer's initial filing of a registration statement for the secondary offering. Oftentimes this is done well in advance (sometimes years) before the secondary at hand. But sometimes it is done by WKSIs (because they can file an automatic shelf registration statement)

right before the offering, in which case, this period may be shorter than the five-business day period.

(ii) A prospectus supplement containing the specific information with respect to the offering might be filed right before the offering. This is not the initial registration statement.

(f) What is a short sale?

(i) "The term short sale shall mean 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" 17 CFR § 242.200(a). This definition from Reg SHO is imported into Rule 105.

(ii) A person is deemed to own a security when that person:

(1) Has title to it;

(2) Has purchased it pursuant to an unconditional contract, binding on both parties, to purchase it but has not yet received it;

(3) Owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange;

(4) Has an option to purchase it and has exercised the option; or

(5) Holds a security futures contract and received notice that it will be physically settled and is irrevocably bound to receive the underlying security. 17 CFR § 200.242(b).

(g) Unexpected Situations Where You Could End Up Having a Short Sale

(i) As explained in Section II(A)(2)(a) above, short and long determinations are made on a net basis, i.e., you will only be deemed to own a security if you are net long. If you sell securities you own, but your net position is short, you will actually be selling short within the meaning of the statute. In a Rule 105 situation, calculating your net position is crucial to avoiding a violation.

(ii) If you are party to a call contract where the counterparty can force you to sell and you don't already own the underlying security, an exercise by the counterparty can cause you to have a short sale.

(iii) A preexisting short position can be increased by your broker to the extent stock dividends are issued by the issuer and the party you have borrowed from has the right to receive those dividends. It isn't clear whether the SEC would consider such an increase in your short position to be an actual short sale.

(iv) The movement of a short position from one fund to another as part of an internal rebalancing could be deemed to be a short sale, but it is not clear if the SEC could consider such a transaction to be an actual short sale for purposes of Rule 105.

4. Exceptions to Rule 105

(a) Bona Fide Purchases

(i) Even if a person has shorted during the Rule 105 restricted period, they can still participate in the offering if they have a "bona fide purchase" of the subject security:

(1) 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;

(2) During regular trading hours;

(3) That is reported; and

(4) Effected after all short sales that occurred during the Rule 105 restricted period (all purchases

must be after the last short sale to count!) and no later than the business day prior to the day of pricing.

(5) For example, if pricing occurs on Wednesday after the close of regular trading, the bona fide purchase could not be made during regular trading on Wednesday, it would have had to be made during regular trading on Tuesday.

(ii) 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. Continuing with the example above, the person could not have shorted in the last half hour of trading on Tuesday.

(b) *Separate Accounts.* A person is not prohibited from purchasing the offered securities if the person sold short during the Rule 105 restricted period in a separate account. What is a separate account?

(i) Accounts that operate without coordination of trading or cooperation. The accounts should have separate and distinct investment and trading strategies and objectives; personnel for each account do not coordinate trading among or between the accounts; information barriers should be in place so investment decisions are not shared between accounts; accounts should maintain separate profit and loss statements, no allocation of securities between or among accounts and persons with oversight over the accounts do not have authority to execute trades or pre-approve trading decisions and do not in fact do so.

(ii) Similar to Reg SHO's independent trading unit exception, but it is available to anyone, not just broker-dealers.

(iii) The SEC has denied the "separate accounts" exception, even though there were two separate accounts with different strategies and portfolio managers, where information about securities positions and investment decisions were available to all of the firm's employees and sometimes communicated between strategies, the chief investment officer exercised oversight over the firm's multiple strategies and influenced trading decisions within the strategies, and the firm did not prohibit its personnel from coordinating trading between or among strategies.

5. Compliance: How do you ensure that you are not facilitating violations?

(a) Robust Compliance Policies

(i) Fund Managers should have a robust compliance policy in place specifically for Rule 105, discrete from a general anti-manipulation policy.

(ii) These policies and procedures should provide for pre-clearance of all secondary offering allocation requests. At a minimum, pre-clearance should entail:

(1) A determination whether the secondary offering is within the scope of Rule 105;

(2) If so, the delineation of the "restricted period" for purposes of Rule 105; and

(3) The identification of any short sales in the subject security during the restricted period.

(b) Training

(i) Portfolio managers, analysts and traders should have training regarding Rule 105.

(c) Special Precautions for the Separate Accounts Exception

(i) If the separate accounts exemption is being relied upon, both training and policies and procedures should focus upon adherence to the above-mentioned conditions for the exemption.

(d) Periodic Reviews

(i) Consider conducting a quarterly review of selected secondary offering allocations and Rule 105 compliance as a means of back-testing the efficacy of your Rule 105 procedures.

6. Enforcement

(a) In 2013, the SEC announced a Rule 105 Initiative that was designed to pursue "every Rule 105 violation over a *de minimis* amount that has come to its attention — promoting a message of zero tolerance for these offenses."[4]

(b) Since this initiative started, the SEC has fined dozens of firms millions of dollars in monetary sanctions for Rule 105 violations.

