

SEC PUBLISHES FINAL AMENDMENTS TO RULE 105 OF REGULATION M

On August 6, 2007, the Securities and Exchange Commission (the “SEC” or the “Commission”) published final amendments that significantly modify Rule 105 of Regulation M under the Securities Exchange Act of 1934 (the “Exchange Act”).¹ The amendments will become effective 60 days after the Commission’s release (the “Release”) adopting the final amendments is published in the Federal Register.

Current Rule 105 prohibits a person from *covering* a short sale with securities purchased from an underwriter or a broker or dealer participating in a firm commitment offering² if such short sale occurred during the Rule’s restricted period.³ In December 2006, the Commission proposed to amend Rule 105 to delete the “covering” element of the current Rule.

The final amendments to Rule 105 adopt the proposed elimination of the covering element. Amended Rule 105(a) generally prohibits a person from purchasing securities from an underwriter or a broker-dealer participating in a firm commitment offering if the person sold short⁴ the security that is the subject of the offering during the “restricted period” outlined in the Rule.⁵ The Commission also is limiting application of amended Rule 105 to equity securities.

¹ *Short Selling in Connection with a Public Offering*, Securities Exchange Act Release No. 34-56206 (Aug. 6, 2007) (<http://www.sec.gov/rules/final/2007/34-56206.pdf>).

² By its terms, the amended Rule applies to all registered equity offerings for cash. Amended Rule 105 retains the exception in current Rule 105 for offerings not conducted on a firm commitment basis. Moreover, in the Release (at footnote 41), the Commission stated:

We note that certain issues discussed in the Proposing Release and comment letters have not been incorporated into amended Rule 105 at this time. However, the Commission intends to monitor whether further action is warranted. For example, amended Rule 105 continues to retain the exception for best efforts offerings. If we become aware of potentially manipulative short selling prior to the pricing of best efforts offerings or other concerns with this exception, the Commission may re-evaluate this exception. By way of another example, PIPEs generally did not fit within the elements of former Rule 105. One reason for this is that PIPEs are typically not conducted on a firm commitment basis. PIPE offerings not conducted on a firm commitment basis continue to be excepted from Rule 105, however other areas of the securities laws continue to apply to PIPE offerings. *See e.g.*, SEC v. Hilary L. Shane, Lit. Release No. 19227 (May 18, 2007).

³ 17 C.F.R. 242.105.

⁴ Amended Rule 105(a) incorporates the definition of short sale contained in Rule 200(a) of Regulation SHO under the Exchange Act. Rule 200(a) defines a short sale 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.” 17 CFR 242.200(a).

⁵ Under Rule 105(a), the restricted period is the shorter of the period: “(1) [b]eginning five business days before the pricing of the offered securities and ending with such pricing; or (2) [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.”

Exceptions

In response to comments that an absolute prohibition on purchasing a security in a public offering that a person sold short during the Rule 105 restricted period would be unnecessarily restrictive, the Commission included three exceptions to amended Rule 105(a).⁶

The Bona Fide Purchase Exception

First, amended Rule 105(b)(1) permits a restricted period short seller to purchase offered securities if the short seller makes a bona fide purchase of the same security no later than the business day before the day of pricing. According to the Commission, this exception allows a trader who had no knowledge of an offering at the time of a short sale to participate in the offering, but also would be available if the person continued to sell short after learning of the offering as long as the person made the requisite bona fide purchase eliminating the entire short position at least one business day before the pricing of the offering.

Whether a purchase of a security sold short during the restricted period is bona fide depends on the facts and circumstances surrounding the transaction. A transaction made in technical compliance with the exception, but that is part of a scheme or plan to evade the Rule, would not be bona fide. The Release provides as an example of a purchase that is not bona fide a transaction that does not include the economic elements of risk associated with a purchase for value and cites the discussion of sham transactions in Exchange Act Release No. 50103 (July 28, 2004) and Exchange Act Release No. 48795 (Nov. 17, 2003), referred to as the “Married Put Release.”

