Memorandum
August 27, 2013

Don’t Get Caught Short by Rule 105: A Refresher for Hedge Fund Managers

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As the U.S. equity markets reach post-crisis heights, hedge fund managers with contrarian views have ample opportunity to express their conviction by taking short positions in stocks they consider overvalued. At the same time, however, the recent rebound in equity capital-raising may expose short-selling managers to risk under Rule 105, the SEC’s tool to deter manipulative shorting related to public stock offerings. This risk is more than theoretical. The SEC’s Division of Enforcement appears to be actively seeking information from fund managers concerning their compliance with Rule 105, and announcements of settled administrative proceedings continue to appear with some regularity. In the most recent Rule 105 settlement, a hedge fund manager agreed in June 2013 to a cease-and-desist order and more than $5 million in disgorgement and civil penalties.¹

The SEC’s ongoing focus on Rule 105 is particularly noteworthy for hedge funds due to the rule’s strict liability nature. A lack of manipulative intent is no defense and the magnitude of the violation is irrelevant. Indeed, the SEC has been willing to pursue Rule 105 enforcement actions in cases involving a small number of shares sold short and quite limited resultant profits.

In light of the regulatory, economic and reputational consequences that may flow from a Rule 105 violation, it is worth reviewing the scope of the rule and the steps a hedge fund manager can take to avoid trouble with it.

BACKGROUND
Rule 105 is an anti-fraud provision contained in Regulation M under Section 10(b) of the Securities Exchange Act.² Regulation M is a set of rules designed to protect the integrity of the U.S. equity market by restricting trading behavior that might artificially affect a security’s price around the time of a public offering. Rule 105 specifically is concerned with pre-offering short sales, which, by exerting downward pressure on an issuer’s stock price, could cause the issuer to receive lower offering proceeds than

independent market dynamics would produce. Rule 105 attempts to prevent that outcome by prohibiting the purchase of offering securities by investors that have shorted securities of the offered class during a defined period preceding the offering.

HOW RULE 105 WORKS
Subject to exceptions discussed below, Rule 105:

- prohibits an investor from purchasing equity securities in a registered firm commitment underwritten offering for cash if-

- the investor has shorted securities of the offered class during the Rule 105 “restricted period.” The restricted period is the shorter of:
  - the period beginning five business days before the pricing of the offered securities and ending with the pricing; and
  - the period beginning with the initial filing of the registration statement for the offering and ending with the pricing.

The full text of Rule 105 is reproduced in Annex 1.

Before proceeding to a more detailed examination of Rule 105, it is worth emphasizing two basic points that sometimes are not understood. First, unless an exception is available, an investor that has shorted the relevant securities during the restricted period simply may not buy in the offering. There is no notion under Rule 105 that the investor may purchase offering securities as long as it does not use them to cover its short position. An investor may short during the restricted period or purchase in the offering, but not both.3

Second, unlike other anti-fraud provisions such as Rule 10b-5, Rule 105 does not have a scienter element. Absent an available exception, an investor that shorts during the restricted period and purchases in the offering has committed a per se violation of Section 10(b).

Which Offerings Are Covered by Rule 105?
Rule 105 applies only to an offering with the following characteristics4:

- the offering is SEC-registered;
- the securities offered are equity securities;
- the offering is underwritten on a firm commitment basis5; and
- the offering is for cash consideration.

Such a transaction could be a primary offering by a public company (a follow-on offering) or an offering by a public company’s shareholders pursuant to a resale registration statement (a secondary offering).

Given the above parameters, Rule 105 does not apply to an equity offering that is exempt from Securities Act registration, such as a Regulation D or a Rule 144A offering. Rule 105 is not implicated by offerings of nonconvertible debt securities, since they are not equity. Nor does the rule typically cover PIPE transactions or registered direct offerings, which are normally underwritten on a best efforts rather than a firm commitment basis. A registered equity offering in which investors do not surrender cash consideration, such as an exchange offer, is also outside the scope of Rule 105.

What Securities May Not Be Shorted if the Investor Wants to Purchase in the Offering?
Rule 105 prohibits an investor from purchasing in the offering if the investor has shorted during the restricted period.