II. Execution Considerations for Fund Managers: Best Execution, Rule 606 and Soft Dollars

A. Introduction: Best Execution

1. Best Execution is commonly understood to refer to the duty owed by broker-dealers.

(a) "Brokers are legally required to seek the best execution reasonably available for their customers' orders. To comply with this requirement, brokers evaluate the orders they receive from all customers in the aggregate and periodically assess which competing markets, market makers, or electronic communications networks (ECNs) offer the most favorable terms of execution. Some of the factors a broker must consider when seeking best execution of customers' orders include: the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood that the trade will be executed."[5]

2. Best Execution for Fund Managers

(a) The SEC has made clear that registered Investment Advisers, as a part of their fiduciary duties to their clients, must consider best-execution. "[W]hen an adviser has the responsibility to select broker-dealers and execute client trades, the adviser has an obligation to seek to obtain "best execution" of client transactions, taking into consideration the circumstances of the particular transaction. An adviser must execute securities transactions for clients in such a manner that the client's total costs or proceeds in each transaction are the most favorable under the circumstances. In directing brokerage, an adviser should consider the full range and quality of a broker-dealer's services including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser."[6]

B. What are an adviser's obligations with respect to best execution?

(a) A 2018 Risk Alert from the SEC Office of Compliance Inspections and Examinations provides useful guidance on what the SEC expects of Advisers with respect to best execution. The Risk Alert identified certain categories of repeat deficiencies it found in examinations of Advisers. Included in these were deficiencies relating to how the Advisers reviewed the best execution provided by brokers, as well as client disclosure deficiencies involving best execution, and inadequate compliance policies and procedures.

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[4] *See,* SEC Press Release, "SEC Charges Six Firms for Short Selling Violations in Advance of Stock Offerings," available here.

[5] SEC Fast Answers: Best Execution, available here.

[6] SEC OCIE Risk Alert, "Compliance Issues Related to Best Execution by Investment Advisers," July 11, 2018, available here (hereinafter (OCIE Best Execution Alert).

2. Deficiencies Relating to Evaluating Best Execution by Brokers:

   (a) Failing to Perform Best Execution Reviews

      (i) "The staff observed advisers that could not demonstrate that they periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions. For example, the staff observed advisers that did not conduct an evaluation of best execution when selecting a broker-dealer to execute transactions or were unable to demonstrate, through documentation or otherwise, that they performed such an evaluation."[7]

   (b) Performing Best Execution Reviews that Were Not Adequate

      (i) "The staff observed advisers that did not consider the full range and quality of a broker-dealer's services in directing brokerage. For example, the staff observed:

         (1) Advisers that, as part of their best execution reviews, did not evaluate any qualitative factors relating to a broker-dealer including, among other things, the broker-dealer's execution capability, financial responsibility, and responsiveness to the adviser.

         (2) Advisers that, as part of their best execution reviews, did not solicit and review input from the adviser's traders and portfolio managers."[8]

   (c) Not Comparing Brokers' Performances Or Seeking Robust Comparisons in Evaluating Brokers

      (i) "The staff observed advisers that utilized certain broker-dealers without seeking out or considering the quality and costs of services available from other broker-dealers. For example, the staff observed:

         (1) Advisers that utilized a single broker-dealer for all clients without seeking comparisons from competing broker-dealers initially and/or on an ongoing basis to assess their chosen broker-dealer's execution performance.

         (2) Advisers that utilized a single broker-dealer based solely on cursory reviews of the broker-dealer's policies and prices.

         (3) Advisers that utilized a broker-dealer based solely on that broker-dealer's brief summary of its services without seeking comparisons from other broker-dealers."[9]

   (d) Deficiencies Relating to Best Execution Disclosures

      (i) Not fully or accurately disclosing best execution practices

         (1) "The staff observed advisers that did not provide full disclosure of best execution practices. For example, the staff observed advisers that did not disclose that certain types of client accounts may trade the same securities after other client accounts and the potential impact of this practice on execution prices. In addition, the staff observed advisers that, contrary to statements in their brochures, did not review trades to ensure that prices obtained fell within an acceptable range."[10]

   (e) Not Properly Disclosing "Soft Dollar" Arrangements[11]

[7] OCIE Best Execution Alert at 2.

[8] *Id.*

[9] *Id.* at 2-3.

[10] *Id.* at 3.

[11] Advisers that "receive research or other products or services other than execution from a broker-dealer or a third party in connection with client securities transactions" (known as "soft dollar benefits") must disclose that fact and discuss whether those benefits create conflicts of interest. *See* Part 2A of Form ADV, Item 12.A.1.

(i) "The staff observed advisers that did not appear to provide full and fair disclosure in Form ADV of their soft dollar arrangements. For example, the staff observed:

(1) Advisers that did not appear to adequately disclose the use of soft dollar arrangements.

(2) Advisers that did not disclose that certain clients may bear more of the cost of soft dollar arrangements than other clients.

(3) Advisers that did not appear to provide adequate or accurate disclosure regarding products and services acquired with soft dollars that did not qualify as eligible brokerage and research services under the Section 28(e) safe harbor."[12]

(f) Disclosure and allocation issues relating to "mixed use" products or services. Mixed use products or services are those obtained from a broker-dealer in connection with client securities transactions which do not qualify for the Section 28(e) safe harbor.

