

Investment Managers and Short Selling: Beyond Form SH

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In autumn 2008 the SEC unleashed an unprecedented wave of regulations on investors who engage in short sales of U.S. listed shares. The centerpiece of these initiatives was the establishment of a weekly reporting requirement on Form SH, introduced by the SEC via emergency order in mid-September. Over the next four weeks, the SEC issued two emergency amendments and then further modified and extended Form SH by adopting an “interim final temporary rule” effective through July 2009.²

The abrupt creation and rapid evolution of the Form SH disclosure regime forced investment managers to confront a spate of real-time interpretive issues and, in many cases, to hastily reconfigure their internal information and reporting systems. It is not surprising that, to the extent investment managers have recently focused on the U.S. short-selling rules, their attention has been consumed by Form SH.

The challenge of dealing with Form SH should not, however, be allowed to obscure the wider range of legal issues faced by short sellers. The purpose of this memorandum is to step back and refresh investment managers’ knowledge of the broader U.S. legal landscape that short sellers must navigate. In the following pages we look “beyond Form SH” to review:

- What a short sale is;

- The marking and locate rules contained in the SEC’s Regulation SHO and Rule 10b-21;
- Short sellers’ potential exposure to allegations of fraud under the Securities Exchange Act of 1934 (the “Exchange Act”);
- A variety of other matters that short sellers should consider under the Exchange Act and the Securities Act of 1933 (the “Securities Act”); and
- Privately-ordered obligations that may affect a manager’s ability to short.

Annex A recaps key issues in checklist form.

WHAT IS A SHORT SALE?

“Short sale” is defined in Regulation SHO (“Reg. SHO”), a package of rules under the Exchange Act.³ Rule 200(a) of Reg. SHO defines a short sale as any sale of a security that:

- the seller does not own; or
- is consummated by the delivery of a security borrowed by, or for the account of, the seller.

Rule 200(b) of Reg. SHO describes the circumstances in which a seller is considered to own a security. These range from the simple case in which an investor has title to a security to situations in which the investor

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“The challenge of dealing with Form SH should not be allowed to obscure the wider range of legal issues faced by short sellers.”

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² Rule 10a-3T. For a discussion of the current Form SH requirements, see our memorandum dated October 17, 2008, “SEC Extends and Modifies Short-Sale Disclosure Regime,” available at www.rkollp.com/2008/10/sec_extends_and_modifies_short.php.

³ Rules 200 through 204T.

has exercised a legal right to obtain the security but has not yet taken delivery⁴.

Rule 200(c), however, adds the important qualification that an investor is deemed to “own” securities only to the extent the investor has a net long position. In other words, if an investment manager is simultaneously long and short in the same securities, Reg. SHO treats the manager as owning only the positive delta, if any, between the long and short positions.

MARKING ORDERS AND BORROWING SHARES

The first consequence of a sale being categorized “short” is that it becomes subject to the order-marking and share-borrowing requirements of Reg. SHO and its recently adopted companion, Rule 10b-21.

Reg. SHO

Reg. SHO is designed to address the phenomenon of “naked” short selling. That term is not defined by law, but refers generally to an investor’s selling short without having ensured that shares are available for delivery to the purchaser. The SEC’s main concern with naked shorting is that it heightens the likelihood of a “fail-to-deliver”—the situation in which a buyer does not receive securities from the seller on the designated settlement date. Reg. SHO combats fails-to-deliver by, among other things, imposing uniform order-marking and share-borrowing obligations on the broker-dealer community.

Marking and Locating

Rule 200(g) of Reg. SHO requires a broker-dealer to mark a customer’s sell order either “long” or “short.” A broker-dealer may mark an order long only if two conditions are satisfied: (i) the seller (i.e., the broker-dealer’s customer) must “own” the security to be sold

for purposes of Rule 200; and (ii) the broker-dealer must have, or reasonably expect to have prior to settlement, physical possession or control of the security to be sold. Otherwise, the order must be marked short.

Once a sell order has been marked short, Rule 203(b)(1) of Reg. SHO obligates the broker-dealer to identify, or “locate,” borrowable securities before executing the trade. The broker-dealer fulfils its locate obligation if it (i) has borrowed or entered into an arrangement to borrow the securities in time for delivery at settlement, or (ii) has reasonable grounds to believe that the securities can, if necessary, be borrowed for delivery at settlement.⁵

Investment Managers’ Implicit Responsibilities

On its face, Reg. SHO is broker-centric—it places no explicit obligations on the customers who actually submit sell orders. As a result, one might have the impression that Reg. SHO is not relevant for investment managers.

