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A legal update from Dechert's Financial Services Group

Hedge Fund Advisers and Former Portfolio Manager Settle with SEC for Short Sale Violations

Executive Summary

On May 19, 2005, the Securities and Exchange Commission ("SEC") entered final orders in actions brought against three hedge fund advisers, DB Investment Managers, Inc. ("DB"), Galleon Management, L.P. ("Galleon"), and Oaktree Capital Management, LLC ("Oaktree"), for violations of Rule 105 under Regulation M.[1] The three hedge fund advisers each violated Rule 105, which prohibits covering a short sale with securities obtained in a public offering if the short sale occurred within five business days before the pricing of the offering (the "Rule 105 restricted period").

Separately, Hilary L. Shane, a former hedge fund portfolio manager at First New York Securities, L.L.C., settled with the SEC and the National Association of Securities Dealers, Inc. ("NASD") for selling short securities of CompuDyne Corporation based on material nonpublic information Ms. Shane possessed about CompuDyne's impending private investment in public equity ("PIPE") offering and prior to the effective date of the resale registration statement for the PIPE shares.

Violations and Settlements

In addition to violating Rule 105 under Regulation M, the SEC found that Galleon and Oaktree engaged in additional transactions which the SEC considered to be "sham transactions" designed to mask the covering of short sales established during the Rule 105 restricted period with offering shares. As a consequence of violating Rule 105 under Regulation M, each adviser had to disgorge profits made from the short sales, pay prejudgment interest, and pay a civil penalty.[2] Furthermore, each adviser agreed to adopt and implement written policies and procedures reasonably designed to prevent violation of Regulation M, to review those policies annually, and to require the chief compliance officer to administer these policies and procedures.

In Shane, the SEC alleged that Ms. Shane violated established prior to the effective date of the resale registration statement with securities from the PIPE offering.[3]

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1 SEC Press Release (May 19, 2005); In the Matter of DB Investment Managers, Inc., Administrative Proceeding File No. 3-11927; In the Matter of Galleon Management, L.P., Administrative Proceeding File No. 3-11928; In the Matter of Oaktree Capital Management, LLC, Administrative Proceeding File No. 3-11929.

2 DB consented to disgorge $15,585 in profits and pay prejudgment interest of $1,989 and to pay a $15,585 civil penalty, Galleon consented to disgorge $1,040,882 in profits and pay prejudgment interest of $109,321 and to pay a $870,247 civil penalty, and Oaktree Capital Management consented to disgorge $169,773 in profits and pay prejudgment interest of $6,155 and to pay a $169,773 civil penalty.

3 The SEC also alleged that Ms. Shane violated Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 thereunder. Ms. Shane consented, subject to the court's approval, to disgorge $652,938 in profits, to pay prejudgment interest of $125,292 and to pay a $296,785 civil penalty. Furthermore, Ms. Shane consented to be suspended from the investment advisory industry. See Securities and Exchange Commission v. Hilary L. Shane, Civil Action No. 05 Civil 4772 (S.D.N.Y.) (May 18, 2005) (hereafter "Shane"); SEC Press Release (May 18, 2005). The NASD permanently barred Ms. Shane from associating with any NASD-registered firm and imposed a $375,000 fine. NASD News Release (May 18, 2005).

Rule 105 under Regulation M and Sham Transactions

Rule 105 under Regulation M

Rule 105 governs short selling in anticipation of public offerings.[4] Specifically, Rule 105 under Regulation M prohibits a short seller from covering short sales with securities being sold in the public offering (referred to as "offering shares") that are purchased from an underwriter or broker or dealer participating in the offering (referred to as a "follow-on offering"), if the short sale occurred during the Rule 105 restricted period, typically the five-day period prior to pricing. Rule 105 does not prohibit short sales during the pre-pricing period. Rather, what is prohibited is the practice of using the offering shares to cover short sales established during the Rule 105 restricted period.[5]

The goal of Regulation M is to promote offering prices that are based upon open market prices determined by supply and demand rather than artificial forces. The underlying rationale for Rule 105 is that covering short sales made during the pre-pricing period with offering shares artificially distorts the market price for the security, and as a consequence the market is prevented from functioning as an independent pricing mechanism.

