

Amendments to Rule 105 of Regulation M

*By Michael P. Malloy and Veena K. Jain
Drinker Biddle & Reath LLP*

The Securities and Exchange Commission ("SEC") has adopted amendments to Rule 105 of Regulation M under the Securities Exchange Act of 1934 ("Exchange Act"). These amendments change the Rule's application to persons who engage in short selling activities. Instead of prohibiting covering, the amended Rule would make it unlawful for a person to purchase a security in a public offering if the person had sold the security short during the Rule 105 restricted period. Prior to the amendments, the Rule prohibited persons from covering a short sale with securities bought in a public offering if the short sale occurred during a restricted period. Typically, the restricted period begins five business days before the pricing of an offering and ends with the pricing. Regulation M was adopted to help ensure that the prices in the securities markets would result from the natural forces of supply and demand, without any artificial manipulation. Rule 105 regulates short selling in connection with a public offering, such as a secondary or follow on offering.

The SEC has always been concerned about the effects of short sales preceding a public offering. Usually, the offering prices of follow on and secondary offerings are priced at a discount to a security's closing price (or closing transaction price, closing bid price or last sale price) prior to pricing in the public offering. When a trader expects to receive shares in an offering, there is an incentive to sell short prior to pricing of an offering and then cover that short position with shares bought at the reduced offering price. Short sales during the period immediately preceding pricing of an offering can exert downward pressure upon a stock's price that can result in lower offering prices. Covering the short sale with a specified amount of registered offering securities at a fixed price allows a short seller to avoid market risk and usually leads to a profit. As a result, the SEC through rulemaking has historically prohibited the covering of a short sale through purchase of securities in a public offering.

Because of the large amount of cases in which the SEC found persons circumventing the requirements of Rule 105 by trying to "cover up" the covering, the SEC proposed to amend Rule 105. In its release proposing amendments to the Rule, the SEC explained that eliminating the covering component of the Rule was designed to end the "progression of schemes and structures engineered to camouflage prohibited covering." The SEC also hoped that it would increase certainty in the market place by creating a bright line test.

Although the SEC adopted the Rule amendments and issued a press release describing the amendments generally, it has not yet, as of the date of this publication, issued a release with the precise wording of the amendments. As proposed, it would have been unlawful for "any person to effect a short sale and then purchase, including entering into a contract of sale for, the security in the offering if that person effected such short sale in the offered security during the shorter of: (i) the period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) the period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing."

The SEC adopted the proposed prohibition against purchasing in the public offering. The element of “cover” has been eliminated so that even if there is no connection between the purchase in an offering and the short sale of the security preceding it, it can result in a violation of the Rule.

The amendments also include exceptions for: (i) bona fide pre-pricing purchases; (ii) registered investment companies; and (iii) separate but related separate accounts. Initially, as proposed, there were no exceptions to the prohibition against purchasing during the public offering, which raised many concerns about the impact of the proposed amendments on investors, including investment managers. Many were concerned that a number of institutional investors who normally participated in capital raising activities would be precluded from purchasing in public offerings.

A number of commenters, including the Securities Industry and Financial Markets Association (SIFMA) and the Managed Futures Association (MFA), were concerned that certain active traders, like hedge funds, would be precluded from participating in secondary public offerings because they engaged in short selling as a part of certain investment strategies. SIFMA recommended that the SEC provide exemptions for certain purchases in a public offering if short sales preceding the public offering were in connection with convertible arbitrage, merger arbitrage, volatility trading, long/short strategies, other hedging strategies, bona fide market-making and customer facilitation activities. The adopted amendments include an exception for bona fide pre-pricing purchases. This exception will permit a person to purchase in an offering if the person sold short during the restricted period prior to becoming aware of an offering and if the short selling activity is part of the person's normal trading strategies. Although it is unclear at what point a person would be deemed to be “aware” of an offering and what are “normal trading strategies,” money managers who frequently use short selling as part of their investment strategies should be aware of this potential exception.

A number of commenters, such as the Investment Company Institute (ICI), asked how the term “person” should be interpreted in the case of mutual funds. The ICI recommended that the SEC clarify that each individual fund within a fund complex, each series of a fund, and each subadvised portion of a particular fund, is a separate “person” for purposes of Rule 105. The amendments, as adopted, include a specific exemption for investment companies registered under the Investment Company Act of 1940. For example, an investment company could purchase securities in a public offering if an affiliated investment company or any series of such company sold short during the restricted period. It is still unclear whether distinct subadvised portions of a fund would be treated as separate persons when each subadviser would be making its own investment decisions with respect to the portion that it manages.

Commenters were also concerned about the amended Rule's impact on investment advisers who managed separate accounts and/or hedge funds. SIFMA requested that the SEC expressly confirm, that the Rule's reference to “person” is limited to the natural person or legal entity for whose account the short sale is effected, which is consistent with the definition of “person” in Section 3(a)(9) of the Exchange Act. The amended Rule, as adopted, now contains an exception permitting a person to purchase securities in a public offering in an account if there was a short sale in a separate but related account as long as decisions regarding securities transactions for each account are made separately and without any coordination of trading among or between the accounts. Among other things, it is

unclear at this point what types of activities would amount to coordination of trading among accounts. Hopefully, these and other questions about the application of the amended Rule will be clarified in the SEC's adopting release. Amended Rule 105 will become effective 60 days after publication in the Federal Register.

Michael P. Malloy (Michael.Malloy@dbr.com) is a partner and chair of the Investment Management Group at Drinker Biddle & Reath LLP and Veena K. Jain (Veena.Jain@dbr.com) is a counsel in the Group. Drinker Biddle & Reath LLP, a Delaware limited liability partnership, is a full service law firm with offices in California, Delaware, Illinois, New Jersey, New York, Pennsylvania, Washington DC and Wisconsin. The Investment Management Group advises a broad array of investment management clients on financial services, products, registration issues and related matters, including products such as registered investment companies, common trust funds, collective investment funds and alternative products, including registered funds of hedge funds, hedge funds and private equity funds. www.drinkerbiddle.com

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