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Short Sales: SEC Adopts Amendments to Rule 105 of Regulation M, Including Important Exceptions For Purchasers

I. Introduction

On June 20, 2007, the U.S. Securities and Exchange Commission (the "SEC") adopted proposed amendments (the "Amendments") to Rule 105 of Regulation M (the "Rule").¹ Under the Rule, short selling is prohibited close in time to public offerings. Under the Rule as it existed before the Amendments, a person was prohibited from "covering" short sales that took place during a restricted period (generally defined in the Rule as the period commencing five business days prior to pricing of the public offering) with securities acquired in a public offering. The Amendments to the Rule broaden the Rule by eliminating the term "cover" and instead prohibit purchasing securities in a public offering where a short sale has been made during the restricted period.² However, the Amendments as adopted also include important exceptions for purchasers, including an exception for "bona fide" purchases and an exception for "separate accounts" and investment companies.

¹ See "SEC Votes to Adopt Final Amendments to Rule 105 of Regulation M, Short Selling in Connection With a Public Offering", SEC Press Release 2007-120 (June 21, 2007), currently available at: <http://sec.gov/news/press/2007/2007-120.htm>. The Amendments are described in the SEC's adopting release, "Short Selling in Connection with a Public Offering" (August 6, 2007), SEC Release 34-56206, currently available at: <http://sec.gov/rules/final/2007/34-56206.pdf> (the "Release").

² For more information regarding the Rule, and regarding the proposals that have now been adopted, please see "SEC Proposed Revisions to Rule 105: Short Selling in Connection with a Public Offering" (March 2007), currently available at: <http://www.shearman.com/Publications/detail.aspx?publication=0aa24e08-6957-4ff4-b74c-21a13ef37147>. For more information regarding short sales generally, please see "SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules" (March 2005), currently available at: http://www.shearman.com/cm_0305/.

The remainder of this publication describes the Amendments in greater detail.

This publication is meant to serve as a general discussion of the Amendments, and does not purport to be a complete discussion of the issues that are described herein. For more information regarding short selling generally or regarding the application of Regulation M, please contact any of the Shearman & Sterling LLP attorneys listed on the last page of this publication.

II. General Overview of the Rule

SEC Regulation M is comprised of a series of rules that prohibit purchases and sales of securities during the periods close in time to public offerings of securities. Generally, Rules 101 through 104 regulate purchases (or inducements to purchase) by persons involved in the offering process. Rule 105, however, regulates short sales by any person during the period immediately prior to the public offering.

Very generally speaking, short sales are sales of securities that are not owned by the seller at the time of the sale. The seller settles the sale with borrowed securities, and returns the securities to the lender at a later date, presumably acquiring such securities (at a lower price) in the open market.

One of the principal purposes of Rule 105 is to prevent certain kinds of short selling immediately prior to a public offering, which can artificially depress the price of the issuer's securities and reduce the issuer's offering

proceeds.³ The Rule also seeks to prevent persons with access to allocations of public offering securities from effecting short sales made immediately prior to an offering, then settling such sales with allocated securities that are priced to take into account the dilutive effect of the offering itself.⁴ Since the adoption of Rule 105, the SEC has repeatedly noted its belief that circumvention of the Rule is ongoing.⁵

III. Description of the Amendments

3.1 Expansion of the prohibition under the Rule

As noted above, the principal function of the Amendments is to replace the Rule's prohibition on "covering" short sales effected during a restricted period with securities received in a public offering with a prohibition on effecting short sales during the restricted period and then purchasing securities in the public offering. In the Release, the SEC explains that the broadening of the prohibition reduces investors' incentive to effect short sales in anticipation of an allocation that is priced at a discount to the existing market, which short sales can reduce the market price, and consequently the issuer's offering proceeds.⁶

³ See the Release at page 2.