(i) "The staff observed deficiencies related to mixed use allocations. For example, the staff observed advisers that did not appear to make a reasonable allocation of the cost of a mixed use product or service according to its use or did not produce support, through documentation or otherwise, of the rationale for mixed use allocations."[13]

(g) Deficiencies Related to Compliance Policies and Procedures

(i) Failing to have robust policies and procedures with respect to best execution

(1) "The staff observed advisers that appeared to have inadequate compliance policies and procedures or internal controls regarding best execution. For example, the staff observed:

a. Advisers that did not have any policies relating to best execution.

b. Advisers with insufficient internal controls because the advisers failed to monitor broker-dealer execution performance.

c. Advisers with policies that did not take into account the current business of the adviser, including the type of securities traded by the adviser."[14]

(ii) Failing to follow written policies and procedures

(1) "The staff observed advisers that did not follow their policies and procedures regarding best execution. For example, the staff observed:

a. Advisers that did not follow their own policies regarding best execution review, including seeking comparisons from competing broker-dealers to test for pricing and execution.

b. Advisers that did not allocate soft dollar expenses in accordance with their policies.

c. Advisers that did not follow their internal policies regarding the ongoing monitoring of execution price, research and responsiveness of their broker-dealers.

C. Where should fund managers look for information to evaluate best execution?

1. Rule 606: Broker-Dealer Data for Evaluating Best Execution

(a) Exchange Act Rule 606 requires broker-dealers to publicly disclose, on a quarterly basis, certain aggregated order routing information for customer orders[15] and to disclose separately to any customer,

[12] OCIE Best Execution Alert at 3.

[13] *Id.*

[14] *Id.* at 4.

[15] Exchange Act Rule 606(a).

upon request, certain customer-specific order routing information for the six-month period preceding the request.[16]

(b) In November 2018, the SEC adopted amendments to Rule 606 ("Amendments") to address changes in the equity market structure, order routing and handling practices since Exchange Act Rule 606 was originally adopted, including the increased percentage of orders being handled by trading algorithms and related routing systems.[17] The Amendments are intended to assist market participants in comparing the routing services of broker-dealers and the relative merits of competing trading centers, and to help customers evaluate how broker-dealers handle conflicts of interest and risks of information leakage.

(c) The Amendments, which became effective in May 2018 implement the following changes:

(i) Broker-dealers are required, upon customer request, to provide customer-specific disclosures regarding the broker-dealer's handling of a customer's orders in NMS stocks[18] submitted on a not-held basis for the prior six months, subject to two *de minimis* exceptions.[19]

(ii) Broker-dealers are required to include in the quarterly order routing reports required by Rule 606(a) all customer orders in NMS stocks submitted on a held basis, and to provide enhanced disclosures regarding payment for order flow,[20] including both the net aggregate amounts of payment received from identified market centers, and amounts received on a per share basis; and

(iii) Broker-dealers are required to offer their Rule 606 quarterly order routing reports and Rule 605 quarterly execution reports free and accessible on a website for three years from the date of posting.

(d) Now that more granular data is available and for a longer time, Advisers should avail themselves of it when conducting reviews of the execution quality provided by their broker-dealers.

2. Reg ATS-N – Information about ATS Executions

(a) ATS as Execution Venues: Evaluating new information:

(i) In July 2018, the SEC adopted amendments to Reg ATS, the regulation governing alternative trading systems. The new amendments impose extensive new transparency requirements on ATS that execute transactions in NMS stocks.

(ii) These ATS will be required to file new Form ATS-N and publicly disclose detailed information regarding the manner of operation of the ATS and the ATS-related activities of both the ATS' broker-dealer operator and the operator's affiliates.[21] The amendments also require ATS operators to memorialize their safeguards and procedures relating to the protection of subscribers' confidential trading information.

(b) Advisers may wish to consider this newly publicly available information in order to review what ATS's are available, the functionality provided by each (some may focus on block trading, for instance) and the costs associated with each (since ATS-N requires disclosure of the range of fees charged users).

[16] Exchange Act Rule 606(b).

[17] *See* Exchange Act Rel No. 34-84528 (Nov. 2, 2018), 83 Fed. Reg. 58338 (Nov. 19, 2018) ("Adopting Release").

[18] As that term is defined at Exchange Act Rule 600(b)(47).

[19] The two exceptions are a firm-level *de minimis* exception and a customer level *de minimis* exception.

[20] Payment for Order Flow, at a high level, is the amount of rebate that securities exchanges pay to broker-dealers in exchange for routing orders and thereby providing liquidity to their exchanges. *See* SEC Fast Answers, Payment for Order Flow, available here.

[21] Form ATS-N filings will be publicly posted through the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR).

III. Broker-Dealer Registration Issues

A. Broker-Dealer Registration Requirements

1. Any person who engages in "broker" or "dealer" activity, as those terms are defined, respectively, at Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), is required to register as a broker-dealer with the SEC pursuant to Section 15 of the Exchange Act.

(a) What is a "Dealer"?

