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# Rule 105 Revisited: SEC Actions Remind Private Fund Managers About Participating In Offering After Selling Short

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In late February 2023, the SEC announced two settled litigation proceedings against private fund managers for violating Rule 105 under the Securities Exchange Act. (1) These actions provide an opportunity for managers to revisit the scope and operation of Rule 105, which essentially bars an investor from purchasing shares in a public equity offering if the investor has sold the issuer's shares short prior to the offering. This client alert reviews the basics of Rule 105; describes the facts in the two recent cases; and discusses how a fund manager can tailor its policies and procedures to avoid Rule 105 compliance problems.

## Background

Rule 105 is an anti-fraud provision contained in Regulation M under the Securities Exchange Act. Regulation M is a set of rules designed to protect the integrity of the U.S. equity markets by restricting trading behavior that might artificially affect a security's price around the time of an offering of the security.

The particular focus of Rule 105 is short selling in advance of an underwritten equity offering. The SEC believes that pre-offering short sales may artificially depress the price at which the issuer's shares are sold in the offering, with the result that a short seller who then purchases in the offering may capture the resultant price disparity at the expense of the issuer or its selling shareholders.

Rule 105 states that absent an exception, if an investor has shorted securities of the offered class during a defined "restricted period" before the offering is priced, the investor may not purchase securities in the offering from a participating underwriter, broker or dealer. Rule 105 is a strict liability provision, which means the SEC in establishing a violation need not prove scienter or knowledge on the investor's part. An investor found to have breached the rule faces profit disgorgement and potentially a civil fine, with the latter's severity often reflecting the presence of mitigating factors (such as remedial efforts or self-reporting) or aggravating factors (such as multiple infractions, internal compliance deficiencies, or lack of cooperation with the SEC).

## Offerings Covered by Rule 105

Rule 105 applies to an offering (i) of equity securities, (ii) that is made pursuant to an effective Securities Act registration statement, and (iii) that is conducted on a firm-commitment underwritten basis. A transaction with these attributes could be either a primary offering by a public company (a follow-on offering) or an offering by one or more of the company's shareholders (a secondary offering). The term "equity securities" encompasses not only common stock, but also convertible debt securities and other securities that are convertible into, or exchangeable or exercisable for, underlying equity securities.

## Restricted Period

If Rule 105 applies to an offering, an investor may not (absent an exception) purchase securities in the offering from a participating underwriter, broker or dealer if the investor has shorted securities of the same class during the applicable pre-offering "restricted period." The restricted period is the shorter of:

- the period beginning five business days before the pricing of the offering 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.

***Period Beginning Five Business Days Before Pricing***

The five-business day restricted period more commonly applies, largely because many follow-on and secondary offerings are conducted as takedowns from an effective shelf registration statement that the issuer filed with the SEC well before the offering. In this case, one calculates the restricted period by looking backward five business days from the time of pricing.

A "business day" must include a complete trading session for the securities. This means the time of day at which pricing occurs affects how far the lookback period extends from the time of pricing. In the typical case of an offering that prices after the close of trading, the day of pricing is Day 1 of the five-business day lookback. (2) If an offering prices before the close of trading, Day 1 of the lookback is the business day prior to pricing.

***Period Beginning with Initial Filing of Registration Statement***

While less common, there are circumstances in which the time between the filing of the registration statement for the offering and pricing will be shorter than five business days. In that case the registration statement-based restricted period will apply. In particular, a well-known seasoned issuer ("WKSI") is allowed to file an automatically effective shelf registration statement. This flexibility could 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. (3)

## The "Bona Fide Purchase" Exception

Rule 105 contains exceptions to the general prohibition on purchasing in an offering after shorting subject securities during the applicable restricted period. The one most likely relevant to a typical private fund manager is the “bona fide purchase” exception. It essentially provides that an investor who has shorted during the restricted period may restore its ability to purchase in the offering by making a curative purchase before the offering is priced. (4)

***Quantity and Timing Requirements***

To qualify as a bona fide purchase, the purchase must satisfy both quantity and timing requirements. The quantity requirement is that the investor must purchase, in one or more transactions, a number of subject securities at least equal to the entire amount of the investor’s restricted-period short sales. To meet the timing requirements for the bona fide purchase exception, the investor’s purchase(s) of subject securities must be:

- made during regular trading hours;
- reported to an “effective transaction reporting plan” (essentially meaning an open market purchase that is therefore reported to the tape);
- made after the investor’s last restricted period short sale; and
- made no later than the business day prior to the day of pricing.

In addition, a bona fide purchase is not possible if the investor’s last restricted-period short sale occurred during the final 30 minutes of regular trading hours on the business day prior to the day of pricing (which is the last day on which a bona fide purchase is possible). (5)

***Points to Note About the Bona Fide Purchase Exception***

It is crucial to understand that an investor does not necessarily satisfy the quantity element of the bona fide purchase exception by purchasing enough shares to become net flat over the course of 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 a restricted-period purchase that is followed by a restricted-period short sale. (6)

It is also important to note that because a bona fide purchase must be made not later than the business day before the pricing day, the exception may not be available in the case of an “overnight deal,” where an offering is announced and priced on the same evening. In this situation, the investor will have learned about the offering too late to have any prospect of deliberately making the necessary remedial purchase.