To take advantage of the bona fide purchase exception, the short seller must purchase a quantity of shares at least equal to the quantity sold short during the amended Rule 105 restricted period. If, for example, a person sold 1,000 shares of stock short during the restricted period and then purchased only 500 shares before pricing, the exception would be unavailable and that person would be prohibited from purchasing any shares in the offering. Moreover, the bona fide purchase must be made during regular trading hours and reported under an effective transaction reporting plan.⁷ The purchase must occur, as noted above, no later than the business day before the day of pricing. Finally, the bona fide purchase exception is not available to persons effecting short sales within the 30 minutes before the close of regular trading hours on the business day before the day of pricing. The Commission stated that potentially manipulative activity near the

⁶ Regardless of whether a purchase is exempt under amended Rule 105 of Regulation M, securities transactions are subject to the antifraud and anti manipulation provisions of the federal securities laws. Moreover, short selling the same securities offered in a registered secondary or follow-on offering may be subject to the registration requirements of Section 5 of the Securities Act of 1933 (the “1933 Act”).

⁷ Amended Rule 105(b)(1)(C) defines “effective transaction reporting plan” by citing to the definition in Rule 600(b)(22) of Regulation NMS under the Exchange Act, which defines the term as any such plan approved by the Commission under Rule 601 of Regulation NMS.

close of trading can put downward pressure on offering prices and possibly reduce the issuer's offering proceeds.

The Separate Accounts Exception

Second, amended Rule 105(b)(2) provides an exception from amended Rule 105(a) for separate accounts. Subparagraph (b)(2) permits a person who has multiple securities accounts to purchase an offered security in one account even if he or she sold the same security short during the Rule 105 restricted period in another, separate account "if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts." This exception incorporates principles of Rule 200(f) of Regulation SHO, which allows broker-dealers to treat non-coordinating units separately. The exception is available to any account manager and is not limited to certain types of persons, such as registered investment companies or registered investment advisers. The SEC reasoned that if decisions regarding securities transactions for each account were made separately, the incentive to manipulate the price of a security would not be present because the short seller could not profit by purchasing the discounted offering shares.

Indicia that accounts are separate would include (1) separate and distinct investment and trading strategies for each account; (2) no coordination by personnel of trading among or between accounts; (3) information barriers to separate the accounts; (4) maintenance by each account of a separate profit and loss statement; (5) no allocation of securities between or among accounts; and (6) personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and owners of multiple accounts, who do not have the authority to, and do not, execute trades in the accounts or pre-approve trading decisions for the accounts. Even if the accounts do not satisfy each of the conditions, a person may fall within the exception as long as the accounts in fact are separate and operating without coordinating trading. Creation of policies and procedures reasonably designed to maintain separate accounts (considering the indicia of separate accounts), coupled with regular review to help ensure effective implementation of those policies and procedures, also would be indications that accounts are separate.

The Commission also provides examples of persons who could fall within the separate accounts exception to Rule 105(a). Those persons include, among others, an adviser who provides capital to two or more sub-advisers or two private investment funds that are separate legal entities, if the funds maintain different accounts and separate profit and loss statements and do not coordinate trading, share information or allocate securities between accounts. An adviser who operates a "black box" using a trading algorithm may take advantage of the separate account exception if the black box is separate from another black box or another trading unit.

A fund of funds that invests in several downstream funds and owns shares of each downstream fund, rather than shares of the securities in which each downstream fund invests, probably will not need to rely on the separate account exception if one of the downstream funds sells short during the restricted period and another one buys offered securities. A fund of funds investing in

several, unaffiliated downstream funds engaging in such activities would not violate amended Rule 105, provided that it does not coordinate the trading of the downstream funds.

A registered investment company with multiple sub-advisers whose activities are subject to supervision by a single, primary investment adviser could take advantage of the separate account exception under certain circumstances. Each sub-adviser to a portion of the fund or series might be able to rely on amended Rule 105(b)(2). If one sub-adviser to a registered fund, or a series of that fund, engaged in a short sale during the amended Rule 105 restricted period while another sub-adviser to that fund or series took a long position in the same offered securities, those trading decisions would be viewed as being made separately and without coordination if (1) the sub-adviser met the elements of Rule 17a-10(a)(1)-(2) under the Investment Company Act of 1940 (the “1940 Act”),⁸ and (2) the primary adviser did not execute trades in individual securities or pre-approve trading decisions for the sub-advised portions.

