

# Client Alert

An informational newsletter from Goodwin Procter LLP

## **Short Selling in Connection with Public Offerings: SEC Proposes Strengthening Rule 105 to Curb Perceived Abuses**

The Securities and Exchange Commission recently published proposed amendments to Rule 105 of Regulation M of the Securities Exchange Act of 1934. Rule 105 prohibits a person from covering a short sale with securities purchased in a follow-on or secondary public offering, if such person sold short within five business days prior to the pricing (or, if shorter, during the period beginning with the filing of the registration statement and ending with the pricing). Rule 105 seeks to prevent short selling that can artificially depress the market price for the offered security, a practice that may result in a lower than expected offering price and, consequently, lower than expected proceeds to the issuer or selling stockholders.

The proposed amendments, which eliminate the covering component of the current rule, are designed to address what the SEC refers to as “a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent.” Under the proposed amendments, Rule 105 will make it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase or enter into a contract to purchase securities of the same class in the offering. As such, Rule 105’s prophylactic objective will be further expanded to prohibit any purchases in the offering by a person who has effected a short sale during the restricted period prior to the offering, regardless of whether the purchased shares are used to cover the short.

The SEC has requested comments on the Rule 105 proposed amendments no later than February 12, 2007.

The text of the SEC release describing the proposed amendments is available on the SEC’s website at: <http://www.sec.gov/rules/proposed.shtml>.

### **Background**

The SEC began expressing concern about the effects of short selling prior to securities offerings in 1972 and, in particular, the “substantial adverse impact” on the market price of securities that were the subject of offerings. In response to these concerns, in 1987 the SEC proposed Rule 10b-21, which was adopted in 1988 and later, in 1996, replaced by Rule 105 of Regulation M in its present form. The principal objective of Rule 105 is to preserve the independent pricing mechanism of the securities markets so that offering prices result from the natural forces of supply and demand rather than from artificial forces. These artificial forces include short sales during the period immediately prior to the offering; such short selling may be designed to capture the offering discount when sales are covered with securities purchased at the lower offering price. In such cases, the offering discount is further exacerbated by the short selling, which can exert downward

pressure on the stock price, resulting in a lower offering price and reduced proceeds to the issuer.

### **Perceived Evasion of Rule 105**

Rule 105 currently prohibits a person from *covering* a short sale with offering securities if the short sale occurred during the restricted period. As a result of this formulation, investors have engaged in a number of different strategies designed to avoid using shares purchased in the offering to cover short sales effected during the restricted period. In some cases, non-compliance with the policy underlying the rule may have been inadvertent or at least seemingly outside the literal language of the rule, such as where an investor effects a short sale during the restricted period and subsequently purchases shares both in the offering and in the open market and asserts that the open market shares were used to cover the short. Another of these “peripheral” contexts involves shorting both prior to the restricted period and during the restricted period and then purchasing securities in the offering to cover the initial short sale. Although the SEC staff in a 2002 FAQ stated that it would view Rule 105 to have been violated in that context, such an interpretation is not consistent with the literal language of the rule. The rule as currently worded also does not impose any temporal boundaries on covering activities, leading to uncertainty in the context where a short is effected during the restricted period and shares are purchased in the offering but not immediately used to cover the short.

The most troublesome circumstances to the SEC, however, are those where investors more clearly seek to engage in short sales in advance of a public offering in direct contravention to the rule through a number of post-offering cross trading activities. These practices are the subject of a number of recent high profile enforcement actions and are the driving force behind the Rule 105 proposed amendments. These cases go to the heart of the “fungibility” issue and involve situations where a short sale was effected during the restricted period and followed by (i) a purchase of securities in the offering, (ii) a nearly contemporaneous sale and (iii) a nearly contemporaneous purchase. Notwithstanding that the SEC first made known its concerns about this type potentially manipulative trading pattern in its 2004 Regulation SHO adopting release, these activities persisted and resulted in a number of subsequent enforcement actions. As the SEC states in the Rule 105 proposed amendments release, “a contemporaneous or nearly contemporaneous post-offering purchase and sale does not undo the Rule 105 violation,” thereby laying to rest the fungibility argument.