That impression would be wrong. The SEC has always believed that investment managers bear implicit responsibilities under Reg. SHO, in the sense that a customer may commit securities fraud by knowingly or recklessly compromising its broker-dealer’s ability to satisfy Reg. SHO’s marking and locate rules. This view is illustrated in the SEC’s 2007 settled enforcement action against a New York hedge fund called Sandell Asset Management (“SAM”).⁶

⁴ More specifically, Rule 200(b) states that a person owns a security if the person: (i) has title to it (directly or through an agent); (ii) owns a security that is convertible or exchangeable for it, and has tendered for conversion or exchange; (iii) owns an option to acquire it, and has exercised the option; (iv) owns rights or warrants to subscribe for it, and has exercised the rights or warrants; (v) holds a security future contract to purchase it, has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security; or (vi) has purchased or entered into an unconditional contract to purchase the security, but has not yet received it.

⁵ In adopting Reg. SHO, the SEC contemplated that, if reasonable, a broker-dealer may rely on a customer’s representations in concluding that shares are available for borrowing under Rule 203(b)(1). Release No. 34-50103 at n.58.

⁶ [In re Sandell Asset Management Corp.](#), Administrative Proceeding File No. 3-12865, Release No. 33-8857 (Oct. 10, 2007).

In Re Sandell Asset Management Corp.

Sandell concerned trading in the stock of Hibernia Corporation, a Louisiana financial services company. In mid-2005, SAM established a synthetic long position in Hibernia shares, in response to the company's announcement that it would be acquired by Capital One Financial Corporation. On August 29, 2005, hurricane Katrina hit New Orleans. Surmising that the storm's impact might prompt Capital One to renegotiate its purchase price, SAM decided to hedge its position.

On August 31, SAM sold several million shares of Hibernia common stock. As alleged by the SEC, although SAM owned no Hibernia shares, it characterized its trades as "long" in the sell orders submitted to its executing brokers. On September 2, SAM began selling again. The SEC's complaint states that SAM's traders correctly characterized these sell orders as short, but quickly realized that a dearth of borrowable Hibernia stock would make it impossible to find locates for many of the proposed trades. Nonetheless, the traders allegedly submitted all the sell orders and incorrectly assured their brokers that SAM had obtained the necessary locates.

SAM's brokers executed all of the August 31 and September 2 orders. The SEC contended that SAM therefore avoided over \$6 million of losses it would otherwise have suffered.

The SEC accused SAM of willfully violating Section 17(a)(2) of the Securities Act, an antifraud provision making it unlawful for any person engaging in a sale of securities to obtain money by means of any untrue statement of a material fact. In the SEC's view, by mismarking the August 31 orders and misrepresenting that locates had been secured for all the September 2 trades, SAM "gained an unfair trading advantage over other market participants" who respected their brokers' obligations under Reg. SHO.

Rule 10b-21

In October 2008 the SEC adopted Rule 10b-21, a new antifraud provision under the Exchange Act.⁷ This rule makes investment managers' role in the Reg. SHO scheme more explicit by extending liability to a broker-dealer's customers for certain fails-to-deliver. Rule 10b-21 states that a person who submits an order to sell an equity security has violated the antifraud provisions of the Exchange Act if the person:

- knowingly or recklessly deceives a broker-dealer about the person's intention or ability to deliver the security on or before the settlement date; and
- actually fails to deliver the security on or before the settlement date.

Underlying Rule 10b-21 is the SEC's practical recognition that a broker-dealer might be relying on its customer in satisfying the requirements of Reg. SHO. With respect to order-marking, the Rule 10b-21 adopting release states:

A seller will be liable . . . for causing a broker-dealer to mark [a sell order] "long" if the seller knows or recklessly disregards that it is not "deemed to own" the security being sold, as defined in [Rule 200], or if the seller knows or recklessly disregards that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the seller fails to deliver the security by the settlement date.