⁴ See the Release at page 11 ("Generally, the offering prices of follow-on and secondary offerings are priced at a discount to a stock's closing price prior to pricing. This discount provides a motivation for a person who has a high expectation of receiving offering shares to capture this discount by aggressively short selling just prior to pricing and then covering the person's short sales at the lower offering prices with securities received through an allocation.") (Footnote omitted.).

⁵ See the Release at page 3 ("In recent years, the Commission has become aware of non-compliance with Rule 105, and in some cases, strategies used to disguise Rule 105 violations. In particular, the Commission has become aware of attempts to obfuscate the prohibited covering.") (Footnote omitted.), see also "*Commission Guidance on Rule 3b-3 and Married Put Transactions*", Release No. 34-48795 (Nov. 17, 2003).

⁶ See the Release at page 11 ("Eliminating the covering component and prohibiting a purchase in the offering ... reduces a potential investor's incentive to aggressively sell short prior to pricing solely due to the anticipation of this discount. Such activity can exert downward pressure on market prices for reasons other than price discovery that result in lowered offering prices and therefore reduced offering proceeds to issuers and selling security holders.").

3.2 Exception for "bona fide" purchases

The Amendments contain three important exceptions. The first is an exception from the prohibitions of the Rule for "bona fide" purchases. Specifically, under the Rule, a person that has effected a short sale during the Rule's restricted period may acquire securities in the ensuing public offering if he or she makes an offsetting purchase during the ensuing period. This offsetting purchase must meet a number of criteria set out in the Rule.⁷ The SEC notes that this exception permits a person that has effected a short sale to participate in a later public offering, and adds flexibility to investors:

"[P]ersons can purchase offered securities even if they sell short during the Rule 105 restricted period if they make a purchase equivalent in quantity to the amount of the restricted period short sale(s) prior to pricing. This provides an opportunity for a trader who had no knowledge of an offering at the time of his short sale to participate in the offering. Thus, a person who did not intend a strategy of shorting into an offering has an opportunity to participate in the offering, provided the person complies with the provision. The amendments also preserve a person's ability to change his or her mind."⁸

The criteria that must be met in respect of the offsetting purchase are:

- **The amount of securities purchased must be at least equal to the amount sold during the Rule 105 restricted period**

⁷ The text of the exception is as follows: "It shall not be prohibited for such person to purchase the offered securities as provided in paragraph (a) of [Rule 105] if: (i) Such person makes a bona fide purchase(s) of the security that is the subject of the offering that is: (A) At least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale(s); (B) Effected during regular trading hours; (C) Reported to an "effective transaction reporting plan" (as defined in Regulation NMS); and (D) Effected after the last Rule 105 restricted period short sale, and no later than the business day prior to the day of pricing; and (ii) Such person did not effect a short sale, that is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours (as defined in Regulation NMS) on the business day prior to the day of pricing."

⁸ See the Release at page 12.

- The purchase must be effected during regular trading hours
- The purchase must be reported to an “effective transaction reporting plan” (as defined in Regulation NMS)
- The purchase must be effected after the last Rule 105 restricted period short sale, and no later than the business day prior to the day of pricing.⁹

As well, the person making the bona fide purchase cannot have effected a short sale, that is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours (as defined in Regulation NMS) on the business day prior to the day of pricing.

3.3 Exception for “separate accounts”

The second exception adopted as part of the Amendments is an exception that permits “separate accounts” of a person to purchase in a public offering if decisions regarding securities transactions are made separately by each account.¹⁰ Because the Rule applies to any “person”, commenters raised concerns that the term “person” might encompass funds within a fund complex, various series of a “series fund”, or separately sub-advised portions of a single fund.¹¹

In response to these concerns, the SEC chose to incorporate certain aspects of the principles of “unit aggregation” found in Regulation SHO into the Rule.¹²

The basic principle of “unit aggregation” is to permit non-coordinating units within a single entity to effect short

sales during the restricted period and subsequently acquire securities of the same issuer in a public offering. The SEC states that the exception is warranted because the separate nature of non-coordinating units removes the motivation to sell short immediately prior to a public offering in anticipation of receiving discounted securities in the offering:

