



In this Alert

Topic: Compliance issues related to Rule 105 of Regulation M, which governs short selling prior to pricing of certain offerings.

Key Takeaways: Investment advisers, investment companies, and broker-dealers should review their compliance programs to promote compliance with Rule 105 of Regulation M.

By the Office of Compliance Inspections and Examinations¹

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RULE 105 OF REGULATION M: SHORT SELLING IN CONNECTION WITH A PUBLIC OFFERING

I. Introduction

Rule 105 generally prohibits purchasing securities in follow-on and secondary offerings when the purchaser has effected short sales in the securities within a specified amount of time prior to the pricing of an offering.²

From January 2010 through the present, the Commission has collected disgorgement, penalties, and interest in excess of \$42 million based on violations of Rule 105 of Regulation M (“Rule 105” or “the Rule”). In that time frame, the Commission has settled over 40 actions in which it found that firms and/or individuals have violated Rule 105. These enforcement actions and the observations from examiners of the National Exam Program (“NEP”) suggest the

need for firms to consider certain control procedures that may improve firms’ compliance with Rule 105 of Regulation M.³ Additionally, the settled enforcement actions listed in Appendix B highlight the serious consequences of trading activities that fail to comply with Rule 105.

II. Overview of Rule 105 of Regulation M

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

¹ The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff including the Divisions of Trading and Markets, Enforcement, and Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

² 17 CFR 242.105. Appendix A includes several resources that may be used to better understand the requirements of Rule 105 of Regulation M such as: the adopting, proposing and interpretive releases issued by the Commission; and interpretive guidance and frequently asked questions issued by the SEC staff.

³ Appendix B includes examples of several recent settled SEC enforcement actions regarding Rule 105.

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.

In 2007, the Commission amended Rule 105 in order to address the proliferation of trading strategies designed to conceal violations of the prior rule and in light of evolving trading strategies. As amended, Rule 105 makes it unlawful for a person to purchase securities in a firm commitment equity offering from an underwriter or broker-dealer participating in the offering *if* that person sold short the security that is the subject of the offering during the Rule 105 restricted period, absent an available exception.⁴

Rule 105 provides three exceptions: the “bona fide purchase” provision; an exception for separate accounts; and an exception for investment companies.⁵ First, the “bona fide purchase” exception generally provides that persons can purchase securities in the offering even if they sell short during the Rule 105 restricted period as long as they make a bona fide purchase equivalent in quantity to the amount of the restricted period short sale(s) prior to pricing. Eligibility for the bona fide purchase exception depends on compliance with specific timing and trade reporting requirements that are intended to allow the market to see and take into account purchasing activity in the stock prior to the pricing of the offering.

Second, the limited exception for trading in separate accounts generally allows a purchase of the offered securities in an account of a person where such person sold short in another account during the restricted period, if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts.⁶ Whether an account may be considered separate for purposes of this exception depends on the facts and circumstances. However, the Commission noted there were several indicators that may assist in demonstrating that accounts are separate, such as:

- The accounts have separate and distinct investment and trading strategies and objectives;

⁴ The Rule 105 restricted period is typically the period beginning five days before the pricing of the offered securities and ending with such pricing. Specifically, Rule 105(a) provides as follows: In connection with an offering of equity securities for cash pursuant to a registration statement or notification on Form 1-A or Form 1-E filed under the Securities Act of 1933 (“offered securities”), it shall be unlawful for any person to sell short (as defined in Rule 200(a) of Regulation SHO) 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. 17 CFR 242.105(a).

⁵ 17 CFR 242.105(b).

⁶ 17 CFR 242.105(b)(2).