(i) The Exchange Act defines the term "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[22]

(ii) The courts and the SEC have identified certain indicia of "dealer" activity, including:

(1) Purchasing or selling securities as principal to or from customers[23];

(2) Carrying a dealer inventory in securities[24];

(3) Holding oneself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis[25];

(4) Engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the person's investment, liquidity or other permissible trading objective[26];

(5) Participating in a selling group or underwriting with respect to securities[27];

(6) Engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices[28];

(7) Having a regular clientele[29]; and

(8) Advertising or otherwise holding itself out as buying or selling securities on a continuous basis or at a regular place of business.[30]

(iii) Notably, the Exchange Act excludes from the definition of "dealer" any "person that buys or sells securities [ ] for such person's own account, either individually or in a fiduciary capacity, *but not as a part of a regular business.*"[31] This exclusion is intended to carve-out from the definition of "dealer" people who trade for their own accounts, but not as part of a regular business (e.g., "traders").

(b) What is a "Broker"?

(i) The Exchange Act defines the term "Broker" as "any person engaged in the business of effecting

[22] *See* Exchange Act section 3(a)(5)(A).

[23] *See* Exchange Act Release No. 34-47364 (Feb. 13, 2003).

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *See* Exchange Act Release No. 34-46745 (Oct. 30, 2002) ("*Bank Exemptions Proposing Release*").

[30] *See* Bank Exemptions Proposing Release; Joseph McCulley, SEC No-Action Letter (Aug. 2, 1972); Continental Grain Company, SEC No-Action Letter (Nov. 6, 1987).

[31] *See* Exchange Act Section 3(a)(5)(B). (*Emphasis added*).

transactions in securities for the account of others." While the terms "effecting transactions in securities" and "engaging in the business of effecting transactions in securities transactions" are not defined in the Exchange Act, the SEC has interpreted both terms broadly and stated that a person who participates in *any* of the steps necessary to engage in a securities transaction may be required under the Exchange Act to register as a broker.

(ii) Through no-action letters and other pronouncements, the SEC has identified certain indicia of "Broker" activity, including:

(1) Solicitation, negotiation, facilitation or execution of a transaction[32];

(2) Receipt of transaction-related compensation[33];

(3) Handling of securities or funds of others in connection with the transaction[34];

(4) Structuring a transaction;

(5) Identification of potential purchasers or sellers of securities;

(6) Engaging in credit-related activities;

(7) Participation in the order-taking or order-routing process[35];

(8) Arranging for, or performing of, clearance and settlement of executed trades;

(9) Holding oneself out as a broker, as conducting the activities of a broker, including executing trades or assisting others in settling securities transactions[36]; and

(10) Participation in the securities business with some degree of regularity.[37]

(iii) Issuer's Exemption

(1) Exchange Act rule 3a4-1 provides a non-exclusive safe harbor whereby "associated persons of an issuer"[38] will not be deemed to be "brokers" solely due to their participation in sales of the issuer's securities.

a. To qualify for the safe harbor, the associated person:

i. Must not be subject to a statutory disqualification (as that term is defined in section 3(a)(39) of the Exchange Act) at the time of his or her participation in the selling efforts[39];

[32] Exchange Act Release No. 34-44291 (May 11, 2001). Exchange Act Release No. 34-27017 (July 11, 1989).

[33] Exchange Act Release No. 34-20943 (May 9, 1984). *But see SEC v. Kramer*, et al., 778 F. Supp. 2d 1320 (M.D. Fla. 2011), stating that no single factor alone, including the receipt of transaction-based compensation, should be dispositive of "broker" status.

[34] SEC, Division of Trading and Markets, Guide to Broker-Dealer Registration (April 2008), available here.

[35] Exchange Act Release No. 34-44291 (May 11, 2001).

[36] *SEC v. Margolin*, Fed. Sec. L. Rep (CCH) 97,025 at 94,517 (S.D.N.Y. 1992). Swiss American Securities, Inc. and Streetline, Inc., SEC No-Action Letter (May 28, 2002).

[37] *Mass. Fin. Serv., Inc. v. SIPC*, 411 F. Supp. 411, 415 (D. Mass.), *aff 'd*, 545 F.2d 754 (1st Cir. 1976).

[38] An "associated person of an issuer" is defined as any natural person who is a partner, officer, director or employee of: (i) the issuer; (ii) a corporate general partner of a limited partnership that is the issuer; (iii) a company or partnership that controls, is controlled by or is under common control with, the issuer; or (iv) an investment adviser registered under the Investment Advisers Act of 1940 to an investment company registered under the Investment Company Act of 1940 which is the issuer.

[39] *See* Exchange Act rule 3a4-1(a)(1).

ii. Must not receive transaction-based compensation in connection with his or her selling efforts[40];

iii. Must not be an associated person of a broker-dealer at the time or his or her participation[41]; and

iv. Must satisfy one of three non-exclusive conditions relating to his or her selling activities,[42] including by (i) primarily performing substantial duties for or on behalf of the issuer other than in connection with securities transactions, (ii) not having been registered with a broker-dealer or investment adviser within the past 12 months and (iii) not having participated in the sale of any securities other than in reliance on one of the other provisions of Exchange Act rule 3a4-1.[43]

(c) Finders

(i) The term "finder" is commonly used to describe a person involved in putting together buyers and sellers of securities. However, the term "finder" is not defined in the Exchange Act; rather, analysis of whether a person acts as a "finder" requires an analysis of whether a person's activities in connection with a securities transaction are sufficiently limited that he or she does not meet the definition of "broker" under Exchange Act section 3(a)(4).