A short seller that is able to cover pre-pricing short sales with offering shares obtained directly from the follow-on offering does not assume the same market risk as a short seller that has to go to the open market to cover such short sales because the price of the shares obtained from a follow-on offering are fixed as opposed to shares purchased in the open market which are variable and depend on supply and demand at the time of purchase. The SEC believes that such actions as by-passing the open market to cover the pre-pricing short sales with shares from the follow-on offering do not contribute to pricing efficiency, and do not lead to true price discovery.

Sham Transactions

In July 2004, the SEC issued interpretive guidance on "sham transactions" that the SEC believes violate Rule 105 under Regulation M.[6] According to the SEC, "sham transactions" in the context of Rule 105 are transactions that are structured to give the appearance that short sales made during the pre-pricing restricted period are covered with shares purchased in the open market, when in fact the short sales were covered with offering shares that have been received by the trader.[7] The SEC provides two examples of "sham transactions": arrangements to purchase; and sell/buy, buy/sell.

Arrangements to Purchase

Using offering securities obtained through an arrangement with a third party who acquires the securities in the primary offering to cover short sales effected during the Rule 105 restricted period is a sham transaction. In this transaction, the trader is attempting to accomplish indirectly what it can not do directly.[8]

Sell/Buy and Buy/Sell

Another sham transaction is a series of transactions whereby chronologically a trader effects shorts sales during the Rule 105 restricted period, receives an allocation of offering shares, sells the offering shares in the open market, and then contemporaneously or nearly contemporaneously purchases an equivalent number of the same class of shares as the offering shares, which are then used to cover the short sales.[9] According to the SEC, where the transaction is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk, that transaction may be a sham transaction that violates Rule 105.[10]

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4 See Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38067. (Dec. 20, 1996) ("Release No. 34-38067"); Short Sales, Exchange Act Release No. 34-50103 (July 28, 2004) ("Release No. 34-50103"). Rule 105 applies to offerings of securities for cash pursuant to a registration statement or a notification on Form 1-A filed under the Securities Act). See Release No. 34-50103, note 115. Note that effective September 7, 2004 Rule 105 applies to shelf registrations (offering filed under Rule 415 promulgated pursuant to the Securities Act). Furthermore, Rule 105 applies to non-equity offerings as well. See Release No. 34-50103, note 123 ("...we have therefore determined that non-equity offerings will continue to be subject to the prohibitions of Rule 105").

5 In the matters involving DB, Galleon, and Oaktree, each adviser violated the basic prohibition of Rule 105: the adviser sold securities short within five business days before the pricing of the follow-on offering and then covered the short positions with securities purchased in the follow-on offering.

6 See Release No. 34-50103, *supra,* note 4.

7 *Id.*

8 *Id.*

9 *Id.* (emphasis added).

10 *Id.* (emphasis added).

In the matters involving Galleon and Oaktree, the SEC found that each adviser engaged in certain activities that violated Rule 105. These activities provide specific examples of what the SEC considers to be "sham transactions."

Collapsing the Box

In connection with eleven follow-on offerings, Galleon created "boxed" positions by establishing a long position with offering shares that were purchased in a follow-on offering while simultaneously maintaining a short position in securities of the same issuer established during the Rule 105 restricted period. To cover the short sales, Galleon instructed its prime broker to make journal entries that canceled out the long and short positions through the use of riskless, offsetting journal entries (a practice known as "collapsing the box"). In essence, the offering shares obtained from the follow-on offering were used to cover the short positions.

Contemporaneous Unwinding of Follow-on Boxed Positions (Sell/Buy and Buy/Sell)

In connection with three follow-on offerings, Galleon established boxed positions by establishing a long position with offering shares that were purchased in a follow-on offering while simultaneously maintaining a short position in securities of the same issuer established during the Rule 105 restricted period. To unwind these boxed positions, Galleon contemporaneously entered a market order to sell the offering shares it obtained from the follow-on offering and entered another order to purchase an equivalent number of shares to be used to cover the short position that had been established during the Rule 105 restricted period. Such activities fall squarely within the "Sell/Buy and Buy/Sell" illustration that the SEC cites as being a "sham transaction."

