

The SEC's Continuing Focus on Rule 105: No Let-Up in Sight

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In 2015, the Division of Enforcement (the "Division") of the Securities and Exchange Commission (the "SEC") continued its focus on Rule 105 ("Rule 105" or "Rule") of Regulation M, as evidenced by the SEC's announcement of its third round of enforcement actions against six firms. See Press Release, SEC Charges Six Firms for Short Selling Violations in Advance of Stock Offerings (Oct 24, 2015), available at <https://www.sec.gov/news/pressrelease/2015-239.html>. One of the respondents, which previously had been sanctioned for violations of Rule 105, was barred for a period of one year from participating in stock offerings. See *In the Matter of War Chest Capital Partners LLC*, Release No. 34-76140 (Oct. 14, 2015), available at <https://www.sec.gov/litigation/admin/2015/34-76140.pdf>.

These actions demonstrate that the SEC has not softened its position on Rule 105 violations and that the stakes can get higher for repeat violations of the Rule. The SEC's stance was first brought home in 2013 when the agency announced enforcement actions alleging violations of the Rule against 23 hedge fund managers and other market participants. See Press Release, SEC Announces Largest Monetary Sanction for Rule 105 Short Selling Violations (Mar. 5, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376>. At the time, Andrew J. Ceresney, then co-director of the Division, heralded these cases as a sign of the SEC's "zero



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tolerance for any securities law violations, including violations that do not require manipulative intent." These actions were followed in 2014 with the SEC's announcement of its largest monetary sanction to date in connection with violations of Rule 105. See *In the Matter of Worldwide Capital, Inc., and Jeffrey W. Lynn*, Release No. 34-71653 (Mar. 5, 2014), available at <https://www.sec.gov/litigation/admin/2014/34-71653.pdf>.

The Commission's ability to bring Rule 105 enforcement actions without proving manipulative intent means that the Division is able to utilize a streamlined investigative process to pursue and resolve these actions, without great expenditures of the SEC's resources. Accordingly, these cases are not only a reminder that market participants who effect short sales in securities and also purchase equity securities in underwritten offerings need rigorous compliance policies and procedures, but also a clear message that the SEC is continuing to aggressively pursue alleged Rule 105 violations on an expedited basis.

This article provides an overview of the Rule as well as some practical steps that investment managers may want to consider, particularly in light of the SEC's 2013 National Exam Program Risk Alert on Rule 105, available at <http://www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf>, which was issued contemporaneously with its announcement of the 23 enforcement actions.

Rule 105 Refresher

1. Overview

Rule 105 prohibits short sales of equity securities that are the subject of a firm commitment cash offering pursuant to a registration statement (or to a notification pursuant to Regulation A or Regulation E of the Securities Act of 1933) ("Offered Securities") by any

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person who purchases the Offered Securities from an underwriter or broker-dealer participating in the offering. For purpose of Rule 105, “short sale” has the same meaning as in Rule 200(a) of Regulation SHO (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”).

The Rule’s restriction on short sales applies during the shorter of the period beginning (i) five business days before the pricing of the Offered Securities and ending with the pricing, or (ii) with the initial filing of the registration statement or notification and ending with the pricing (each a “Restricted Period”). Unlike other provisions of Regulation M, Rule 105 only applies to equity securities and does not apply to reference securities (e.g., a security into which an Offered Security may be converted, exchanged, or exercised, such as the underlying stock in the case of an offering of options or convertible debt) or to best efforts offerings.

2. Excepted Activity

In 2007, the SEC amended Rule 105 (the “2007 Amendments”), to exclude three categories of transactions from the Rule’s prohibitions. See Release No. 34-56206 (Aug. 6, 2007), available at <http://www.sec.gov/rules/final/2007/34-56206fr.pdf>.

Bona Fide Purchase Exception

Paragraph (b)(1) of Rule 105 conditionally permits purchases of Offered Securities in an offering even if the purchaser sold the security short during the Restricted Period. To be eligible for this exception, all of the following conditions must be met:

- The quantity of the Offered Securities that are purchased must at least equal the entire amount of the shares of Offered Securities sold short during the Restricted Period;
- The purchase must be *bona fide*. In

other words, even if the purchaser is in technical compliance with this exception, the purchaser must be subject to the economic risks associated with a purchase for value;

- The purchase(s) must be reported pursuant to an effective transaction reporting plan, and effected during regular trading hours so that they occur no later than the end of the regular trading session on the business day preceding the day of pricing;
- The transactions must be sequenced so that the purchase(s) occur after the last short sale of the Offered Securities during the Restricted Period; and
- The person seeking to claim the exception may not effect a reported short sale within 30 minutes before the close of regular trading on the business day prior to the day of pricing. In other words, there must be a “cooling-off” period after the last short sale and before pricing.

Separate Accounts

Paragraph (b)(2) of the Rule permits short sales in separate accounts to be disregarded for purposes of determining eligibility to purchase Offered Securities in an offering. A separate account can include “portions of a particular fund,” a “unit,” a “department” or an “identifiable division.” For this exception to apply, however, decisions regarding securities transactions for each “account” must be made separately and without any coordination of trading or cooperation among or between accounts.

