

Recent SEC Enforcement Actions Put Spotlight On Prohibited Short Selling

Recent SEC enforcement actions demonstrate the SEC's increased focus on violations of Rule 105 of Regulation M.

On September 17, 2013, the Securities and Exchange Commission (the SEC) announced enforcement actions against 23 firms for short selling violations under Rule 105 of Regulation M (Rule 105), which generally prohibits short selling of equity securities during a restricted period and then purchasing the same securities in follow-on and secondary public offerings.¹ In the press release announcing these actions, the SEC stated that “[t]he benchmark of an effective enforcement program is zero tolerance for any securities law violations, including violations that do not require manipulative intent. 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.”² As such, market participants who engage in short selling activities should “provide training to their employees regarding the application of [Rule 105], develop and implement policies and procedures reasonably designed to achieve compliance with [Rule 105], and enforce those policies and procedures.”³

How Does the SEC's “Zero Tolerance” Policy Affect My Firm?

The firms charged with violations of Rule 105 include various market participants, such as broker-dealers, investment advisers, asset management firms, hedge fund advisers and private equity firms. 22 of these 23 SEC enforcement actions have been settled, resulting in more than \$14.4 million in monetary sanctions against the firms in total.⁴ The disgorgement that firms agreed to pay in these settled enforcement actions ranged from \$4,091 to more than \$2.5 million, indicating that the SEC is determined to bring claims irrespective of the magnitude of the violation measured in terms of illicit profits. In the one case that is still being litigated in an administrative proceeding, the SEC's Enforcement Division is seeking “full disgorgement of the trading profits, prejudgment interest, penalties, and other relief as appropriate and in the public interest.”⁵

These enforcement actions follow a sweep of buy-side firms by the SEC staff concerning compliance with Rule 105 earlier this year and are, according to Andrew J. Ceresney, Co-Director of the SEC's Division of Enforcement, part of the SEC's attempt to “increase[] its focus on preventing firms from improperly participating in public stock offerings after selling short those same stocks.”⁶

The SEC's zero-tolerance policy coupled with the fact that Rule 105 does not require intent on the part of the short seller to engage in a prohibited transaction makes for a toxic combination for any market participant that inadvertently violates Rule 105.

What Is Rule 105?

What Conduct Does Rule 105 Prohibit?

Rule 105 is designed to prevent market participants from manipulating the price of secondary offerings by shorting the securities offered shortly before the secondary offering is priced. Rule 105 seeks to prevent this activity by prohibiting any person that has sold short a security that is the subject of a registered offering from purchasing securities in the offering from an underwriter, broker or dealer participating in the offering if the short sale took place during a specified period prior to the pricing of the offered securities (the pre-pricing period). For purposes of Rule 105, the pre-pricing period begins on the later of (i) the fifth business day before pricing or (ii) the initial filing of the registration statement, and ends with the pricing of the securities.⁷ For purposes of Rule 105, 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.”⁸

What Is the Scope of Rule 105?

Rule 105 applies to registered offerings of equity securities for cash that are conducted on a firm commitment basis. Accordingly, Rule 105 is not applicable to (i) offerings of nonconvertible debt securities, (ii) offerings that are not registered under the Securities Act of 1933, or (iii) best efforts offerings. In addition, Rule 105 does not prohibit a person that shorted common stock in the pre-pricing period from purchasing securities that are convertible into or exchangeable for such common stock (*i.e.*, the prohibition does not extend to reference securities).

Are There Any Exceptions to Rule 105?