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3 Lingering confusion about what Rule 105 prohibits is often due to a recollection of what Rule 105 formerly said. Rule 105 was amended in 2007 pursuant to SEC Release No. 34-56206, “Short Selling in Connection with a Public Offering” (Aug. 6, 2007) (the “2007 Release”). Rule 105 previously had barred an investor from using shares purchased in the offering to cover its restricted-period short sales. In explaining the SEC’s decision to switch the proscribed activity from covering to purchasing, the 2007 Release noted a proliferation of trading strategies designed to “obfuscate the prohibited covering.” Having tired of playing cat-and-mouse with short sellers about their use of purchased shares, the SEC opted for the blunter tool of prohibiting purchases in the first place.

4 Rules 105(a) and (c).

5 In a firm commitment underwriting, the underwriters are contractually bound to purchase all the offered securities. This contrasts with a best efforts underwriting, in which the underwriters agree to purchase only as many securities as necessary to meet actual investor demand (following best efforts by the underwriters to generate that demand).
period the “subject security” of the offering—i.e., has shorted securities of the class being offered. An investor that shorts only “reference securities,” meaning securities into which the offered class may be converted, exchanged or exercised, is not barred from purchasing in the offering. For example, in an offering of convertible notes, an investor may short the underlying common stock (the reference security) during the restricted period and purchase notes (the subject security) in the offering.7

What is a “Short Sale”? Rule 105 is activated by an investor’s short sale of a subject security during the restricted period. A “short sale” is a sale of a security that (i) the seller does not own or (ii) is consummated by the delivery of a security borrowed by or for the account of the seller.8

This definition is relatively straightforward, but there are traps for the unwary. Of particular interest for hedge fund managers is the fact that a person is deemed to “own” securities only to the extent it has a net long position in those securities.9 For example, assume an investor is flat in a security by virtue of a 10,000-share long position and a 10,000-share short position. If the investor sells shares out of its long inventory, it is still deemed to have made a short sale, because the investor was not net long at the time of sale. Hedge fund managers also should be alert to the possibility that being the writer of a call option will result in a short sale if the counterparty exercises at a time when the manager does not own the underlying security.

How is the Restricted Period Calculated? The Rule 105 restricted period is the shorter of: (i) the period beginning five business days before the pricing of the offering and ending with the pricing; and (ii) the period beginning with the initial filing of the registration statement for the offering and ending with the pricing.10

Restricted Period Beginning Five Business Days before Pricing Since many follow-on and secondary offerings are made as takedowns from an existing shelf registration statement, the five-business-day restricted period quite often applies. To calculate this restricted period, we begin with the term “business day.” It means a 24-hour period determined with reference to the principal market for the securities being offered, and including a complete trading session for that market.11 We then count backward five business days from the time of pricing.

By way of illustration, assume the principal market for the offered security is the NYSE, for which a complete trading session is 9:30 a.m. to 4:00 p.m. ET. If the offering prices on Wednesday, July 17 at 7:00 p.m. ET (after trading hours), the restricted period begins at 7:00 p.m. ET on Wednesday, July 10. If pricing occurs on Wednesday, July 17 at 3:00 p.m. (during trading hours), the restricted period begins at 9:30 a.m. on Wednesday, July 10, in order that each 24-hour period includes an entire trading session.

See Annex 2 for a visual illustration of a five-business-day restricted period.

Restricted Period Beginning with Initial Filing of Registration Statement While less common, there are circumstances in which the time between registration and pricing will be shorter than five business days. In that case the registration-based restricted period will apply. In particular, the Securities Act allows well-known seasoned issuers (or

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6 Rule 105(a).
7 See the 2007 Release at n.85 and accompanying text. (An offering of convertible notes implicates Rule 105 because a convertible note—like any instrument convertible, exchangeable or exercisable into an underlying equity security—is itself an equity security. See Rule 3a11-1 under the Securities Exchange Act.)
8 Rule 200(a) of Regulation SHO, to which Rule 105(a) refers.
9 Rule 200(c) of Regulation SHO.
10 Rule 105(a).
11 Rule 1006(b) of Regulation M.
effect of the activity that Rule 105 is designed to prevent.” The SEC also has noted more generally that “any transaction or series of transactions remain subject to the anti-fraud and anti-manipulation provisions of the securities laws even if they do not implicate Rule 105.”16