In connection with locates, the adopting release warns:

If a seller elects to provide its own locate source to a broker-dealer, the seller is representing that it has contacted that source and reasonably believes that the source can or intends to deliver the full amount of the

⁷ 17 C.F.R. 242.10b-21, Release No. 34-58774 (Oct. 14, 2008).

securities to be sold short by settlement date.⁸

In essence, with Rule 10b-21 the SEC reiterates and obtains a new tool for enforcing the theory—at work in *Sandell*—that an investor may be liable for undermining its broker-dealer’s ability to comply with Reg. SHO.

Practical Advice

Investment managers who regularly sell short should consider:

- Adopting systems to ensure that a trader may not enter a sell order marked “long” without confirming that the manager owns the securities for purposes of Reg. SHO.
- Ensuring that traders communicate transparently about their selling activities in potentially disparate accounts, including accounts relating to different product areas or maintained at separate prime brokers.
- With respect to locates arranged by the manager itself (i.e., not by the manager’s broker-dealer), maintaining records of: (a) the ticker symbol and quantity of the located securities; (b) the name of the employee who arranged the locate; (c) the identity of the share lender; and (d) the agreed duration of the locate.
- Implementing a review process for locates involving: (a) positions subject to market events that may affect borrower demand (e.g., earnings misses, analyst downgrades, corporate news announcements or significant stock price movements); and (b) securities for which the trading market is illiquid.

POTENTIAL EXPOSURE TO ALLEGATIONS OF SECURITIES FRAUD

Apart from the customer-broker communication issues discussed above, an investment manager must take care to avoid other shorting-related behavior that might give rise to allegations of securities fraud.

Market Rumors

The SEC has recently devoted particular attention to “short and distort” schemes, in which traders short a security and then allegedly disseminate negative rumors about the issuer in an attempt to drive the stock price down.

The SEC’s enforcement division sent subpoenas to a number of hedge funds in autumn 2008, seeking information on shorting activity in the shares of Bear Stearns, Lehman Brothers, AIG, Freddie Mac, Fannie Mae and other troubled financial institutions. The subpoenas seek, among other things, information about the timing, source, receipt and dissemination of any rumors or speculation about the issuers in question. In addition, together with the NYSE and FINRA, the SEC has been conducting sweep examinations focusing on whether broker-dealers have adequate controls to prevent the creation of false information intended to affect securities prices.

The SEC evinced its concern about rumors in the short-selling context in April 2008, when it announced a settled enforcement action against Paul S. Berliner, a Wall Street trader formerly associated with Schottenfeld Group, LLC.⁹ In this order—the first of its type—the SEC alleged that the trader committed securities fraud by spreading a false rumor about The Blackstone Group’s pending acquisition of Alliance Data Systems Corp.

⁸ Such a representation is also deemed to be made by a seller that enters a short sale order and a locate source into a broker-dealer’s direct market access or sponsored access system. Conversely, no representation is deemed made by a seller that relies on a broker-dealer to comply with Reg. SHO’s locate requirement (including when the broker-dealer employs an “easy to borrow” list).

⁹ Litigation Release No. 20537 (Apr. 24, 2008).

SEC v. Paul S. Berliner

The SEC’s complaint alleges that on Nov. 29, 2007—six months after Blackstone had entered into a definitive agreement to acquire ADS at \$81.75 per share—Berliner fabricated and spread through instant messaging a rumor that the acquisition was being renegotiated at a price of \$70. The complaint further alleges that Berliner began shorting ADS stock soon after disseminating the rumor.

Within minutes of the rumor entering the market, ADS’ share price had fallen 17 percent on the NYSE. Following a trading halt, ADS issued a press release refuting the rumor. By the close of trading, the share price had recovered to its opening level.

Berliner consented to an injunction and disgorgement of trading profits. In a press release announcing the settlement, SEC Chairman Christopher Cox stated: “It is probably because of the difficulty in tracing where a false rumor starts, and proving that it was knowingly false, that these [rumor-related fraud] cases haven’t been brought in the past. But now the same technology that instantly spreads market rumors across the globe is also helping law enforcement track down the culprits.”

Material Nonpublic Information

In General

A short trade is a “sale” for purposes of the federal securities laws, including the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. This means, among other things, that an investment manager must consider whether it possesses material nonpublic information about the issuer before effecting a short sale.

The risk of having material nonpublic information increases significantly if the investment manager has been in contact with the issuer’s board or senior executives regarding potential restructurings or similar unannounced corporate matters. Similar risk arises if the investment manager has access to nonpublic information about the issuer through participation in a loan facility or representation on a creditors’ committee.