(ii) The SEC has provided guidance regarding where a person may be deemed to act as "finder" (as opposed to "broker") in the form of certain No-Action Letters.

(1) For instance, in a No-Action Letter to Richard S. Appel (dated Feb. 14, 1983), the staff indicated that broker-dealer registration was required where a person (i) provided names of potential investors to an issuer, (ii) received transaction-based compensation and (iii) participated in negotiations to the limited extent of describing the investment in general terms to prospective investors.

(2) In another No-Action Letter to Davenport Management, Inc., (April 13, 1993), the SEC denied requested no-action relief where a service provider would:

a. Act repeatedly and continuously as an intermediary in securities transactions;

b. Be actively involved in securities transactions, by negotiating their terms, providing advice regarding their terms, or providing other assistance;

c. Receive compensation tied directly to transactions in securities;

d. Provide "investment banking services," albeit to an affiliated entity; and

e. Have direct contact with outside investors, both in finding co-investors for the issuer and in finding purchasers for investments previously made by the issuer.

(iii) Notwithstanding the above, in a No-Action Letter to Mr. Paul Anka (dated July 24, 1991, "Paul Anka Letter"), SEC staff stated that it would not recommend enforcement action under Section 15(a) of the Exchange Act where an unregistered individual whose involvement in selling efforts was to be limited to providing an issuer with a list of potential investors and related contact information would receive transaction-based compensation (e.g., commissions) in connection with any resulting securities transactions.

[40] *See* Exchange Act rule 3a4-1(a)(2).

[41] *See* Exchange Act rule 3a4-1(a)(3).

[42] *See* Exchange Act rule 3a4-1(a)(4).

[43] *See* Exchange Act rule 3a4-1(a)(4)(ii).

(1) Importantly, Mr. Anka's proposed selling efforts were limited to providing the issuer with a list of potential investors. Mr. Anka would not, for instance, participate in any negotiations between the issuer and investors, nor would Mr. Anka solicit the investors or recommend purchasing the issuer's securities.

(d) M&A Broker No-Action Guidance

(i) In two 1985 cases, the Supreme Court determined that in situations where the sale of an entire business is effected by selling the target's securities (rather than its assets), these transactions are securities transactions subject to the federal securities laws.[44] In 2014, the SEC issued no-action relief to clarify the impact of these decisions on those involved in certain types of M&A transactions.[45]

(1) In the letter, the SEC Division of Trading and Markets stated that it would not recommend enforcement actions under Section 15(a) of the Exchange Act, where a person facilitates certain types securities transactions without first registering as a broker (such persons, "M&A Brokers").

a. M&A Brokers are those that are "engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company…through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company."[46]

(ii) The letter notes that the buyer (or group of buyers) may choose to operate the company or business through the "power to elect executive officers and approve the annual budget or by service as an executive or other executive manager" and need not be the sole owner of the target company post-closing.[47]

(iii) The letter identified certain additional characteristics of a transaction necessary to fall within the M&A Broker relief, including:

(1) The privately-held company being sold must not have any class of securities registered or required to be registered with the SEC under Section 12, and it must itself be a going concern and not a "shell" company;

(2) The broker facilitating the transaction may not have power to bind any party to the transaction, and may not, either directly or indirectly, finance the transaction;

(3) The M&A Broker may not have custody of, or handle funds or securities issued or exchanged, in connection with the transaction;

(4) The transaction may not involve a public offering of securities;

(5) If the M&A Broker represents both buyer and seller, it must provide clear disclosures and obtain consent from both sides;

(6) If there is a group of buyers, that group must have been formed without involvement from the M&A Broker;

[44] *See Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Gould v. Reufenach*, 471 U.S. 701 (1985).

[45] Division of Trading and Markets No-Action, Exemptive, and Interpretive Letter: M&A Brokers, Jan. 31, 2014.

[46] *Id.* at 2-3.

[47] *Id*. at 3, noting, among other things, that "control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities … ."

(7) At the conclusion of the transaction, the buyer must actively control the company[48]; and

(8) The M&A Broker and all of its affiliated persons may not be barred or suspended from registration as a broker-dealer as a result of a disciplinary action.[49]

B. Broker-Dealer Registration

1. As noted above, any person that acts as a "broker" or "dealer" generally must register with the SEC pursuant to Section 15 of the Exchange Act. Additionally, such persons must, subject to certain very limited exceptions, become a member of FINRA.[50]

2. In 2017, new FINRA rules relating to capital acquisition brokers ("CAB Rules") became effective. These rules were adopted in hopes of providing certain regulatory relief to broker-dealers solely engaged in certain brokerage activities.[51] CAB Rules apply to FINRA members that meet the definition of capital acquisition broker ("CAB") under FINRA rule 016(c) and have been approved by FINRA to be regulated as CABs. CABs are subject to a more limited set of rules than other FINRA members.