- Personnel for each account do not coordinate trading among or between the accounts;
- Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;
- Each account maintains a separate profit and loss statement;
- There is no allocation of securities between or among accounts; and
- Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trading in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and, in fact, do not pre-approve trading decision for the accounts.⁷

Third, the investment company exception allows a registered fund (or series of such fund) to participate in an offering, even if another series of the registered fund or an affiliated registered fund (or series of such fund) sold short during the restricted period.⁸

III. Corrective Actions Implemented to Comply with Rule 105 of Regulation M

Recent SEC enforcement actions have specified, and NEP examinations have observed, deficient practices relating to Rule 105.⁹ Rule 105 does not require intent on the part of the short seller to engage in a prohibited transaction; one violates the rule if such person sells short the security that is the subject of the offering during the restricted period (and does not fit into one of the Rule's three exceptions) *and* then purchases shares of that security in the offering. To be in compliance with Rule 105, a person that for any reason has sold short shares of a security that is the subject of an offering during the restricted period must generally either refrain from purchasing shares of that security in the offering, or rely on an exception. Firms are reminded that, in order to advance compliance with Rule 105, it is important to provide training to their employees

⁷ Exchange Act Release No. 56206, 72 Fed. Reg. 45,094 (August 10, 2007) at 45,098-45,099.

⁸ 17 CFR 242.105(b)(3). For example, an individual fund within a fund complex is generally not prohibited by Rule 105 from purchasing an offered security if another fund within the same complex (i.e., an affiliate) sold short the same security within the restricted period. Exchange Act Release No. 56206, 72 Fed. Reg. 45,094 (August 10, 2007) at 45,100.

⁹ *See, e.g., Carlson Capital, L.P.*, Exchange Act Rel. No. 62982 (Sept. 23, 2010)(settled matter)(according to SEC order, investment personnel either misunderstood or were unaware of Rule 105's requirements, the firm's compliance manual did not address it, and the firm lacked policies and procedures sufficient to prevent violations).

regarding the application of the Rule, develop and implement policies and procedures reasonably designed to achieve compliance with the Rule, and enforce those policies and procedures.¹⁰

In determining the penalties associated with the violations in settled Rule 105 enforcement actions, the Commission has considered, among other factors, whether the firms implemented remedial efforts, such as developing and implementing policies, procedures and controls to prevent or detect Rule 105 violations in determining the appropriate resolution in those cases.¹¹

Additionally, in examination summary letters to firms, the NEP staff has specifically commented on inadequate policies and procedures that fail to identify, mitigate and manage risks involving short sales in connection with follow-on or secondary offerings. Effective and enforced policies, procedures and controls can promote compliance with Rule 105.

Even though firms or individuals may take prompt remedial steps to address violations of Rule 105 brought to their attention, these same remedial steps, had they been proactively implemented, may have prevented the violations.¹² After-the-fact remediation would not absolve a firm or individual from the violation of Rule 105.

Robust procedures, as well as a system for applying such procedures, can help prevent and detect, insofar as practicable, violations of Rule 105 by a broker, dealer, investment adviser, or investment company.

IV. Conclusion

This alert informs investment advisers, investment companies and broker-dealers about the importance of complying with Rule 105. It also describes some practices and controls that firms have employed for compliance with Rule 105. The staff hopes that by sharing these observations, it will better encourage firms and individuals who are subject to compliance with

¹⁰ See, e.g., *Appaloosa Management, L.P.*, Exchange Act Rel. No. 62447 (July 2, 2010)(settled matter); *Level Global Investors, L.P.*, Exchange Act Rel. No. 64763 (June 28, 2011)(settled matter); *UBS O'Connor, LLC*, Exchange Act Rel. No. 69680 (June 3, 2013)(settled matter).

¹¹ See, e.g., *Touradji Capital Management, L.P.*, Exchange Act Rel. No. 65923 (Dec. 9, 2011) (settled matter). In this administrative proceeding, an investment adviser violated Rule 105 of Regulation M by purchasing securities in certain public offerings after having sold short the securities during the five business days prior to the pricing of the public offerings (absent a relevant exception), realizing profits of \$833,976. The adviser was required to disgorge these profits, as well as pay a civil penalty of \$350,000 and prejudgment interest of \$119,360. In determining to accept the settlement, the Commission considered the adviser's remedial efforts, including the development and implementation of policies, procedures and controls to prevent or detect Rule 105 violations.