To be in compliance with Rule 105, a market participant that for any reason has sold short shares of a security that is the subject of an offering during the restricted period must either refrain from purchasing shares of that security in the offering, or rely on one of the following three exceptions:

1. The “Bona Fide” Purchase Exception

Rule 105 permits a person that established a short position in the offered securities during the pre-pricing period to purchase securities in the offering if such person entered into a bona fide transaction that closed out that short position prior to the pricing of the offering. In order to qualify for the exception, the pre-pricing covering purchase must be (i) in an amount at least equal to the amount of the pre-pricing period short sale, (ii) effected during regular trading hours, (iii) reported pursuant to an effective transaction reporting plan, and (iv) effected at least one business day prior to the pricing of the offering. However, the exception is not available to a person that has effected a pre-pricing period short sale within the 30 minutes prior to the close of regular trading on the business day prior to the pricing date of the offering.⁹

2. The “Separate Accounts” Exception

Rule 105 provides an exception for certain accounts that may be affiliated with each other or otherwise “related,” but for which the decisions regarding securities transactions are made separately and without coordination or cooperation between the accounts (separate accounts). This exception permits broker-dealers, investment advisers, individual investors and other persons to purchase securities in an offering even if a short sale was effected during the pre-pricing period on behalf of a related account, so long as the trading decisions for each account are “made separately and without coordination of trading or cooperation among or between the accounts.”¹⁰

3. The “Investment Companies” Exception

Rule 105 also contains an exception specifically applicable to investment companies registered under Section 8 of the Investment Company Act of 1940. This exception allows a registered investment company to purchase securities in the offering even if an affiliated investment company (or another fund in the same fund family or fund series) sold the offered security short during the pre-pricing period.¹¹

What Can My Firm Do to Avoid a Rule 105 Related SEC Enforcement Action?

On the same day that the SEC announced these enforcement proceedings, the SEC’s National Examination Program issued a risk alert (the Risk Alert) to highlight compliance issues related to Rule 105 and the implications for firms that do not comply with Rule 105. For example, 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.”¹² The Risk Alert also reminds market participants of the need to “provide training to their employees regarding the application of [Rule 105], develop and implement policies and procedures reasonably designed to achieve compliance with [Rule 105], and enforce those policies and procedures.”¹³ While the SEC has in the past considered whether a firm “implemented remedial efforts, such as developing and implementing policies, procedures and controls to prevent or detect [future] Rule 105 violations” in determining penalties, any such “[a]fter-the-fact remediation would not absolve a firm or individual from the violation of Rule 105.”¹⁴ In addition, in light of the publication of the Risk Alert, it is not clear whether a market participant’s promise to put in place adequate policies and procedures would result in a lower penalty for a Rule 105 violation going forward.

As a result of the SEC’s recent focus on combating Rule 105 violations, broker-dealers, investment advisers, investment companies, hedge funds, private equity firms and other market participants should “provide training to their employees regarding the application of [Rule 105], develop and implement policies and procedures reasonably designed to achieve compliance with [Rule 105], and enforce those policies and procedures.”¹⁵

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Endnotes

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- ¹ SEC Press Release, "SEC Charges 23 Firms With Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings," (September 17, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376> (the SEC Press Release). The SEC Press Release specifies the firms that were charged with violations of Rule 105 in this series of settled enforcement actions.
 - ² See SEC Press Release.
 - ³ See Risk Alert, at 3-4.
 - ⁴ See SEC Press Release. From January 2010 through September 17, 2013, the SEC has collected disgorgement, penalties, and interest in excess of \$42 million based on violations of Rule 105. In that time frame, the SEC has settled over 40 actions in which it found that firms and/or individuals have violated Rule 105.
 - ⁵ See SEC Press Release.
 - ⁶ See SEC Press Release.
 - ⁷ 17 C.F.R. 242.105(a).
 - ⁸ 17 C.F.R. 242.220(a).
 - ⁹ 17 C.F.R. 242.105(b)(1).
 - ¹⁰ 17 C.F.R. 242.105(b)(2).
 - ¹¹ 17 C.F.R. 242.105(b)(3).
 - ¹² See Risk Alert, at 4.
 - ¹³ See Risk Alert, at 3-4.
 - ¹⁴ See Risk Alert, at 4.
 - ¹⁵ See Risk Alert, at 3-4.