(a) CAB is defined by FINRA as a broker that solely engages in certain delineated activities, including advising issuers regarding "securities offering or other capital raising activities" and acting as a placement agent in connection with the sale of newly-issued, unregistered securities to "institutional investors."[52]

(b) The term "institutional investor" has substantially the same meaning as that term is defined at FINRA Rule 2210, and includes any person meeting the definition of "qualified purchaser" under Section 2(a)(51) of the Investment Company Act of 1940. The term does not, however, include "accredited investors" (as defined at rule 501(a) of the Securities Act of 1933, as amended).

(c) FINRA noted that it did not believe it was necessary or appropriate to extend the definition of "institutional investor" to include "accredited investors" as accredited investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs."[53]

IV. Section 13(d) and Section 16 Reporting Requirements under the Exchange Act

A. Section 13(d) Reporting Requirement Trigger

1. Upon becoming a greater than 5% "beneficial owner" of any voting, equity security registered under the Exchange Act ("Subject Securities").

(a) A beneficial owner of a security includes any person who, *directly or indirectly*, through any contract, arrangement, understanding, relationship or otherwise has or shares *voting power* and/or *investment power* with respect to such security. An Investment Manager's beneficial ownership should be calculated based on the aggregate positions of all entities it manages that are not disaggregated from each other for purposes of Section 13(d) and Section 16 reporting.

(i) Voting power includes the power to vote, or to direct the voting of, a security.

(ii) Investment power includes the power to dispose, or the power to direct the disposition, of a security.

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[48] *See* footnote 28, *supra*.

[49] See *Id.* at 2-4.

[50] FINRA is a "self-regulatory organization" that enforces its members' compliance with the federal securities laws and FINRA's own rules.

[51] *See* Exchange Act Release No. 34-78617, 81 Fed. Reg. 57948 (Aug. 24, 2016).

[52] *See* FINRA Rule 016(c).

[53] *See* 81 FR at 57957.

(b) Rule 13d-3(d)(1)(i) provides that a person is deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of that security within 60 days.[54]

(c) Rule 13d-5(b)(1) provides that when two or more persons agree (whether formal or informal, orally or in writing) to act together for the purpose of acquiring, holding, voting or disposing of Subject Securities, all members of the group formed thereby will be deemed to have beneficial ownership of all Subject Securities beneficially owned by the other members of the group.

(i) To be a member of a group, a person first must be the beneficial owner of Subject Securities.

(ii) If considered a group, the Subject Securities held by the group members must be aggregated when determining whether the 5% threshold has been crossed.

(iii) A group can also be formed with affiliated or unaffiliated entities or persons, if an agreement as to the acquisition, holding, voting or disposition of Subject Securities exists.

B. Type of Filing Required: Schedule 13D or the short form Schedule 13G?

1. Section 13(d) of the Exchange Act requires a beneficial owner that acquires more than 5% of a class of Subject Securities to file on Schedule 13D unless eligible to file on Schedule 13G.

(a) The initial Schedule 13D filing must be made within 10 calendar days of crossing 5%.

(b) Amendments must be made "promptly"[55] upon any material change in the information previously reported.

(i) An acquisition or disposition of 1% or more of the class of securities is deemed to be a material change requiring an amendment.

(ii) Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer (under Item 4 of Schedule 13D).

2. Eligibility to File on Schedule 13G

(a) *13d-1(b) Qualified Institutional Investors*. Certain institutional investors (e.g., registered investment advisers, registered investment companies and registered brokers or dealers) may file on Schedule 13G as long as they have acquired the Subject Securities in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer.

(i) The initial Schedule 13G is required to be filed within 45 days after the end of the calendar year if the beneficial ownership of the reporting person(s) exceeds 5% as of December 31; provided that, if the reporting person(s) beneficial ownership exceeds 10% prior to the end of the calendar year, the reporting person(s) initial Schedule 13G must be filed within 10 days after the end of the first month in which the reporting person(s) beneficial ownership exceeds 10% on the last day of the month.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage

[54] However, non-passive holdings confer beneficial ownership for a right to acquire at any time — even after 60 days. This important exception to the 60-day rule provides that any person who has a right to acquire beneficial ownership of a security with the purpose or effect of changing or influencing control of the issuer, or in connection with, or as a participant in, any transaction having such purpose or effect, is deemed to be a beneficial owner of the security immediately upon acquiring the right to acquire the security regardless of whether that right cannot be exercised within 60 days. Nonetheless, a person does not beneficially own Subject Securities underlying a derivative security if the right to acquire the underlying Subject Security is subject to material contingencies outside the control of such person that cannot be waived (e.g., the requirement to obtain a governmental approval or the effectiveness of a registration statement). Such a right does not create beneficial ownership until the contingency is met even where these material contingencies could be met within the 60-day period.

[55] "Promptly" is not defined in the rules, but has generally been interpreted by courts to mean not more than two business days.

beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) Within 10 calendar days after the end of any month in which beneficial ownership exceeds 10% as of the end of the month; and

(3) Once over 10%, within 10 calendar days of the end of any month in which beneficial ownership increases or decreases by more than 5% as of the end of the month.