PIPE Transactions

Knowledge of a planned securities offering that has not yet been publicly announced, such as an upcoming PIPE transaction, may constitute possession of material nonpublic information. Indeed, as discussed below, while courts have recently rejected the SEC’s theory of Securities Act liability in certain shorting-related PIPE cases, courts have allowed to proceed the SEC’s claims that receipt of a confidential PIPE offering memorandum renders the prospective investor a temporary insider whose subsequent short sales violate Rule 10b-5.¹⁰

Practical Advice

Investment managers who sell short should ensure that:

- Their compliance manuals emphasize that it is illegal to trade while in possession of material nonpublic information, or to knowingly create or disseminate false rumors about an issuer.
- Appropriate internal controls are in place to identify and prevent trading in the securities of issuers about which the manager may have material nonpublic information.
- Traders receive periodic training with respect to the foregoing, either from the manager’s compliance or legal staff or from outside counsel.

¹⁰ See note 22, *infra*, and accompanying text. Although not a short-selling case, the SEC’s well publicized recent suit against Dallas entrepreneur Mark Cuban hinges on the same theory that trading with knowledge of an impending unannounced PIPE offering violates Rule 10b-5. See Litigation Release No. 20810 (Nov. 17, 2008).

**OTHER SHORTING-RELATED ISSUES
 UNDER THE FEDERAL SECURITIES
 LAWS**

Beyond potential fraud issues, there are a host of other securities law concerns that investment managers should keep in mind when shorting an equity security.

***Exchange Act Section 13: Five-Percent
 Beneficial Owners***

Schedule 13D

Section 13(d) of the Exchange Act requires an investor that beneficially owns more than five percent of a public company's equity securities to file a Schedule 13D disclosing its holdings, intentions and other detailed information.¹¹ Rule 13d-2 requires the investor to amend its Schedule 13D upon any material change to previously reported information, including a one-percent or greater change in the percentage of the class of securities beneficially owned.

Short sales by an investor reporting on Schedule 13D normally will not change the investor's degree of beneficial ownership, because a short sale does not alter the number of shares over which the investor has voting or investment power. However, short sales may trigger an amendment if they result in material changes to the other facts previously set forth in the reporting person's Schedule 13D. In particular, the short sale might represent a possible shift in purpose requiring an amendment to Item 4 of Schedule 13D (especially to the extent that a plan or proposal to dispose of securities of the issuer was not disclosed previously), a "transaction" in the subject security disclosable under Item 5 or a "contract, agreement, understanding, or relationship . . . with respect to . . . securities of the issuer" disclosable under Item 6.¹²

If the reporting investor is amending its Schedule 13D for reasons unrelated to a short sale, it may need to consider whether any recent short selling nonetheless

should be disclosed in the amendment. Disclosure of the short sale might be appropriate, for example, in Item 5(c), which requires a description of any transactions in the issuer's stock effected by the reporting person within the preceding 60 days.

Schedule 13G

Unlike Schedule 13D, the short-form Schedule 13G does not require disclosure of trading history and therefore does not generally entail disclosure of short sales. However, five-percent investors reporting on Schedule 13G should analyze their particular circumstances before concluding that they are comfortable shorting without public disclosure.

***Exchange Act Section 16: 10-Percent
 Beneficial Owners***

An investor that acquires beneficial ownership of more than 10 percent of a class of equity securities of a U.S. public company becomes subject to Section 16 of the Exchange Act. Section 16 requires the investor to report its purchases and sales of the company's securities and to disgorge "short-swing" profits on trading in the issuer's securities during any six-month period. Section 16 also limits a 10-percent investor's ability to short the issuer's stock.¹³

Limits on Shorting: Section 16(c)

Section 16(c)(1) provides that a 10-percent investor may not sell an equity security of the issuer that it does not own. Section 16(c)(2) states that if the investor does own the security being sold, it must deliver the security for settlement within 20 days of the sale or deposit the security in the mail or other normal channel for delivery within five days of the sale. In effect, Section 16(c) prohibits a 10-percent investor from engaging in any short sale other than against a boxed position, and in that case only if the specified delivery or deposit deadline is met.¹⁴

¹¹ Investors able to certify as to their passive status may be able to file a briefer Schedule 13G instead.

¹² See SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Part O, Question 9.

¹³ An issuer's directors and executive officers are also subject to Section 16.