Rule 105 is intended to also prohibit the creation of “boxed” positions post-offering, *i.e.*, by effecting a short during the restricted period, purchasing securities in the offering in excess of the number required to cover the short, using offering securities to immediately cover the short and maintaining a net long position following the covering transaction. Other potentially manipulative conduct cited by the SEC in the release includes the use of post-offering crossed limit orders and market orders at the same or nearly the same prices, as well as the use of “married puts” and other types of indirect covering purchases, such as arrangements to acquire securities from third parties who purchase shares in the offering. The fundamental theme in all of the cited contexts is that one cannot do indirectly what one cannot do directly if it otherwise violates the policy behind Rule 105.

## **Strengthening Rule 105**

To address the SEC's concerns stemming primarily from conduct that has been the subject of its enforcement actions, the SEC has proposed revising Rule 105 to simply prohibit a person from purchasing, or entering into a contract to purchase, securities in an offering if that person had effected a short sale during the restricted period. In the SEC's words, "[e]liminating the covering component is designed to end the progression of schemes and structures engineered to camouflage prohibited covering" and the current expenditure of government resources on case-by-case enforcement actions. More fundamentally, the SEC believes that the proposed revision of the rule will permit natural market forces to be the determinative factor in establishing the offering price rather than allowing the effects of artificial price movements to be a meaningful element. Thus, the scope of the new formulation should stop the more blatant violations of the existing rule, as well as eliminate the uncertainty associated with some of the less obvious short selling and covering activities that may occur in connection with the pricing of public offerings. It is important to understand that the SEC's proposed strengthening of the rule is designed to further its prophylactic effect, *i.e.*, the investor's intent is not a factor in determining whether a violation has occurred.

Key to Rule 105 compliance is, and under the proposed amendments (if adopted) will be, the maintenance of internal controls designed to prevent violations of the rule, whether inadvertent or otherwise. In this regard, the SEC noted in the proposed amendments release that while primary responsibility for compliance with the rule rests with the investor, broker-dealers may be charged with aiding and abetting or causing violations of the rule by their customers. In any event, we remind our clients as well as other investors and financial intermediaries of the critical importance of designing and maintaining an appropriate control environment, including policies and procedures reasonably designed to prevent violation of laws and regulations to the extent necessary or appropriate under the regulatory regime applicable to such investor or financial intermediary.

### **Permitted Activities and Request for Comments**

The SEC was careful to note that the proposed amendments to Rule 105 will not prohibit a person from effecting a short at a time prior to the restricted period and subsequently purchasing shares to cover that short, so long as the person did not also effect any short sales during the restricted period. The proposed rule changes also do not prohibit a person from shorting during the restricted period so long as the person does not also purchase securities in the offering, although the SEC did not discuss whether some temporal boundary following the offering might be appropriate, such as having a post-offering "restricted period." The SEC also noted that the amendments, as proposed, do not provide an exception to permit a person to effect a short sale during the restricted period, close out that short through a covering transaction effected before the end of the restricted period and then subsequently purchase shares in the offering.

In addition, the SEC stated that Rule 105 currently does not apply to derivative securities, and the proposed amendments do not seek to change this (however the use of derivatives as part of trading strategies designed to evade Rule 105 continue to be prohibited under Section 20(b) of the Exchange Act). The SEC requested comment on derivative trading activities that might produce effects on the market similar to those the proposed amendments seek to prevent, and investors and financial intermediaries may

wish to consider the extent to which they should address derivative securities under their applicable compliance policies and procedures. Finally, the SEC also is soliciting comment on a wide range of other issues relevant to Rule 105, including whether the length of the restricted period should be changed, whether the Rule 105 exception for offerings that are not conducted on a firm commitment basis should be eliminated or retained, and whether the rule should address short sales effected in and around PIPE transactions.

## Conclusion

Recognizing that investors have been engaging in numerous types of trading activities not specifically addressed by the present formulation of Rule 105 and have otherwise developed trading strategies designed to evade the prohibitions of the rule, the SEC has proposed amendments to strengthen the restrictions imposed by the rule. Through a reformulation of the language of the rule, a person who effects a short sale during the restricted period prior to an offering will no longer be permitted to purchase shares in the offering. This will eliminate the various forms of post-offering transactions that have been structured largely around the concept of fungibility of securities. The proposed amendments clarify that any short effected during the restricted period will preclude the investor from purchasing shares in the offering, even under circumstances where the investor is seeking to use offering securities to cover a short effected prior to the restricted period.

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