

Recent SEC Enforcement Actions Suggest Continued Attention to Rule 105 of Regulation M

On September 16, 2013, the Securities and Exchange Commission (“SEC”) charged over 20 firms with violations of Rule 105 of Regulation M of the Securities Exchange Act of 1934 (“Rule 105” or “the Rule”), which prohibits the purchase of securities in a secondary offering when the buyer has a short position, as that term is defined in SEC rules, of the same securities established during a specified restricted period.¹ The same day, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) issued guidance to firms on issues they had observed regarding compliance with Rule 105 and made suggestions to firms as to how to address the relevant risk. These recent cases, and contemporaneous SEC statements on the subject, suggest that the SEC will continue to focus attention on Rule 105 violations in examinations and enforcement inquiries. Companies should therefore take steps to ensure that their policies contain appropriate provisions related to Rule 105 and consider training of relevant staff to avoid such issues.

The Substance and Policy of Rule 105 of Regulation M

Rule 105 proscribes purchasing securities in a firm commitment underwritten offering of public equity if one has made a short sale of such security during a restricted period (regardless of whether the firm has an economic long position), which is generally defined as five business days prior to the pricing of the offering.² A short sale is defined 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.”³

While the Commission holds the position that short selling can benefit the market by correcting undervalued stock and promoting market liquidity, it believes that short selling in close temporal proximity to public offerings can dilute offering prices and inhibit the capital raising process. Since the price of shares in a follow-on or secondary offering is generally set at a discount to the closing price just before the offering, the SEC seeks to prevent investors from artificially depressing prices by aggressively selling short shares prior to the offering. These same investors could then purchase shares in the offering at an unnaturally reduced price to cover the short sales, which would insulate them from market risk and lower the issuer’s proceeds.

The SEC implemented Rule 105 to protect the “independent pricing mechanism of the securities market so that offering prices result from the natural forces of supply and demand,” rather than from market manipulation.⁴ Prior to 2007, the Rule prohibited investors from using shares bought in a public offering to cover a short sale that was effected during the restricted period. In 2007, the SEC amended the Rule to create a blanket proscription against purchasing securities in an offering that were the subject of a short sale during the restricted period. This bright-line rule was intended to prevent attempts at concealing trading structures that circumvented the prior version of the Rule.

¹ 17 C.F.R. § 242.105

² The restricted period is the shorter period of that “[b]eginning five business days before the pricing of the offered securities and ending with such pricing . . . or . . . [b]eginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.” 17 C.F.R. 242.105(a)(1)-(2).

³ 17 C.F.R. § 242.200(a).

⁴ See Short Selling in Connection with a Public Offering, Release No. 34-56206, 72 Fed. Reg. 45094 (Aug. 10, 2007) (effective Oct. 9, 2007).

Rule 105 is prophylactic in nature and no intent is required to prove a violation. It contains three limited carve-outs that allow participation in public offerings after shorting the same securities, in specific circumstances constituting (1) bona fide purchases, (2) trading in separate accounts, and (3) purchases by registered funds when an affiliated investment company previously shorted securities. These safe harbors have detailed requirements and, especially with respect to the separate account exception, can be very challenging to establish.

The Recent Enforcement Actions

In the enforcement actions announced last week, the SEC alleged that each firm violated Rule 105 by first shorting securities during the restricted period and then purchasing these same securities from an underwriter, broker, or dealer through a follow-on public offering, between 2008 and 2013.⁵ The subjects of the enforcement actions include registered investment advisors, asset managers, registered broker-dealers, and trading firms. All but one of the firms agreed to settle with the SEC.

The SEC has not charged any individuals in the most recent Rule 105 enforcement actions, but has done so in the past. Principals of firms should be aware that they may be implicated in future enforcement actions.

Highlighting the lack of an intent requirement is the seemingly mechanical nature of the violations at issue. Indeed, the SEC imposed a heavy penalty on a firm despite noting that it had relied on the advice of outside counsel that its trading was proper. Moreover, there seems to be no materiality threshold for the SEC to bring enforcement actions regarding Rule 105, as actions have been brought for violations resulting in total profits as small as \$4,091. These settlements, therefore, send a strong signal to the market that Rule 105 will be scrupulously enforced for even minor violations.

Disgorgement and Penalties

Settlements generally involve the disgorgement of all illicit profits, with hefty prejudgment interest attached, as well as civil penalties. The civil penalty for a violation of Rule 105 by an entity is typically up to the greater of \$65,000 or the wrongful gain, per violation.⁶ The minimum \$65,000 penalty has been imposed on violations resulting in profits as small as \$4,091 and \$8,402. In the most recent enforcement actions, the median civil penalty as a percentage of profits was 51%, with penalties ranging from 20% to 1,589% of profits. Excluding cases in which the minimum statutory fine was imposed, the highest penalty was 96% of the profits. Despite this wide range in relative penalties, the settlement orders contain scant details regarding the specific circumstances that led to the penalty imposed in each case.

Suggested Remedial Measures and Mitigating Factors

Last week's settlements are part of a trend of greater SEC attention to short selling violations over the last three years. A review of Rule 105 enforcement actions from 2010 to present indicates that the SEC considers several mitigating factors when determining penalties. The existence of policies aimed at Rule 105 compliance prior to a violation may result in less harsh civil penalties. Strong cooperation with the SEC and

⁵ The statute of limitations for Rule 105 violations is five years.

⁶ The \$65,000 number equates to a Tier I penalty which applies to simple violations of law. The SEC could possibly try to seek Tier II or III violations if it believed there to be fraud involved with the violation, but such an application in the course of prosecuting a Rule 105 violation would be in the very least an aggressive position and of questionable legal merit.

the implementation of remedial measures also seem to have influenced lower penalties. Such remedial measures include developing policies and procedures that prevent Rule 105 violations and instituting educational programs for employees.

The following steps are recommended:

- Firms that participate in offerings of public equity should provide educational programs regarding Rule 105 to their employees, focusing in particular on their investment managers and trade desk personnel;
- Firms should develop and consistently enforce policies and procedures that prevent Rule 105 violations and consider establishing some form of formal or informal check that requires someone at the firm, perhaps on the trade desk, to confirm no short positions were added in the prohibited period prior to placing the order in the offering; and
- If a violation occurs, a firm should immediately take remedial action in response to the violation and cooperate with SEC Staff in any investigation.

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