¹⁴ The SEC staff has stated that Section 16(c)(2) does not apply to a transaction in which the seller satisfies the delivery or deposit obligation with securities it already owns, as opposed to borrowed securities. See Release No. 34-18114 (1981) at n.30.

Reporting and Disgorgement: Sections 16(a) and (b)

If a short sale is permitted under Section 16(c), it is treated no differently than any other sale of issuer equity securities by a 10-percent investor for purposes of Sections 16(a) and (b) of the Exchange Act. That is, the sale must be reported within two business days on Form 4 and will be subject to profit-disgorgement “matching” with any purchase occurring within a six-month period.

Regulation M

In a follow-on equity offering, the offered stock is typically priced at a discount to its market price. Rule 105 of Regulation M is designed to prevent investors from improperly profiting by selling short prior to the offering with the expectation that they will cover using lower-priced shares obtained in the offering. The SEC’s concern is that this type of pre-pricing shorting activity, by depressing the issuer’s share price, may reduce the offering proceeds and diminish the value of existing shareholders’ investments.¹⁵

Restricted Period

Rule 105 prohibits an investor that shorts during a pre-pricing “restricted period” from purchasing shares in the offering, even if those shares would not be used to cover the short position. The restricted period is the shorter of (i) the five business days preceding pricing and (ii) the period beginning with the filing of the registration statement and ending with the pricing.

Offerings Covered

Rule 105 applies only to firm commitment offerings of equity securities for cash. This means the rule does not cover PIPE transactions, registered direct offerings, or other best-efforts underwritings.

Securities Covered

Rule 105 applies only to the class of securities being distributed in the offering. This means an investor who purchases in the offering is not barred from shorting “reference securities,” i.e., securities into which the security being distributed in the offering may be converted, exchanged or exercised. For example, in an offering of convertible notes, an investor may short the underlying common stock during the restricted period without losing the ability to purchase convertible debt in the offering.

Excepted Purchases

Rule 105 contains three exceptions that allow the purchase of shares in a covered offering notwithstanding short sales during the restricted period. The first generally allows an investor that shorted during the restricted period to purchase in the offering if it makes a subsequent bona fide purchase at least one day before pricing.¹⁶ An exception for separate accounts allows an investor to purchase the offered securities for one account even if there was a short sale in another account held by the investor, as long as the accounts’ trading decisions are made separately. A third exception allows a fund within a registered fund complex to purchase an offered security if a sister fund sold short during the restricted period.

In enforcing Rule 105, the SEC has often attacked transactions allegedly designed to obscure an investor’s use of offering shares to cover short positions established during the restricted period. An example is the SEC’s pending suit against Lion Gate Capital, a Beverly Hills hedge fund.¹⁷

¹⁵ Release No. 34-38067 (Dec. 23, 1996).

¹⁶ The purchase must be effected not later than the business day before pricing, and must be at least equivalent in quantity to the entire amount of securities the investor sold short during the Rule 105 restricted period.

¹⁷ Litigation Release No. 20775 (Oct. 7, 2008).

SEC v. Lion Gate Capital

The SEC alleges that Lion Gate realized ill-gotten gains by using shares purchased in 14 public offerings to cover short sales effected during the Rule 105 restricted period.

The suit maintains that Lion Gate engaged in riskless transactions intended to create the appearance that shares used to cover the short positions had been purchased in the open market rather than in the offering. In some cases, Lion Gate allegedly entered cross trades to buy and sell the same quantity of shares at the same price. In other instances, Lion Gate allegedly entered contemporaneous open market orders, purportedly to sell the offering shares and purchase pre-existing shares to cover its short positions. The SEC’s complaint characterizes these trades as sham transactions, as a result of which Lion Gate should be viewed as having used offering shares to cover its pre-pricing short positions.

Risk of Underwriter Status

An investor that shorts an issuer’s securities after purchasing shares in an unregistered offering must consider whether the short sale makes it an “underwriter” for purposes of the Securities Act. This concern arises when an investor quickly shorts a large number of shares after the offering, and thus looks more like a conduit or agent that delivers shares into the market than an investor that has taken economic risk. The prospect of underwriter status may be especially relevant to PIPE investors, who sometimes

wish to hedge their exposure through rapid short selling after the PIPE offering closes.