(b) *13d-1(c) Passive Investors*. Investors that are not one of the types of institutional investors permitted to file under Rule 13d-1(b) may file under Rule 13d-1(c) as long as they have not acquired the Subject Securities with the purpose, or with the effect of, changing or influencing control of the issuer and their beneficial ownership does not constitute 20% or more of the class of Subject Securities.

(i) The initial Schedule 13G is required within 10 days of crossing 5% beneficial ownership.

(ii) Amendments are required:

(1) Within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding);

(2) "Promptly" upon crossing 10% beneficial ownership; and

(3) Once over 10%, "promptly" after beneficial ownership increases or decreases by more than 5%.

(c) *13d-1(d) Exempt Investors*. Investors who are or become the beneficial owner of more than 5% of a class of Subject Securities but who have not made an "acquisition" subject to Section 13(d) are permitted to file on Schedule 13G (for example those who become beneficial owners of more than 5% of a class of Subject Securities as a result of a stock buy-back, or those who owned the Subject Security prior to the Subject Security becoming registered under the Exchange Act) .[56] This provision is available regardless of control intent or ownership level. The ability to file under 13d-1(d) is lost if the investor acquires more than 2% of the class of Subject Securities within any 12-month period. For example, if the investor acquired 1.5% of the Subject Security two months prior the Exchange Act registration and one month following the registration acquired another 0.6% of the Subject Security, the ability to file under 13d-1(d) would be lost and instead of filing under Rule 13d-1(d) after the year-end, the investor would instead file under Rule 13d-1(b), 13d-1(c) or file a Schedule 13D, as appropriate.

(i) The initial Schedule 13G filing is required within 45 days of the end of the calendar year, if beneficial ownership exceeds 5% as of the end of the calendar year.

(ii) Amendments are required within 45 days of the end of the calendar year if, as of December 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned and such change is a result of a change in the number of shares of the class outstanding).

C. Section 16 Reporting Requirement Trigger

1. Upon becoming an officer, director[57] or greater than 10% "beneficial owner" of any Subject Security.

(a) "Beneficial ownership" for determining who is subject to Section 16 is, for the most part, the same as

[56] This comes up most often where an issuer's securities are held, such as by a private equity or venture capital fund, prior to the issuer's initial public offering (concurrently with which the securities will become registered under the Exchange Act).

[57] It is possible for an entity to be treated as a director for purposes of Section 16 if it can be shown that the entity has deputized an individual to sit on the board of an issuer in order to represent the interests of the entity. If an entity is deemed to be a director-by-deputization, the entity will be treated as a director and subject to Section 16 as such regardless of whether the entity beneficially owns more than 10% of the issuer's securities.

the Section 13(d) beneficial ownership determination. Therefore, a Schedule 13D/G filer that is a greater than 10% beneficial owner separately will be subject to Section 16 reporting. Accordingly, reporting persons are typically the same as under the Section 13(d) analysis.

D. What is Reported and Subject to Matching Under Section 16(a)?

1. The beneficial ownership test used to determine whether a person is subject to Section 16 as a greater than 10% beneficial owner is different from the test used to determine what is reported under Section 16(a) and what is subject to matching for purposes of Section 16(b). Section 16(a) requires the disclosure of, and Section 16(b) subjects to profit disgorgement under Section 16, any equity securities of the issuer in which the reporting persons have a direct or indirect "pecuniary interest" (discussed below).

2. The use of different tests for determining greater than 10% beneficial ownership on the one hand, and what is included on Section 16 reports on the other hand, can result in a filer not reporting securities that were taken into account when determining whether the filer was subject to Section 16. It can also result in securities that are reported under Section 16 being excluded from Section 13(d) reporting and vice versa.

3. Pecuniary interest is defined as the "opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities." Rule 16a-1(a)(2)(i).

   (a) An indirect pecuniary interest is defined to include a general partner's proportionate interest in the portfolio securities held by a general or limited partnership to the extent of the greater of the partner's share of the partnership's profits or capital account. Rule 16a-1(a)(2)(ii)(B).

   (b) An Investment Manager will have an "indirect pecuniary interest" with respect to a class of an equity security if it receives a performance fee based, in part, on the security's performance unless, with respect to the performance fee:

      (i) The performance fee is calculated over a period of one year or more; and

      (ii) The equity securities of the issuer do not account for more than 10% of the market value of the portfolio of the applicable fund or account. Rule 16a-1(a)(2)(ii)(C).[58]

   (c) Asset based fees are excluded from the definition of indirect pecuniary interest. Rule 16a-1(a)(2)(ii)(C).

   (d) A Fund will be deemed to have a direct pecuniary interest in any securities directly held by it.

4. Forms Filed Under Section 16(a)

   (a) *Form 3 – Initial Statement of Beneficial Ownership of Securities*. Generally must be filed within 10 days of becoming an officer, director or greater than 10% "beneficial owner" to report all equity securities in which the filer has a pecuniary interest as of the time of crossing 10% (except that if the filing is a result of the initial registration of the issuer's securities under the Exchange Act (e.g., in connection with an IPO) the filing is required to be made on the date the issuer's registration statement is declared effective by the SEC).