Cross Trade

In one instance with a follow-on offering, Galleon flattened its boxed position by executing a cross trade in which Galleon crossed the long and short position against each other resulting in a flat position in the issuer's stock. The cross trade between the long and short positions resulted in the short position that was established during the Rule 105 restricted period being covered with offering shares from the follow-on offering.

In three instances with follow-on offerings, Oaktree engaged in cross trades to flatten its boxed positions. Oaktree crossed the long and short position against each other resulting in a flat position in an issuer's stock. The cross trade between the long and short positions resulted in the short position that was established during the Rule 105 restricted period being covered with offering shares from the follow-on offering. According to the SEC, such a cross trade served no legitimate economic purpose and had no real market risk.[11]

Implications for Hedge Fund Advisers

Policies and Procedures; Role of the Chief Compliance Officer

The SEC has implicitly signaled in the three final orders that hedge fund advisers engaging in short selling should have policies and procedures that address short selling and compliance with Regulation M. In each of the final orders, the advisers agreed to adopt and implement written policies and procedures reasonably designed to prevent violations of Regulation M. Hedge fund advisers, whether registered or exempt from registration, must be cognizant of their obligations under Regulation M. In particular, hedge fund advisers engaged in short selling that are registered or are preparing to register as investment advisers by February 1, 2006 should take notice that the written compliance program should include a section devoted to short selling.[12]

Moreover, the SEC has indicated that the chief compliance officer should play a role in monitoring short sales transactions. Under the terms of the final

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11 See Oaktree, *supra*, note 1.

12 Hedge fund advisers that had been exempt from federal registration as investment advisers with the SEC prior to February 1, 2005 are required to register with the SEC by February 1, 2006 if they satisfy the following conditions:

- the fund is relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended;
- there is less than a 2 year lock up;
- there are fifteen or more investors in the fund; and
- the adviser has $30 million or more of assets under management.

See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Advisers Act Release No. 2333 (Dec. 2, 2004). Registered investment advisers are required to adopt a written compliance program pursuant to Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). See Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003).

orders, the chief compliance officer of each adviser is to administer policies and procedures reasonably designed to prevent violations of Regulation M. As such, it is not enough that the chief compliance officer updates Parts I and II of Form ADV and collects transaction reports under the Code of Ethics. A chief compliance officer is now expected to monitor trades to ensure the firm's compliance with the various trading regulations under federal securities laws. Furthermore, the chief compliance officer will have the responsibility of reviewing the adviser's short sale policies and procedures on an annual basis.

The Shane case also raises certain compliance issues to consider. Ms. Shane sold shares short based on material nonpublic information about CompuDyne's impending PIPE offering. As such, advisers should establish written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser and its associated persons.[13] Also, hedge fund managers investing in PIPEs that are registered or are preparing to register as investment advisers should consider expanding the Code of Ethics to prohibit employees from trading in the securities of companies that the adviser's fund is investing in via a PIPE offering.[14]

If an adviser wishes to permit its employees to invest in companies that the adviser's fund is investing in via a PIPE, then the adviser should consider restricting such personal investments until after securities issued from the PIPE offering are freely tradable in the open market.

PIPEs and Short Selling

Significantly, in Shane, the SEC treats the selling of PIPE shares to cover short sales made prior to the SEC declaring a resale registration statement effective as equivalent to selling unregistered shares. Between October 9 and October 24, 2001, Ms. Shane sold short CompuDyne. To cover the short sales, Ms. Shane used the PIPE shares she obtained after the SEC declared effective the resale registration statement on October 29, 2001. According to the SEC, "[i]n effect, Shane sold the CompuDyne shares she obtained from the PIPE offering at the time she executed the short sales."[15]

Moreover, at the time she executed the short sales of CompuDyne shares between October 8 and October 24, 2001, there was no resale registration statement in effect with respect to the CompuDyne PIPE shares and the sales of those PIPE shares were not exempt from registration. Accordingly, without a resale registration statement in effect, Ms Shane sold unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act.[16] As such, the SEC's position in the Shane complaint effectively curtails the practice of covering short sales made prior to the date of the resale registration statement with shares obtained from a PIPE offering because such transactions are treated as selling unregistered shares.