The SEC has not adopted a Rule 144-like safe harbor under which purchasers can ensure that they are deemed not to be underwriters in connection with post-closing short sales. In the normal case, however, the risk of underwriter status should not be serious when an investor shorts a reasonable period of time after the offering and the short sale does not represent a large percentage of the issuer’s outstanding stock.

Covering a Short Position

An investor covering a short position must take care to comply with Section 5 of the Securities Act (or at least with the SEC’s interpretation of Section 5 in the shorting context). The key point is that, in the SEC’s view, the shares used to cover a short position were sold at the time of the underlying short trade.¹⁸ This means an investment manager must be able to conclude that the shares it will use to cover a short position could have been sold by the manager in compliance with Section 5 when the short trade was executed.

Covering with Restricted or Control Securities

An investor that intends to cover a short position with restricted or control securities must establish that the securities were saleable at the time of the short trade pursuant to either Rule 144 or an effective resale shelf registration statement maintained by the issuer.

Rule 144. For a short seller that is not an affiliate of the issuer, Rule 144’s recently liberalized resale requirements present a fairly modest hurdle.¹⁹ For affiliates, though, the full panoply of Rule 144’s requirements, including current public information,

¹⁸ See, e.g., Release No. 33-8869 (Dec. 6, 2007) at n.90, Release No. 34-56206 (Aug. 6, 2007) and Release No. 33-8107 (June 21, 2002).

¹⁹ The SEC amended Rule 144 effective February 15, 2008. The amendments were the most significant in a decade, and were designed to increase the liquidity of privately placed securities. Among other things, the amendments: (i) reduce from one year to six months the holding period for restricted securities issued by Exchange Act reporting companies; (ii) eliminate the volume limits and other conditions for resales by non-affiliate holders of restricted securities issued by reporting companies once the holding period has elapsed; and (iii) remove all limits on resales of restricted securities by non-affiliates after a one-year holding period. The amendments retain, however, most of Rule 144’s historical constraints on resales by affiliates. See Release No. 33-8869 (Dec. 6, 2007).

volume, manner-of-sale and notice provisions, remain central to the analysis of whether Rule 144 was available at the time of the short sale.²⁰ If the securities held by an affiliate are also restricted securities, a six-month holding period under Rule 144(d) will apply as well.

Resale Shelf. If an investor plans to cover a short position with restricted or control shares registered under a resale shelf registration statement, the investor must confirm that, at the time the short sale occurred, the registration statement: (i) was effective; (ii) identified the investor as a selling shareholder; (iii) entitled the investor to sell shares at least equal to the number of shares sold short; and (iv) permitted short transactions in its plan of distribution.

Covering with Shares Purchased on the Open Market

In general, the SEC’s Section 5 interpretive position does not affect an investor’s ability to cover a short position with shares purchased on the open market. However, a special situation arises when, at or around the time of the open market purchases, the investor is selling restricted or control shares of the same issuer into the public market under Rule 144 or a resale shelf registration statement. In this case, the investor risks the SEC characterizing the sale and purchase as a “wash transaction” in which the investor is effectively using restricted or control securities to cover the short position.

In order to avoid possible wash transaction problems, an investor buying shares on the open market to cover a short and also selling restricted or control shares into

the market should: (i) avoid having its sell and buy orders in the market at the same time; (ii) take demonstrable market risk between the two transactions; and (iii) determine the appropriate amount of time between placing the two orders based on the trading volume of the security.

PIPE Offerings

The SEC has aggressively applied its Section 5 theory in the area of PIPE transactions, alleging in a number of settled enforcement proceedings that Section 5 is violated by a PIPE investor that (i) sells the issuer’s stock short before the post-closing resale shelf registration statement has become effective and (ii) covers the resulting short position with registered PIPE shares following effectiveness. In other words, the SEC views such an investor as distributing yet-to-be-registered (i.e., restricted) PIPE shares when it engages in the short sale.²¹

The SEC’s Section 5 theory has recently suffered judicial setbacks in a handful of PIPE cases.²² Short-selling PIPE investors should not, however, take undue comfort from this development. It would not be surprising if the SEC responded to these cases by initiating rulemaking to codify its Section 5 position. Moreover, the courts have declined to dismiss the other key element of the SEC’s charges, namely that a PIPE investor commits illegal insider trading by shorting after receipt of the confidential information memorandum for the offering.