   (b) *Form 4 – Statement of Change of Beneficial Ownership of Securities.* Must be filed within 2 business days after a change in pecuniary interest takes place to report such change.

   (c) *Form 5 – Annual Statement of Beneficial Ownership of Securities.* Must be filed within 45 days of the issuer's fiscal year end to report transactions that took place in the prior year that should have been reported but were not. It can also be used to report certain transactions exempt from 16(b). If there are no transactions required to be filed on a Form 5, no such filing is made for the year.

[58] The determination of "market value" is not defined. A factor that can be relevant to the determination includes how the Fund or account carries the position on its books.

5. Section 16(b) Short Swing Profit Liability

   (a) Section 16(b) imposes liability for short-swing profits from the issuer's equity securities (including derivative securities) upon all persons required to file reports under Section 16(a).

   (b) Section 16 insiders must disgorge to the issuer any profits realized as a result of a purchase and sale or sale and purchase of any equity securities of the issuer within a period of less than six months ("short swing profits").

   (c) With respect to 10% beneficial owners, the purchase that puts the beneficial owner over the 10% threshold does not qualify as a "purchase" subject to Section 16(b); only purchases made after becoming a greater than 10% beneficial owner will give rise to short swing profits when matched against sales occurring within six months, and while a Section 16 insider.

   (d) The "lowest-in, highest-out" method of calculating matching transactions is used to calculate profits under Section 16(b). Under this approach, "the highest sale price during the six month period is matched against the lowest purchase price in that period, followed by the next highest sale price and next lowest purchase price and so on, until all shares have been included," irrespective of the order in which the transactions were executed. Under this approach, it is possible for an insider to have an actual loss but a "realized" profit that is payable under Section 16(b).

Example

Transactions	Investment Status
Transaction 1 Buy 1,000,000 shares at $10 ($10M)	$10,000,000
Transaction 2 Buy 1,000,000 shares at $20 ($20M)	$30,000,000
Transaction 3 Sell 1,000,000 shares at $20 ($20M)	$10,000,000
Transaction 4 Sell 1,000,000 shares at $5 ($5M)	$5,000,000

Total Loss = $5,000,000

Under §16(b)
Lowest price in = $10 = $10,000,000
Highest price out = $20 = $20,000,000
Total Realized Profit = $10,000,000

V. Rule 14e-4: The Short Tender Rule

A. Rule 14e-4 Generally

1. Rule 14e-4 prohibits a person from tendering shares into a partial tender offer unless the person is "net long" both at the time of tender and at the end of the proration period of the tender offer. Under Rule 14e-4(a)(1) a person's "net long position" is the excess, if any, of its "long position" over its "short position."

2. In adopting Rule 14e-4 (which at the time was Rule 10b-4. It was designated as Rule 14e-4 in 1990), Congress indicated that its intention was for each shareholder to receive equal treatment based upon the shareholder's interest in the securities that are the subject of a tender offer. By short tendering or hedging their tender, market professionals reduce their proration risk while increasing the proration risk of all those who cannot short or engage in hedged tendering, because the short or hedged tendering often leads to over tendering (i.e., the same shares being tendered more than once). The SEC has observed that short and hedged tendering often requires access to borrowed shares which market professionals have a clear advantage in obtaining access to. (See Release No. 34-26609 (March 8, 1989)).

B. Things to Note When Calculating a Person's Long and Short Positions

1. Rule 14e-4(a)(1)(i) defines a person's long position to include the amount of subject securities that such person:

   (a) Or his agent has title to or would have title to but for having lent such securities; or

   (b) Has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase but has not yet received; or

   (c) Has exercised a standardized call option for; or

   (d) Has converted, exchanged or exercised an equivalent security for; or

   (e) Is entitled to receive upon conversion, exchange or exercise of an equivalent security.

C. Rule 14e-4(a)(1)(ii) defines a person's short position to include the amount of subject securities that such person:

1. Has sold, or has entered into an unconditional contract, binding on both parties thereto, to sell; or

2. Has borrowed; or

3. Has written a non-standardized call option, or granted any other right pursuant to which his shares may be tendered by another person; or

4. Is obligated to deliver upon exercise of a standardized call option sold on or after the date that a tender offer is first publicly announced or otherwise made known by the bidder to holders of the security to be acquired, if the exercise price of such option is lower than the highest tender offer price or stated amount of the consideration offered for the subject security. For the purpose of this paragraph, if one or more tender offers for the same security are ongoing on such date, the announcement date shall be that of the first announced offer.

D. Enforcement

1. On Dec. 18, 2019, the SEC announced settlements against two registered broker-dealers for violating SEC Rule 14e-4 by tendering more shares than their net long positions.[59] Disgorgement, prejudgment interest and fines for the violations exceeded $500,000.

2. Prior to this action, the SEC had not brought an SEC Rule 14e-4 case in over 20 years.

[59] *See* SEC Press Release, "SEC Charges Broker-Dealers With Illicitly Profiting in Partial Tender Offer," available here.

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