EXCEPTIONS TO THE RULE 105 PROHIBITION

For hedge fund managers, Rule 105 contains two exceptions to the general proposition that a person who has shorted the subject security during the restricted period may not purchase offered shares. These exceptions are for “bona fide purchases” and purchases by “separate accounts.”

Bona Fide Purchases

The bona fide purchase exception17 allows an investor that shorted subject securities during the restricted period to purchase in the offering if the investor has effectively cured the short position prior to pricing. This is achieved by a purchase of subject securities in a transaction meeting specific requirements. The purchase must be:

- for a number of subject securities at least equivalent to the entire amount of the investor’s restricted-period short sales;
- effected after the investor’s last restricted-period short sale;
- effected not later than the business day prior to pricing;
- completed during regular trading hours; and
- reported pursuant to an “effective transaction reporting plan” (which will be the case for all U.S. exchange-traded securities).

In addition, if the investor intends to make the bona fide

WKSIs) to file automatically effective shelf registration statements. This flexibility would enable a WKSI to file the registration statement for an offering less than five business days before pricing. An investor can ascertain the date of the initial registration statement filing by consulting EDGAR.

See Annex 2 for a visual illustration of a restricted period based on the initial filing of the registration statement.

Other Aspects of Rule 105

Foreign Short Sales

Rule 105 has no exception for short sales outside the United States. Therefore, an investor cannot purchase in a U.S. public offering if it has shorted the subject security on a foreign exchange during the restricted period. The SEC has made clear, however, that an exclusively offshore offering of an equity security with no U.S. market is not governed by Rule 105, even if there is a reference security that has a U.S. market.14 For instance, assume that a foreign issuer with ADRs listed in the United States simultaneously conducts a non-U.S. offering of its common stock and a U.S. offering of ADRs. Rule 105 would not prevent an investor from shorting common stock on the foreign exchange and purchasing ADRs in the U.S. offering, because the common stock and the ADRs are not the same subject security.15

Derivative Transactions

Rule 105 does not apply to the use of derivative strategies. An investor generally can use options or swaps to create an economically short position during the restricted period without compromising its ability to purchase offered securities. However, the SEC has cautioned that it will “continue to monitor the use of derivative strategies that may replicate the economic

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12 See Rules 401, 405 and 462 under the Securities Act.
13 One often sees an issuer file with the SEC, very shortly before pricing, a prospectus supplement specifying the terms of the offering. This prospectus supplement is not the registration statement for the offering; if a prospectus supplement is being filed, the underlying registration statement is already in effect.
15 Even though purchasing the ADRs would not violate Rule 105, the investor would want to consider whether it might present problems under the general anti-fraud and anti-manipulation provisions of the U.S. securities laws. Id.
16 See section III of the 2007 Release.
17 Rule 105(b)(1)(i).
purchase on the business day prior to pricing (the last permissible day), the purchase must occur before the final 30 minutes of regular trading hours. An investor that waits until the eleventh hour to restore its ability to purchase in the offering thus risks failing in that objective.

The requirement that the bona fide purchase be made not later than the business day preceding pricing can put the exception out of reach if the offering is a true “overnight” deal, in which the offering commences on the evening of pricing. In this situation, the short seller will have no opportunity to make a qualifying purchase.

Note also that the bona fide purchase exception is not necessarily satisfied by a purchase that makes the investor net flat over the restricted period. The requirement is that the investor purchase, after its last restricted-period short sale, at least as many subject securities as it has shorted during the entire restricted period. This means the investor does not “get credit” for purchases that occur between restricted-period short sales. To illustrate:

**Required Number of Bona Fide Purchase Shares**

- **Day 1 of Restricted Period:** Investor shorts 1,000 shares.
- **Day 2:** Investor buys 1,000 shares.
- **Day 3:** Investor shorts 2,000 shares.
- **Day 4:** Investor decides to make bona fide purchase to restore its ability to participate in the offering. The required purchase is at least 3,000 (not 2,000) shares.

