

CLIENT MEMORANDUM

SEC's Short Selling Crackdown Highlights Role of Inspections in Enforcement Actions and Continuing Need for Compliance Vigilance

September 20, 2013

AUTHORS

Elizabeth P. Gray | Daniel Schloendorn | Howard L. Kramer

The Securities and Exchange Commission ("SEC") recently announced enforcement actions for short selling violations by 23 firms, primarily registered investment advisers and other asset managers.¹ At the same time, the staff of the SEC's Office of Compliance Inspections and Examinations issued a related National Exam Program "Risk Alert" that, among other things, discusses certain legal requirements applicable to short selling and describes various steps that firms can take to remedy violations or to avoid violations in the first instance.²

All of the firms charged were found to have violated the short selling restrictions set out in Rule 105 under Regulation M of the Securities Exchange Act of 1934 ("Rule 105" or the "Rule").³ Rule 105 in general prohibits short selling a security within a specified period of time (the restricted period) prior to a purchase of the security in a follow-on or secondary firm

¹ SEC Charges 23 Firms With Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings, SEC press release (Sept. 17, 2013). For the full content of the press release, see:

<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376>

² Rule 105 of Regulation M: Short Selling in Connection With a Public Offering, Office of Compliance Inspections and Examinations National Exam Program Risk Alert (Sept. 17, 2013). For the full content of the Risk Alert, see:

<http://www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf>.

³ Rule 105 is codified at 17 C.F.R. § 242.105.

SEC's Short Selling Crackdown Highlights Role of Inspections in Enforcement Actions and Continuing Need for Compliance Vigilance

Continued

commitment offering. In the typical scenario, a security in such an offering will be priced at a discount to current market price. Rule 105 is intended to prevent those who would short sell such a security from profiting from the expected drop in the price of the security after the offering is consummated.

What seems clear from the announced enforcement actions is that the SEC is willing to commence proceedings for rule violations that in prior years might have been resolved other than through the enforcement process. It also seems clear that firms should expect greater collaboration between the SEC's inspection and enforcement programs, with more enforcement cases having their origins in routine staff inspections. Vigilance over internal compliance programs is increasingly important to avoid violating applicable legal requirements such as those set out in Rule 105 and, more importantly, a potential enforcement action over witting or unwitting compliance violations.

RULE 105: REQUIREMENTS AND EXCEPTIONS

From a compliance perspective, it is important to understand the general prohibition of Rule 105 so that proper procedures can be implemented to avoid a violation. Imposing restrictions on short selling securities that your firm intends to purchase in a follow-on or secondary firm commitment offering or, conversely, on purchasing such a security that your firm has sold short during the restricted period, are the basic tenets. But there are several exceptions under the Rule, including, for example, those for so-called *bona fide* purchases and for separate accounts separately managed, that should be taken into account to the extent that they apply to your firm and its trading practices.

Subject to certain requirements, a firm generally can avail itself of the *bona fide* purchase exception where it makes a *bona fide* purchase of the offered security that is at least equivalent in quantity to the entire amount of its short sales during the restricted period, is effected after the last such short sale and occurs no later than the business day prior to the pricing date. The separate account exception in general is applicable where a person or firm effects a short sale of a security for one account and a purchase of the same security for another account, so long as there is no coordination of trading or cooperation between the accounts. Registered investment companies are separately excepted from the Rule's requirements where, for example, one series of an investment company sells a security short and another series of the investment company purchases the security in a subsequent offering. The exception for investment companies is somewhat analogous to the separate account exception. Each of these exceptions is subject to certain specified requirements and a comprehensive compliance program should address each such requirement.

SEC CRACKDOWN: INSPECTIONS LEADING TO MORE ENFORCEMENT CASES

The 23 enforcement actions collectively show that the SEC is not reluctant to act on the strict liability imposed under the Rule (or, for that matter, other rules and regulations), which imposes liability even where there is no intention to evade the Rule's requirements. In several cases, for example, the offending firms had on only two or fewer occasions run afoul of the Rule and had garnered relatively little in terms of financial gains. One case in particular is worth noting: the offending

SEC's Short Selling Crackdown Highlights Role of Inspections in Enforcement Actions and Continuing Need for Compliance Vigilance

Continued

firm was found to have violated the Rule on one occasion and to have netted total profits of approximately \$4,000.⁴ The settlement order in the case required disgorgement of the illicit profits and imposed a civil penalty in the amount of \$65,000, an amount far in excess of the amount of the alleged gains and that appears to be the minimum penalty imposed by the SEC in these types of cases. More significant penalties were imposed in cases involving more egregious conduct.

Equally important to note is that the SEC's inspection and enforcement programs likely will cooperate to an even greater extent than in the past so that an increasing number of enforcement cases may have their origins in routine staff inspections. As the SEC noted in its announcement, "[t]he coordination between the enforcement and examination programs reaffirms that market participants must be in compliance with Rule 105 to preserve and protect the independent pricing mechanisms of the securities markets." This cautionary statement is likely no less applicable to other types of rule violations that are discovered during an SEC staff inspection.

KEY TAKEAWAY: CONTINUING VIGILANCE OVER COMPLIANCE

These 23 enforcement actions highlight the need to review existing compliance programs to ensure that proper procedures are in place regarding short selling restrictions in particular and regarding other legal requirements in general. Even seemingly minor violations can entangle firms in costly enforcement actions. In this regard, the Risk Alert advises firms "to provide training to their employees 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." Although the SEC staff, in determining the amount of penalties to impose on firms found to have violated Rule 105, considers remedial efforts implemented by the firm to prevent or detect Rule 105 violations, after-the-fact remediation does not absolve an individual or firm from a Rule 105 violation. Vigilance over internal compliance aimed at detecting and preventing violations in the first instance is the best and most cost effective antidote to a potential SEC enforcement action.

⁴ *Credentia Group, LLC*, Exchange Act Release No. 70394 (Sept. 16, 2013).

SEC's Short Selling Crackdown Highlights Role of Inspections in Enforcement Actions and Continuing Need for Compliance Vigilance

Continued

If you have any questions concerning the matters described in this memorandum, please contact Elizabeth P. Gray (202-303-1207, egray@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Howard L. Kramer (202-303-1208, hkramer@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Paris, London, Milan, Rome, Frankfurt and Brussels. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

September 20, 2013

Copyright © 2013 Willkie Farr & Gallagher LLP.

WILLKIE FARR & GALLAGHER_{LLP}