The Investment Company Exception

Third, amended Rule 105(b)(3) provides an exception from amended Rule 105(a) for registered investment companies. This exception permits an individual fund that is part of a complex or series to purchase an offered security if another fund within the same complex or a different series of the fund sold the subject security short during the amended Rule 105 restricted period. In adopting this exception, the Commission reasoned that 1940 Act Section 17(d) and Rule 17d-1 thereunder, which generally prohibit an affiliated person of a registered investment company from participating in any joint enterprise or arrangement with the affiliated investment company, would prevent the funds from engaging in the activities that amended Rule 105(a) seeks to prohibit.

Additional Guidance on the Scope of Rule 105

Amended Rule 105 captures offerings made under Form 1-E, Notification pursuant to Regulation E. Regulation E exempts from registration under the 1933 Act securities issued by registered small business investment companies or by business development companies registered under Section 54(a) of the 1940 Act. The Commission stated that application of amended Rule 105 to Regulation E offerings “is designed to ensure that participants in the secondary market for the securities of small business investment companies and business development companies will enjoy the same protections afforded to participants in the secondary market for the securities of similarly placed non-investment companies.” Including offerings made pursuant to Form 1-E also is intended to place small business investment companies and business development

⁸ Rule 17a-10(a)(1)-(2) under the 1940 Act governs the circumstances under which a sub-adviser to a registered investment company may enter into transactions with another sub-adviser to the same registered investment company without violating Section 17(a) of the 1940 Act. Section 17(a) generally prohibits a sub-adviser from entering into principal transactions with a registered investment company or an affiliated person of a registered investment company, such as a sub-adviser.

companies on equal footing with small issuers exempt from 1933 Act registration requirements under Regulation A, which is subject to amended Rule 105.

Unlike other provisions of Regulation M, amended Rule 105 does not apply to “reference securities.” That is, a person may sell short an underlying common equity security and purchase in an offering a security convertible into the subject common equity without violating amended Rule 105. According to the Commission, convertible securities are priced on a number of factors other than the underlying equity’s price, making the convertible less susceptible to manipulation through short selling the underlying equity during pre pricing of the convertible.

As noted above, amended Rule 105 is limited to firm commitment offerings. PIPE offerings, for example, typically are conducted on a best efforts basis and, therefore, would not be subject to amended Rule 105 if conducted on such a basis.

The Commission also clarified that for purposes of Rule 105, the purchase occurs at the time the investor becomes committed by agreement or is committed to by the offered security, regardless of whether such agreement is written or oral.

The amended Rule does not apply to short swap transactions, but the Commission stated that it would examine whether the use of such transactions is designed to be manipulative, in which case they would be subject to the antifraud provisions even if not within the scope of amended Rule 105. The Commission also stated that it will continue to monitor the use of derivatives strategies that mirror the economic effects of the activities that Rule 105 was intended to prevent.

Practical Considerations

Amended Rule 105 could affect trading strategies involving short sales by prohibiting persons who effect short sales during the amended Rule 105 restricted period from purchasing the subject securities in a public offering. Amended Rule 105 does not contain a scienter requirement and therefore applies even if the short sale involved in the trading strategy was not effected to manipulate the stock price of the subject securities and even if the short sale was hedged at the time it was effected, as would be the case, for example, in some reverse conversions (short stock, short put, long call). Amended Rule 105, however, does recognize certain exceptions and, importantly, extends the principles of aggregation units contained in Regulation SHO to Rule 105.

Persons who engage in short sales should review and update their policies and procedures to address activities that amended Rule 105 does not permit and should prohibit those who have sold short during the restricted period from purchasing deal stock in the offering unless they have completely covered the short sale no later than one business day before the day of pricing of the offering. The policies and procedures also should describe activities that fall within one of the three enumerated exceptions to the amended Rule and, to that end, identify separate trading units. In addition, the policies and procedures should outline activities that would appear to be encompassed by the Rule, but are outside of its scope.

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