**Purchases by Separate Accounts**

A manager that has sold the subject security short for one account during the Rule 105 restricted period may purchase in the offering for another account, as long as decisions regarding transactions for the respective accounts are made separately and without coordination of trading or other cooperation between the accounts.

The SEC has provided the following indicia of account separateness:

- the accounts have separate and distinct investment and trading strategies and objectives;
- personnel for the respective accounts do not coordinate trading;
- information barriers separate the accounts and information about securities positions or investment decisions is not shared between the accounts;
- each account maintains a separate profit and loss statement;
- there is no allocation of securities between the accounts; and
- personnel who manage multiple accounts in a single entity or affiliated entities do not have authority to execute trades or pre-approve trading decisions for the accounts.

The SEC often has taken a skeptical view of hedge fund managers that claim protection under the separate accounts exception. In particular, the exception may be challenging for managers whose investment function is organized by strategy rather than by fund. Although this type of investment management structure may possess the “separate and distinct strategies” and “separate profit and loss” indicia of separate accounts, the manager may be unable to claim separate account treatment if other factors outweigh those indicia.

For example, a manager operating by strategies may fall short of the separate accounts exception if information about securities positions and investment decisions is available to employees across the firm or communicated between strategies; if there is a chief investment officer or other individual with the power to veto or otherwise influence trading decisions across strategies; or if the manager allows coordination of trading between strategies. As these approaches to investment management are not uncommon at hedge funds, many managers may conclude that their customary operating behavior is incompatible with the separate accounts exception.
CONSEQUENCES OF VIOLATING RULE 105

The SEC may bring an action for violation of Rule 105.23 A hedge fund manager that agrees to settle with the SEC over an alleged violation may face the following consequences under the resultant administrative order.

Cease-and-Desist Order
A settled administrative proceeding will include a cease-and-desist provision enjoining the manager from future Rule 105 violations.

Profit Disgorgement
Profit disgorgement typically includes two elements. The first is the “short profit,” which is calculated by reference to the difference between the per-share price received in the short sale and the per-share price paid in the offering.24 The second element of profit disgorgement is the improper benefit the manager obtained with respect to any shares purchased in the offering in excess of the number of shares sold short. This disgorgement amount is often calculated by reference to the closing price of the issuer’s shares on the offering date.25

Civil Fine
Civil money penalties vary and may be affected by mitigating factors (e.g., the inadvertency of the Rule 105 violation or the manager’s cooperation with the SEC) or aggravating factors (e.g., repeated misconduct or evidence of a poor internal Rule 105 compliance environment). Settlements where mitigating factors are present tend to feature a civil fine of up to 50% of the amount disgorged.

Pre-judgment Interest
Pre-judgment interest runs from the date of the violation to the date of settlement. It is calculated at the IRS non-payment penalty rate.26

Public Disclosure
The hedge fund manager should expect to see the SEC publish the administrative order detailing the facts of the case and the settlement terms. The SEC sometimes accompanies the order with a press release. The manager must disclose the settlement in its Form ADV and, if applicable, its Schedule 13D relating to the issuer.27

WHAT CAN HEDGE FUND MANAGERS DO TO AVOID TRIPPING UP ON RULE 105?

Rule 105 compliance is challenging for two reasons. The first is timing. The suddenness with which many issuers can access the equity markets means that fund managers often have only a brief window in which to recognize that Rule 105 is in play and evaluate their compliance options. The second challenge arises from the absence of a scienter requirement. A foot fault violates the rule just as much as conscious wrongdoing.

