

Client Alert

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Renewed Focus on an Old Rule: SEC Steps Up Rule 105 Enforcement Efforts

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On September 17, 2013, the Securities and Exchange Commission (SEC or “Commission”) announced settled enforcement actions against 23 firms for short selling in violation of Rule 105 of Regulation M, which limits the ability of firms, in the absence of an exception, from participating in firm commitment offerings after short selling those same stocks. Andrew J. Ceresney, Co-Director of the SEC’s Division of Enforcement, stated that their efforts will continue to focus on these violations: “Through this new program of streamlined investigations and resolutions of Rule 105 violations, we are sending the clear message that firms must pay the price for violations while also conserving agency resources.”

On the same day that the SEC announced these proceedings, the SEC’s National Examination Program (NEP), and the Office of Compliance Inspections and Examinations issued a National Exam Program Risk Alert (“Risk Alert”) directing investment advisers, investment companies and broker-dealers to review their compliance programs to promote compliance with Rule 105 of Regulation M. The Risk Alert reported that, in 40 settled actions finding Rule 105 violations since January 2010, the Commission has collected disgorgement, penalties and interest in excess of \$42 million. The Risk Alert highlighted observations by SEC examiners about Rule 105 compliance issues and corrective actions that some firms have taken proactively to remedy Rule 105 concerns.

These events provide the opportunity for firms not named in these proceedings to educate themselves about the requirements of Rule 105 and to ensure that their systems and procedures are adequate to prevent violations.

THE ENFORCEMENT ACTIONS

The SEC brought these enforcement actions against a wide range of regulated entities that violated Rule 105 from 2008 to 2013, including registered investment advisers, asset management firms, money management firms, hedge fund advisers, registered broker-dealers, Brazilian-based investment advisers, a proprietary trading firm, a Swedish-based investment firm, a private equity firm, and a hedge fund manager. The relief in these proceedings included a total of more than \$14.4 million in monetary sanctions, with disgorgement in some of the cases exceeding \$1 million, and civil monetary penalties of over \$500,000. In a couple of these cases, like in some previous Rule 105 settlements, the SEC was willing to bring claims even when relatively small numbers of shares, and, consequently, small amounts of disgorged profits were involved. Only one of the 23 respondents did not settle.

RULE 105 PROHIBITS CERTAIN PUBLIC OFFERING PURCHASES AFTER SHORT SELLING THE SAME SECURITY

Rule 105 prohibits the purchase of securities from an underwriter, broker or dealer participating in follow-on and secondary firm commitment equity offerings when the purchaser has entered into short sales in those same

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securities within a specified amount of time prior to the pricing of an offering. The Rule 105 restricted period 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 a registration statement or notification on Exchange Act Form 1-A or Form 1-E and ending with pricing.

A fundamental goal of Rule 105 is to protect “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.” Put simply, the rule seeks to avoid manipulation through short selling that could artificially depress market prices and lead to lower than anticipated offering prices, causing an issuer’s offering proceeds to be reduced. Because the offering prices of follow-on and secondary offerings are typically set at a discount to a stock’s closing price just prior to pricing, a person expecting 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. Rule 105 is prophylactic and is a strict liability rule prohibiting the conduct irrespective of the short seller’s intent. No manipulative intent or scienter needs to be alleged for a Rule 105 violation to occur.

Note that the rule does not ban short sales. Traders can sell short during a Rule 105 restricted period if they choose not to purchase securities in the offering and under the rule they can sell short prior to the restricted period and receive an offering allocation. The prohibition is against short selling during the restricted period, and purchasing the offered securities. According to the Risk Alert: “[t]o 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.”

The three exceptions to Rule 105 are: (a) the “bona fide purchase” exception that generally permits persons to 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 short sale during regular trading hours of the restricted period prior to pricing, no later than the business day prior to the pricing; (b) the “separate account” exception that generally allows a purchase of the offered securities in an account that is related to or affiliated with the account that made the short sale, if decisions regarding securities transactions for the two accounts are made separately and without any coordination of trading or cooperation among or between the accounts; and (c) the “investment company” exception that allows a registered fund to participate in an offering, even if an affiliated investment company or any series of such investment company sold short during the restricted period.

EFFECTIVE COMPLIANCE POLICIES AND PROCEDURES ARE CRUCIAL

In prior enforcement actions, the SEC has discussed firms’ failures to have appropriate policies and procedures in place to ensure compliance with Rule 105 as well as specific remedial actions taken by respondents, such as the development and implementation of policies, procedures and controls designed to detect and prevent Rule 105 violations, and training. For instance, in *Carlson Capital, L.P.*, Exchange Act Rel. No. 62982 (Sept. 23, 2010), the Commission noted that the investment personnel who directed the firm’s participation in the offerings either misunderstood or were unaware of Rule 105’s requirements; the firm’s compliance manual did not address Rule 105; and the firm conducted no formal firmwide training addressing Rule 105 compliance.

In contrast, the current crop of 23 cases includes no specific discussion about firm procedures – adequate or

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otherwise – that might provide guidance to the industry (beyond noting that, in setting the sanctions, the Commission considered remedial actions promptly undertaken by the respondents and cooperation afforded to Commission staff). Instead, given the relative haste in which these cases apparently were concluded, the Commission probably decided to take advantage of the *in terrorem* effect of the announcement of these cases together with the discussion in the Risk Alert to send the industry a message about bringing its practices and supervisory controls into compliance with Rule 105.

The Risk Alert reminds firms that training their employees regarding the application of Rule 105 and developing, implementing and enforcing policies and procedures reasonably designed to achieve compliance with the rule are important to ensuring compliance with the rule. In addition, in examination summary letters to firms, NEP staff has specifically criticized inadequate policies and procedures that failed to identify, mitigate and manage risks involving short sales in connection with follow-on or secondary offerings. This further reflects the SEC's view that effective and enforced policies, procedures and controls can promote compliance with Rule 105.

The Risk Alert emphasized the importance of having adequate procedures in place when it observed that, in determining the penalties associated with the violations in previously settled Rule 105 enforcement actions, the SEC considered, among other factors, the firms' remedial efforts, including developing and implementing policies, procedures and controls to prevent or detect Rule 105 violations. See, e.g., *Touradji Capital Management, L.P.*, Exchange Act Rel. No. 65923 (Dec. 9, 2011). Nevertheless, while robust procedures can help prevent and detect violations, implementation of these procedures after the SEC identifies Rule 105 violations will not necessarily avoid liability. Through its announcement of these enforcement actions and the contemporaneous release of the Risk Alert, the SEC has provided the motivation and the tools for firms to bring their procedures into compliance with the rule.

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