Whether regulators will take further action to restrict short sales in connection with PIPE offerings in the future remains to be seen. Since the summer of 2004, the SEC and the NASD have been examining PIPEs and short sales and the involvement of hedge funds in PIPEs. This investigation has resulted in the Shane proceeding as well as other settlements and ongoing investigations.[17] What could influence regulators are theories critical of PIPEs and short selling. When a company publicly announces it will conduct a PIPEs offering, the market tends to react negatively. A company's public stock is likely to decline in value because the PIPE shares are privately issued at a market discount and are eventually converted into common stock which in turn increases the number of shares outstanding, and as a result, frequently, the value of a company's shares is diluted.

If the public price of a stock is likely to go down, this creates an incentive for traders to short the stock. An investor in a PIPE such as a hedge fund is likely to capitalize on this dynamic. As such, there is a perception that PIPE investors such as hedge funds are profiting at the expense of a company's existing shareholders.[18] If the SEC and the NASD find further instances of abuse or market manipulation involving hedge funds and their use of short sales with respect to PIPE offerings, the regulators may be inclined to push

13 See Section 204A of the Advisers Act.

14 Registered investment advisers are required to adopt a Code of Ethics pursuant to Rule 204A-1 of the Advisers Act. See Investment Adviser Code of Ethics, Advisers Act Release No. 2256 (July 2, 2004).

15 See Shane, *supra,* note 3.

16 *Id.*

17 See e.g. Matthew Goldstein, *Refco Faces SEC Charges in Short-Selling Probe*, May 17, 2005, at http://www.thestreet.com/_tscs/markets/matthewgoldstein/10223924.html; *Part of FBR's Spirit Exists with Its CEO*, Washington Post (May 2, 2005).

18 Nina Mehta, *PIPEs: Quick Financing, the Hail Mary Pass and New Investors*, at http://www.fenews.com/fen41/inside_black_box/black_box.html.

for further restrictions to discourage hedge fund advisers from selling short companies conducting PIPE offerings.

The Future of Short Selling

The SEC is currently reviewing the practice of short selling. The SEC has temporarily suspended the "tick" test under Rule 10a-1 under the Exchange Act[19] and any price test of any exchange or national securities association for short sales of stocks in the Russell 3000 Index.[20] The SEC has implemented this pilot program to study the effectiveness of unrestricted short shelling on market volatility, price efficiency and liquidity before possibly adopting on a wholesale basis the proposal of replacing the "tick" test with a "bid" test.[21] The "bid" test, if adopted, would require that all short sales in covered securities be effected at a price at least one cent above the consolidated best bid at the time of execution.[22]

The cases discussed above and the current SEC and NASD investigation of PIPEs and the role hedge funds play indicate that the regulators will be closely scrutinizing the practice of short selling this year and next year. The direction the SEC and the NASD will take in increasing or lessening regulation will likely depend on the SEC's conclusions after the pilot program has ended and the extent to which the SEC uncovers further short selling abuses.

If you are a hedge fund manager, you should monitor these developments closely and engage in a dialogue with the SEC and the NASD to ensure that the regulation of short sales strikes a proper balance between protecting the integrity of the market and your ability to trade securities effectively. Also, we will keep you posted on future important developments.

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19 Rule 10a-1 under the Exchange Act sets forth what is commonly referred to as the "uptick" test. In general, Rule 10a-1 requires that a short sale of a listed security may only be effected if the most recent price of that security is higher than the previous price quoted or displayed by the market.

20 See Regulation SHO - Spotlight, at http://www.sec.gov/spotlight/shopilot.htm; Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions, Exchange Act Release No. 34-50747 (November 29, 2004) ("Release No. 50747"); Release No. 34-50103, *supra*, note 4. The pilot program is effective May 2, 2005 and ends on April 28, 2006.

21 *Id*. According to the SEC, the pilot test is to assist the SEC in considering alternatives such as (1) eliminating a SEC-mandated price test; (2) adopting a uniform bid test; and (3) leaving in place the current price test. See Release No. 34-50103, *supra*, note 4.

22 *Id*.

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