¹² See, e.g., *Harbinger Capital Partners*, Exchange Act Rel. No. 67279 (June 27, 2012)(settled matter)(firm developed employee training and new policies, procedures and controls to prevent or detect Rule 105 violations once it learned of its past violations); *Brookside Capital, LLC*, Exchange Act Rel. No. 64764 (June 28, 2011)(settled matter)(firm developed and implemented policies, procedures and training programs related to Rule 105 compliance).

Rule 105 to apply greater focus on regulations governing short selling in connection with a public offering, implement compliance procedures to manage applicable transactions, and actively monitor transactions for potential violative conduct.

NEP staff welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

Appendix A

Supplemental Information Regarding Rule 105 of Regulation M

You may find the non-comprehensive list of reference sources identified below useful in learning more about Rule 105.

- The adopting release for the amendments to Rule 105, *Short Selling in Connection with a Public Offering*, SEC Release No. 34-56206 (August 2, 2007), which can be found on the SEC's website at <http://www.sec.gov/rules/final/2007/34-56206.pdf>.
- The proposing release for the amendments to Rule 105, *Short Selling in Connection with a Public Offering*, SEC Release No. 34-54888 (December 6, 2006), which can be found on the SEC's website at <http://www.sec.gov/rules/proposed/2006/34-54888.pdf>.
- The adopting release for Regulation M, *Anti-manipulation Rules Concerning Securities Offerings*, Release No. 34-38067 (December 20, 1996), which can be found on the SEC's website at <http://www.sec.gov/rules/final/34-38067.txt>.
- The proposing release for Regulation M, *Trading Practices Rules Concerning Securities Offerings*, Release No. 34-37094 (April 11, 1996), which can be found on the SEC's website at <http://www.sec.gov/rules/proposed/33-7282.txt>.
- SEC Staff-Issued Guidance by the Division of Market Regulation, *Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M, A Small Entity Compliance Guide* (May 21, 2008), which can be found on the SEC's website at <http://www.sec.gov/divisions/marketreg/tmcompliance/regmrule105-secg.htm>.
- SEC Staff-Issued Guidance by the Division of Market Regulation, *Frequently Asked Questions About Regulation M*, Staff Legal Bulletin No. 9 (October 27, 1999 and Revised September 10, 2010), which can be found on the SEC's website at <http://www.sec.gov/interps/legal/mrslb9.htm>.

Appendix B

Examples of Recent Settled Enforcement Actions Regarding Rule 105 of Regulation M

From January 2010 through the present, the Commission has collected disgorgement, penalties, and interest in excess of \$42 million based on violations of Rule 105 of Regulation M. In that time frame, the Commission has settled over 40 actions in which it found that firms and/or individuals have violated Rule 105. Over 75 percent of cases noted here include investment advisers (both registered and unregistered). Several of these settled enforcement actions are identified below.

- Blackthorn Investment Group, LLC, Exchange Act Rel. No. 70392 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70392.pdf>.
- Claritas Investments Ltd., Exchange Act Rel. No. 70393 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70393.pdf>.
- Credentia Group, LLC, Exchange Act Rel. No. 70394 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70394.pdf>.
- D.E. Shaw & Co., L.P., Exchange Act Rel. No. 70396 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70396.pdf>.
- Deerfield Management Company, L.P., Exchange Act Rel. No. 70398 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70398.pdf>.
- Hudson Bay Capital Management LP, Exchange Act Rel. No. 70399 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70399.pdf>.
- JGP Global Gestão de Recursos Ltda., Exchange Act Rel. No. 70415 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70415.pdf>.
- M.S. Junior, Inc., Swiss Capital Holdings, Inc., and Michael Stango, Exchange Act Rel. No. 70400 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70400.pdf>.
- Manikay Partners LLC, Exchange Act Rel. No. 70401 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70401.pdf>.
- Meru Capital Group, LP, Exchange Act Rel. No. 70402 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70402.pdf>.
- Merus Capital Partners, LLC, Exchange Act Rel. No. 70405 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70405.pdf>.