Although the availability of the separate accounts exception turns on a facts-and-circumstances determination, the SEC has provided guidance regarding when accounts will be viewed as separate and operating without coordination of trading or cooperation among or between accounts:

- Each account must have separate and distinct investment and trading strategies and objectives;

- Personnel must be assigned separately to each account and may not coordinate trading among or between the accounts;
- There must be information barriers separating the accounts, and information about securities positions or investment decisions may not be shared between accounts;
- Each account must maintain a separate profit and loss statement, but they need not have separate legal identities or separate taxpayer identification numbers to be considered separate;
- There can be no allocation of securities between or among accounts;
- Senior supervisory personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts; and
- Account owners of multiple accounts cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts.

According to the SEC, a “fund of funds” that invests in multiple unaffiliated funds and owns shares of each fund, rather than shares of each fund’s underlying investments, will likely not need to rely on the separate account exception, assuming that there is no coordinated trading activity.

Investment Companies

Paragraph (b)(3) of Rule 105 permits an investment company registered under Section 8 of the Investment Company Act of 1940 (the “1940 Act”), or a series of such investment company, to purchase Offered Securities without

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regard to short sales by an affiliated investment company, a series of such affiliated investment company, or a separate series of the investment company. The SEC views this exception as consistent with 1940 Act Section 17(d) and Rule 17d-1 thereunder, which generally prohibit any arrangement or concerted action between affiliated persons of registered investment companies. This reflects that an arrangement between principals of affiliated funds to coordinate short sales by one fund and purchases by another fund, which would be a problematic scenario under Rule 105, would generally be the type of joint enterprise that is prohibited by the 1940 Act.

Compliance Considerations

Given the SEC's view that "Rule 105 applies irrespective of the short seller's intent in effecting the short sale," see *In re Genesis Advisory Services Corp., ABJ Societe Anonyme Corp*, Bruce J. Fixelle, Release No. 34-72212 (May 21, 2014), available at <https://www.sec.gov/litigation/admin/2014/34-72212.pdf>, the development, implementation, and enforcement of policies and procedures designed to prevent a violation of the Rule are critical for investment managers that participate in firm commitment offerings and effect short sales in equity securities. Although compliance policies and procedures need to be tailored to a particular manager's activities, management, organizational structure, some points to consider in designing policies and procedures are:

1. Short Selling — Generally

- Periodically reviewing and testing order entry and trading systems to confirm the timely input of order and execution information and the accurate decrementation of positions.
- Assessing the speed and accuracy with which position information is updated to reflect trading errors and cancelled trades. This is particularly important in the case of "in flight or-

ders," where a seller who is net long a security (e.g., 1,000 shares) enters multiple simultaneous sell orders that are each for the full number of shares (e.g., multiple 1,000 share orders). Rule 200(g)(1) of Regulation SHO permits only one of these sell orders to be marked "long;" any additional orders must be marked "short." This reflects the view of the SEC's Division of Trading and Markets that after the first order to sell 1,000 shares is entered, it is no longer reasonable to expect that delivery can be made on additional orders to sell the same 1,000 shares. See SEC Division of Trading and Markets, Frequently Asked Questions Concerning Regulation SHO, Question 2.5 (Aug. 28, 2009) and updated Mar 18, 2015, available at <http://www.sec.gov/divisions/marketreg/mrfaqreg-sho1204.htm>.

- Testing that accurate information regarding whether orders are "long" or "short" is provided to executing and prime brokers. See *In the Matter of OZ Management, L.P.*, Release No. 34-75445 (July 14, 2015), available at <https://www.sec.gov/litigation/admin/2015/34-75445.pdf>.
- Confirming that all required trading and position information is aggregated on a timely basis.

2. Securities and Offerings Subject to Rule 105

- Reviewing the process for identifying equity securities, which may require a case-by-case determination in the case of convertible debt and convertible preferred securities.
- Confirming that offerings are appropriately flagged as "firm commitment offerings."
- Ensuring that relevant non-U.S. transactions are considered.

3. Restricted Period

- Implementing a process for calculating Restricted Periods, so that it correctly takes into account holidays and is based on the shorter of the pe-

riod triggered by pricing or the filing of the initial registration statement.

4. Compliance with Separate Account Exceptions

- Reviewing current trading authority, trading practices, and organizational structure for the availability of the separate account exception.
- Reviewing and updating policies and procedures that document and implement information barriers and segregate trading activities, including algorithms, and non-public order and trading information.
- Periodically updating and documenting each "account's" investment and trading strategy and authorized trading personnel.
- Prohibiting or implementing appropriate controls and approval processes relating to any journaling of positions between accounts.

5. Compliance Generally

- Providing appropriate training on Rule 105's current requirements, including the application of the Restricted Period to shelf offerings, the trade sequence requirements of the *bona fide* purchase exception, and controls to demonstrate the separation of accounts.
- Implementing and documenting restrictions on personnel with management or oversight responsibility with respect to (i) executing or pre-approving trades in multiple accounts that rely on the separate account exception and (ii) approving the journaling of trades or allocation of securities between or among separate accounts.
- Reviewing tools to generate alerts regarding short sales and potential participation in offerings of equity securities to help reduce inadvertently triggering Rule 105 restrictions.
- Conducting periodic assessments of the relevant controls, including reviewing for signs of coordination or

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cooperation between accounts and for trading activity that appears to be inconsistent with the stated strategy or objectives of the account.

- Documenting compliance reviews, including the appropriate resolution of any potential red flags.

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