

Compliance Clinic



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How CCOs Can Tackle Rule 105 Compliance

By K. Susan Grafton of K&L Gates

Rule 105 of Regulation M continues to be a hot issue for the **Securities and Exchange Commission's** Division of Enforcement—which means chief compliance officers at broker/dealers and investment advisers may want to review and test their firms' policies and procedures for complying with the rule.

The rule prohibits short sales of equity securities that are the subject of a firm commitment cash offering pursuant to a registration statement (or to a notification pursuant to Regulation A or Regulation E of the Securities Act of 1933) by any person who purchases the offered securities from an underwriter or B/D participating in the offering. The rule's restriction on short sales applies during the shorter of the period beginning: (i) five business days before the pricing of the offered securities and ending with the pricing; or (ii) with the initial filing of the registration statement or notification and ending with the pricing. Each of these is referred to as the restricted period.

Unlike other provisions of Reg. M, Rule 105 only applies to equity securities. It does not apply to reference securities—for example, one into which an offered security may be converted, exchanged or exercised, such as the underlying stock in the case of a distribution of options or convertible debt—or to best efforts offerings.

Excepted Activity

In August 2007, the SEC adopted amendments to Rule 105 that, among other things, provided three new exceptions from the rule's prohibitions: Bona fide purchases, separate accounts and investment companies.

1. Bona Fide Purchases

Paragraph (b)(1) of Rule 105 permits purchases of offered securities in an offering even if the buyer sold the security short during the restricted period. To be eligible for this exception, all of these conditions must be met:

- The quantity of the offered securities that are bought must at least equal the entire amount of offered securities sold short during the restricted period
- The purchase must be bona fide. In other words, even if the purchaser is in technical compliance with this exception, the buyer must be subject to the economic risks associated with a purchase for value
- The purchase(s) must be reported pursuant to an effective

transaction reporting plan, and effected during regular trading hours such that they occur no later than the end of the regular trading session on the business day before the day of pricing

- The transactions must be sequenced so that the purchases occur after the last short sale of the offered securities during the restricted period
- The person seeking to claim the exception may not effect a reported short sale within the 30 minutes preceding the close of regular trading on the business day before the day of pricing. In other words, there must be a cooling-off period after the last short sale and before pricing

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2. Separate Accounts

Paragraph (b)(2) of Rule 105 permits short sales in separate accounts to be disregarded for purposes of determining eligibility to buy offered securities in an offering. The SEC has issued guidance that the term "account" can include portions of a particular fund, a unit, a department or an identifiable division. For the exception to

apply, however, decisions regarding securities transactions for each account must be made separately and without any coordination of trading or cooperation among or between accounts.

Although the SEC stated in the adopting release for the 2007 amendments that the availability of the separate accounts exception turns on a facts-and-circumstances determination, it also provided guidance on when accounts will be viewed as separate and operating without coordination of trading or cooperation among or between accounts:

- Each account must have separate and distinct investment and trading strategies and objectives
- Personnel must be assigned separately to each account and may not coordinate trading among or between the accounts
- There must be information barriers separating the accounts, and information about securities positions or investment decisions may not be shared between accounts
- Each account must maintain a separate profit and loss statement
- There can be no allocation of securities between or among accounts
- Senior supervisory personnel with oversight or managerial responsibility over multiple accounts in a single entity or

affiliated entities cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts

- Owners of multiple accounts cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts

With respect to funds of funds, the SEC noted that a fund that invests in multiple unaffiliated funds and owns shares of each fund—rather than shares of each fund's underlying investments—will likely not need to rely on this exception, assuming there is no coordinated trading activity. In such scenarios, the shares of each fund are viewed as different securities from the underlying securities.

3. Investment Companies

Paragraph (b)(3) of Rule 105 permits purchases of offered securities in an offering by an investment company, or series of such investment company, registered under Section 8 of the Investment Company Act of 1940 without regard to short sales by an affiliated investment company or series of such a company, or a separate series of the investment company.

In adopting this exception, the SEC noted that 1940 Act Section 17(d) and Rule 17d-1 thereunder generally prohibit any arrangement or concerted action between affiliated persons of registered investment companies. Accordingly, an arrangement between principals of affiliated funds to coordinate short sales by one fund and purchases by another fund, which would be a problematic scenario under Rule 105, would also generally be the type of joint enterprise that is prohibited by the 1940 Act.

Compliance Considerations

The renewed interest by the SEC's Division of Enforcement is a reminder to professionals to review policies and procedures relating to Rule 105 compliance. Potential controls might include one or more of the following:

Short selling in general

- Periodically reviewing and testing order entry and trading systems to confirm the timely input of order and execution information and the accurate decrementation of positions
- Confirming that all required trading and position information is aggregated on a timely basis
- Assessing the speed and accuracy with which position information is updated to reflect trading errors and cancelled trades

Securities and offerings subject to Rule 105

- Reviewing the process for identifying equity securities, which may require a case-by-case determination in the case of convertible debt and convertible preferred securities
- Confirming that offerings are flagged appropriately as "firm commitment offerings"
- Ensuring that relevant non-U.S. transactions are considered.

The restricted period

- Implementing a process for calculating restricted periods, so that it takes holidays into account correctly, and is based on the shorter of the period triggered by pricing or the filing of the initial registration statement

Exceptions

- Reviewing current trading authority, trading practices and organizational structure for the availability of the separation account exception
- Reviewing and updating policies and procedures that document and implement information barriers and segregate trading activities, including algorithms, and non-public order and trading information
- Periodically updating and documenting each account's investment and trading strategy and authorized trading personnel
- Prohibiting or implementing appropriate controls and approval processes relating to any journaling of positions between accounts

Compliance generally

- Providing appropriate training on Rule 105's current requirements, including the application of the restricted period to shelf offerings, the trade sequence requirements of the bona fide purchase exception and controls to demonstrate the separation of accounts
- Implementing and documenting restrictions on personnel with management or oversight responsibility with respect to: (i) executing or pre-approving trades in multiple accounts that rely on the separate account exception; and (ii) approving the journaling of trades or allocation of securities between or among separate accounts
- Reviewing tools to generate alerts regarding short sales and potential participation in offerings of equity securities to help reduce the chances of inadvertently triggering Rule 105 restrictions
- Conducting periodic reviews of the relevant controls, including reviewing for signs of coordination or cooperation between accounts and for trading activity that appears to be inconsistent with the stated strategy or objectives of the account.
- Documenting compliance reviews, including the appropriate resolution of any potential red flags.

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