“Rule 105 is directed at persons who short sell into an offering because they have a high likelihood of receiving discounted offering shares.... [I]f decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts even though the accounts may be affiliated or otherwise related, the incentive that motivates the Rule 105 violation is not present because the short seller cannot lock in a profit by purchasing the discounted offering shares. The exception is, therefore, narrowly tailored to address the abuses that Rule 105 is designed to prevent without triggering inadvertent violations by accounts that do not coordinate their trading activity.” (Footnotes omitted.)¹³

The SEC provides detailed guidance as to the nature of “separate” accounts. Specifically, the SEC sets out a number of specific criteria that it believes should be present as indicia that two accounts are separate for these purposes.¹⁴ However, the SEC notes that,

⁹ The SEC notes that this criterion may make the exception unavailable for an “overnight” deal. See the Release at page 15.

¹⁰ The text of the exception is as follows: “Paragraph (a) of [Rule 105] shall not prohibit the purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a 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.”

¹¹ See the Release at page 17.

¹² See the Release at page 17. For more information regarding “unit aggregation”, please see “SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules” (March 2005), currently available at: http://www.shearman.com/cm_0305/.

¹³ See the Release at page 19.

¹⁴ See the Release at pages 19-20. The indicia noted by the SEC are: (1) The accounts have separate and distinct investment and trading strategies and objectives; (2) Personnel for each account do not coordinate trading among or between the accounts; (3) Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts; (4) Each account maintains a separate profit and loss statement; (5) There is 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 account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decisions for the accounts.

depending on the facts and circumstances, accounts that fail to satisfy each of the six enumerated conditions may nonetheless fall within the exception if the accounts are separate and operating without coordination of trading or cooperation.¹⁵

3.4 Exception for investment companies

The Amendments incorporate a specific exception for registered investment companies. Specifically, under the Rule as amended, a registered investment company, or a series of investment companies may purchase a security in a public offering where either (i) an affiliated investment company, or any series of such a company, or (ii) a separate series of the investment company sold the offered security short during the Rule 105 restricted period.¹⁶

¹⁵ See the Release at page 20. The SEC further notes the importance of policies and procedures in this determination, stating: "Policies and procedures reasonably designed to ensure that the above safeguards are fully implemented would be indications that accounts are separate, as would regular reviews to help ensure that such policies and procedures are up to date and fully implemented. For example, such reviews may include reviewing activities that are indicative of coordination between accounts and reviewing trading activity of a particular account that does not appear to be consistent with the stated strategy or objectives of such account."

¹⁶ The SEC notes that concerted action on the part of affiliated funds, or series of the same fund, to acquire securities in accordance with this exception, would be a violation of the Investment Company Act and of the Rule. See the Release at page 25 ("An arrangement by which one fund sells a security short while another affiliated fund intentionally goes long to cover that position would generally be the type of joint arrangement that is prohibited by Section 17(d) and Rule 17d-1. As a result, Section 17(d) and Rule 17d-1 would prevent these persons from engaging in activities that the amended rule 105 seeks to prohibit. ").

IV. Conclusion

The Amendments to Rule 105 are important because they expand the scope of the Rule's basic prohibition, in part because of the SEC's perception that circumvention of the Rule was persistent. However, the Amendments are also important because of the exceptions that were permitted by the SEC, most notably the implementation of an "aggregation unit" or "separate account" concept beyond the context of registered broker-dealers.

The Amendments to Rule 105 are also significant because they were adopted by the SEC close in time to other, important amendments to the regulation of short sales, particularly the elimination of the price or "tick" tests and the consequent elimination of the "short exempt" marking category,¹⁷ and the recent proposal that brokers and dealers marking a sale as "long" document the present location of the securities being sold.¹⁸

¹⁷ See "Regulation SHO and Rule 10a-1", SEC Release 34-55970 (June 28, 2007).

¹⁸ See "Amendments to Regulation SHO", SEC Release 34-56213 (August 7, 2007).

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this issue, please contact:

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