- Ontario Teachers' Pension Plan Board, Exchange Act Rel. No. 70407 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70407.pdf>.
- Pan Capital AB, Exchange Act Rel. No. 70409 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70409.pdf>.
- PEAK6 Capital Management LLC, Exchange Act Rel. No. (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70410.pdf>.
- Philadelphia Financial Management of San Francisco, LLC, Exchange Act Rel. No. 70412 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70412.pdf>.
- Polo Capital International Gestão de Recursos Ltda., Exchange Act Rel. No. 70397 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70397.pdf>.
- Soundpost Partners, LP, Exchange Act Rel. No. 70403 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70403.pdf>.
- Southpoint Capital Advisors LP, Exchange Act Rel. No. 70404 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70404.pdf>.
- Talkot Capital LLC, Exchange Act Rel. No. 70406 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70406.pdf>.
- Vollero Beach Capital Partners LLC, Exchange Act Rel. No. 70408 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70408.pdf>.
- War Chest Capital Partners LLC, Exchange Act Rel. No. 70411 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70411.pdf>.
- Western Standard, LLC, Exchange Act. Rel. No. 70413 (September 16, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70413.pdf>.
- UBS O'Connor, LLC, Exchange Act Rel. No. 69680 (June 3, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-69680.pdf>.
- Ardley Advisory Partners, Exchange Act Rel. No. 68828 (February 5, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-68828.pdf>.
- JCSD Capital, LLC, Exchange Act Rel. No. 67919 (September 24, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-67919.pdf>.

- Peter Siris, Litigation Rel. No. 22430 (July 30, 2012), available at <http://www.sec.gov/litigation/litreleases/2012/lr22430.htm>.
- Wesley Capital Management, LLC, Exchange Act Rel. No. 67510 (July 26, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-67510.pdf>.
- Harbinger Capital Partners, Exchange Act Rel. No. 67279 (June 27, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-67279.pdf>.
- Touradji Capital Management, L.P., Exchange Act Rel. No. 65923 (Dec. 9, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-65923.pdf>.
- Fontana Capital, LLC and Forrest Fontana, Exchange Act Rel. No. 34-64839 (July 8, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-64839.pdf>.
- Brookside Capital, LLC, Exchange Act Rel. No. 64764 (June 28, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-64764.pdf>.
- Level Global Investors, L.P., Exchange Act Rel. No. 64763 (June 28, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-64763.pdf>.
- Aristeia Capital, LLC, Exchange Act Rel. No. 34-64374 (May 2, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-64374.pdf>.
- Horseman Capital Management, L.P., Exchange Act Rel. No. 63757 (Jan. 24, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-63757.pdf>.
- Gartmore Investment Ltd., Exchange Act Rel. No. 63460 (Dec. 8, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-63460.pdf>.
- New Castle Funds LLC, Exchange Act Rel. No. 63358 (Nov. 22, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-63358.pdf>.
- Carlson Capital, L.P., Exchange Act Rel. No. 62982 (Sept. 23, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62982.pdf>.
- Appaloosa Management, L.P., Exchange Act Rel. No. 62447 (July 2, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62447.pdf>.
- Leonard J. Adams, Exchange Act Rel. No. 62072 (May 11, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62072.pdf>.
- Peter G. Grabler, Exchange Act Rel. No. 62073 (May 11, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-62073.pdf>.

- GPS Partner LLC and Brett S. Messing, Exchange Act Rel. No. 61718 (Mar. 16, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-61718.pdf>.
- AGB Partners LLC, Gregory Bied and Andrew J. Goldberger, Exchange Act Rel. No. 61422 (Jan. 26, 2010) available at <http://www.sec.gov/litigation/admin/2010/34-61422.pdf>.
- Palmyra Capital Advisors, LLC, Exchange Act Rel. No. 61421 (Jan. 26, 2010), available at <http://www.sec.gov/litigation/admin/2010/34-61421.pdf>.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified in the course of examinations regarding compliance with Rule 105 of Regulation M. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