Given these realities, a focused Rule 105 compliance effort is critical for managers that short with any regularity. There is nothing magic about the effort—it boils down to internal education and preventive systems—but the nuts and bolts must be actively mastered by the right people at the firm. Unlike some other anti-fraud provisions of the securities laws, a generalized awareness of Rule 105 across the manager’s personnel does not really improve the odds of successful compliance. Rather, avoiding trouble depends on specific individuals having a thorough technical understanding of the rule, and on procedures enabling those people to intervene quickly when the manager’s

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23 It is generally understood that there is no implied private right of action under Regulation M.
24 For example, assume an investor shorts 100,000 shares during the restricted period at $10 per share (for proceeds of $1 million) and then purchases 100,000 shares in the offering at $9 per share (for a cost of $900,000). The resultant short profit is $100,000.
25 For example, assume the investor shorts 100,000 shares as above, but in this case purchases 200,000 rather than 100,000 shares at the $9 offering price. Assume further that the closing price of the shares on the offering date is $9.10. The resultant improper benefit is $10,000, i.e., (200,000 - 100,000) x ($9.10 - $9.00).
26 17 CFR 201.600.
27 See Item 11 of Form ADV Part 1A and Item 2(e) of Schedule 13D.
investment program implicates Rule 105.

From an internal education perspective, the most basic task is ensuring that the manager’s relevant compliance and/or legal personnel know the details of Rule 105, and arranging training for portfolio managers, analysts and trading staff involved with short sales and public equity investments. In addition, the manager should consider devoting a specific section of its compliance manual to Rule 105; a surprising number of SEC administrative orders state that the sanctioned manager’s policies did not address the rule explicitly. If a manager intends to rely on the separate accounts exception to Rule 105, it should make sure that its training and policies focus on the requirements of the exception, including in particular the need for a viable and respected information barrier between funds or accounts.

Prevention means an internal process that triggers compliance or legal department intervention whenever the manager’s short sales and an issuer’s capital-raising combine to make Rule 105 relevant. For example, the process might feature a pre-clearance requirement that is activated when a portfolio manager requests an allocation of securities in a U.S. registered equity offering. The pre-clearance process first would entail ascertaining whether the offering is of a type subject to Rule 105. If the offering is subject to the rule, the process then would involve calculating the restricted period; determining whether and to what extent the manager has shorted the subject security during the restricted period; and, if short sales have been made, concluding whether or not the manager is able to purchase in the offering in reliance on the bona fide purchase or the separate accounts exception. If the manager regularly receives allocations of offering securities, it may wish to run periodic back-tests to confirm that the pre-clearance process is working as intended.

QUESTIONS
Richards Kibbe & Orbe LLP provides counsel to many of the largest U.S. hedge fund managers. We regularly advise on Rule 105 compliance and other issues concerning the trading of public equity securities. If you have 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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§ 242.105 Short Selling in Connection With a Public Offering.

(a) Unlawful Activity. In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1-A (§ 239.90 of this chapter) or Form 1-E (§ 239.200 of this chapter) filed under the Securities Act of 1933 (“offered securities”), it shall be unlawful for any person to sell short (as defined in § 242.200 (a)) the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period (“Rule 105 restricted period”) that is the shorter of the period:

(1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or
(2) Beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing.

(b) Excepted Activity.

(1) Bona Fide Purchase. It shall not be prohibited for such person to purchase the offered securities as provided in paragraph (a) of this section 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 §242.600(b)(22)); 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 § 242.600(b)(64)) on the business day prior to the day of pricing.

(2) Separate Accounts. Paragraph (a) of this section 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.

(3) Investment Companies. Paragraph (a) of this section shall not prohibit an investment company (as defined by Section 3 of the Investment Company Act) that is registered under Section 8 of the Investment Company Act, or a series of such company (investment company) from purchasing an offered security where any of the following sold the offered security short during the Rule 105 restricted period:

(i) An affiliated investment company, or any series of such a company; or
(ii) A separate series of the investment company.

(c) Excepted Offerings. This section shall not apply to offerings that are not conducted on a firm commitment basis.

(d) Exemptive Authority. Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

Example of Five-Business-Day Restricted Period

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10 Last day for shorting
17 Pricing after close

Example of Registration Statement-Based Restricted Period

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15 Last day for shorting
16 Registration statement filed after close
17 Pricing after close