²⁰ The Rule 144(c) current public information requirement is generally satisfied if the issuer has timely fulfilled its Exchange Act reporting obligations during the 12 months preceding the resale. Rule 144(e) provides that the amount of securities resold, together with all sales of securities of the same class for the account of the seller within the preceding three-month period, may not exceed the greater of (i) one percent of the class of securities outstanding and (ii) the average weekly trading volume. Rule 144(f) generally requires the resale to be made in a broker’s transaction, through a market-maker or in a riskless principal transaction. Subject to a de minimis threshold, Rule 144(h) requires the selling shareholder to file with the SEC a notice of resale on Form 144.

²¹ See, e.g., Litigation Release No. 20356 (Nov. 5, 2007).

²² See, e.g., *SEC v. Lyon*, 06-CV-14338 (S.D.N.Y. Jan. 2, 2008), and *SEC v. Berlacher*, 07-CV-3800 (E.D. Pa. Jan 23, 2008).

Practical Advice

An investment manager planning to effect a short sale should:

- If applicable, determine whether the short sale requires an amendment to Schedule 13D.
- If applicable, consider the Section 16 implications of the short sale, including whether the trade is permitted under Rule 16(c) and, if so, whether it will be matchable against a prior or subsequent purchase under Rule 16 (b).
- Ensure compliance with Regulation M if the short sale will occur around the time of a public offering in which the manager expects to acquire shares.
- Confirm that the short position may be covered in compliance with Section 5 of the Securities Act.

PRIVATELY-ORDERED RESTRICTIONS AND DISCLOSURE OBLIGATIONS

Aside from analyzing short-selling constraints under the federal securities laws, an investment manager must be alert to potential impediments arising under contract or a company’s governing documents.

Contractual Restraints on Shorting

Investors that purchase securities in an unregistered offering are typically required to sign a subscription agreement or similar contract. In addition to containing standard resale restrictions, these agreements sometimes prohibit hedging transactions, including short sales, for a specified period following the offering. Similarly, if an unregistered offering includes a registration rights agreement for the purchasers’ benefit, it is common for the agreement to prohibit short sales at the time of a future underwritten equity offering by the issuer.

Advance Notice Bylaws

As activist investors increasingly submit director nominations and other proposals for inclusion in companies’ annual proxy statements, some issuers have tightened the “advance notice” provisions of their bylaws to require more detailed disclosure from shareholder proponents. The new disclosure standards often require a breakdown of the proponent’s derivative and hedging positions relating to the issuer’s stock. Thus, the price of access to the proxy statement may be disclosure of the investor’s hedging strategy, including short sales, with respect to the issuer.

Practical Advice

Investment managers who sell short should recall that:

- Contractual provisions may impede their ability to short.
- An issuer’s advance notice bylaws may subject an activist investor to detailed disclosure obligations regarding short sales and other hedging activities.

CONCLUSION

An investment manager pursuing a short-selling strategy should ensure that it understands the attendant U.S. legal terrain. As described above, the topography contains many features beyond Form SH.

* * *

If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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ANNEX A

Investment Manager's Pre-Shorting Checklist

- Have we correctly marked the trade as “short” in our sell order?
- If settling with borrowed shares and performing the locate ourselves, are we satisfied that the locate is valid?
- Do we have material nonpublic information about the issuer?
- Have we received or forwarded any rumors about the issuer?
- If we have filed a Schedule 13D regarding our position in the issuer, will the short sale trigger an amendment or be disclosable in a future amendment triggered for other reasons?
- Does our position in the issuer subject us to Section 16 of the Exchange Act?
If so:
 - Is the short sale permitted under Section 16(c)?
 - Will the short sale be “matchable” for short-swing profit disgorgement purposes under Section 16(b)? (I.e., have we purchased shares in the prior six months or will we want to buy shares in the next six months?)
- How do we expect to cover the short position we are establishing?
 - If with restricted or control shares, does Rule 144 or a resale registration statement currently permit us to sell the shares we will use to cover?
 - If with shares purchased in an offering, is the offering subject to Regulation M? If so, did we place the short trade prior to the Rule 105 restricted period?
- Are we under any contractual obligation to refrain from shorting the issuer's stock (e.g., pursuant to a subscription or registration rights agreement)?
- Are we considering submitting a director nomination or other proposal for inclusion in the issuer's proxy statement? If so, do the issuer's bylaws contain advance notice provisions that would require disclosure of our shorting activity?