## SEC Proceedings

The SEC’s two recent settlement orders illustrate how easy it can be for a fund manager to trip up on Rule 105. They also highlight the importance of maintaining robust internal policies and procedures specifically addressing compliance with the rule.

## ***HITE Hedge Asset Management LLC***

The *HITE* matter involves a secondary offering of common stock in May 2021. According to the order, on Friday, May 7, the manager sold short an aggregate of 17,428 issuer shares for the accounts of its advised funds; on Monday, May 10, the issuer filed a preliminary prospectus supplement to a shelf registration statement filed the previous year, for a secondary offering to be priced after the market close on May 10; on that day, the manager was contacted by a participating underwriter with an invitation to submit an indication of interest, and the issuer priced the offering after the market close; in connection with the pricing, the manager submitted an indication of interest to purchase 20,000 shares; and on Tuesday, May 11, the manager received and purchased a full allocation of 20,000 shares for the funds' accounts.

Since the offering was made pursuant to a shelf registration statement declared effective months earlier, the five-business day restricted period applied; and since the offering priced after the close of trading, the day of pricing was Day 1 of the lookback. The restricted period thus ran from Tuesday, May 4 through Monday, May 10, such that the manager's May 7 short sales fell squarely within it.

The participating underwriter reportedly notified the manager that any investor requesting an allocation in the offering would be deemed to represent its eligibility to purchase in compliance with Rule 105. The order finds, however, that the manager's CCO approved his trader's request to submit an order in the "mistaken" belief that Rule 105 did not apply to the offering. In this connection, the order finds that the manager had no formal written policies relating to Rule 105 at the time in question, learning of its violation only when one of the underwriters pointed it out well after the fact. The order states that when so advised of the violation, the manager did not review its prior trading history to identify other potential Rule 105 infractions, and did not adopt a written Rule 105 policy.

The penalties in *HITE* include disgorgement of roughly $116,000 by the advised funds and a fine of approximately $103,000 payable by the manager. These modest dollar amounts remind one that liability under Rule 105 has nothing to do with the size of the violation, and that the SEC may pursue enforcement even in non-dramatic cases.

## ***Candlestick Capital Management LP***

The *Candlestick* matter involves a manager's failed attempt to use the bona fide purchase exception to buy common stock in a follow-on offering in June 2020. The order finds that on Tuesday, June 16, the manager sold short an aggregate of 350,000 issuer shares for the accounts of its advised funds; on Sunday, June 21, the issuer filed a preliminary prospectus supplement to a shelf registration statement filed months earlier, for a follow-on offering to be priced after the market close on Monday, June 22 (this filing would have become publicly visible that Monday morning); the issuer priced the offering after the market close on Monday, June 22; in connection with the pricing, the manager submitted to a participating underwriter an indication of interest to purchase 750,000 shares on behalf of the funds; and on Tuesday, June 23, the manager received and purchased a full allocation of 750,000 shares for the funds' accounts.

Because the offering would price after the close on Monday, June 22, the five-business day restricted period encompassed the manager's June 16 short sales. According to the order, the manager therefore recognized that it needed to effect a bona fide purchase if it wished to purchase in the offering. The manager attempted to do so by buying 350,000 shares in the open market on June 22.

That purchase satisfied the quantity element of the bona fide purchase exception: the manager bought at least as many shares (in this case the exact number of shares) as it had sold short during the restricted period. The purchase also partly satisfied the timing element of the exception: it was made on the open market during regular trading hours and occurred after the manager's last (in this case only) restricted-period short sale. Unfortunately for the manager, however, its Monday, June 22 purchase failed the remaining timing requirement of the bona fide purchase exception—it was made on the day of pricing, whereas the exception requires the purchase to occur no later than the business day prior to pricing. This means the last date for a bona fide purchase would have been Friday, June 19.

Unlike *HITE*, there is no suggestion in *Candlestick* that the manager lacked formal written policies concerning Rule 105 compliance, and it appears the manager quickly realized it had violated Rule 105 by purchasing in the offering. The order makes a point of finding, however, that the manager did not self-report to the SEC; did not review its prior trading history to identify other potential Rule 105 problems; and did not document the violation in its books and records, instead acknowledging the issue only when the SEC staff later asked about it during a routine examination. The penalties in *Candlestick* include disgorgement of roughly $1.7 million by the advised funds and a fine of $810,000 payable by the manager.

## How Can Fund Managers Create a Successful Rule 105 Compliance Environment?

Rule 105 compliance is challenging for two reasons. The first is timing. Given the speed with which many issuers can access the equity market, a manager that is approached about participating in an offering may have only a brief window to recognize and react to potential Rule 105 issues. The second challenge arises from the absence of a scienter requirement. An innocent misstep violates the rule just as much as consciously flouting it does.

Given these realities, a focused Rule 105 compliance effort is critical for managers that short public company equity securities. There is nothing esoteric about the effort—it boils down to internal education, communication, and procedures—but the nuts and bolts must be actively mastered by the right people at the firm. Unlike with some other anti-fraud provisions of the federal securities laws, a generalized awareness of Rule 105 across the manager's personnel does not necessarily improve the odds of successful compliance. Rather, avoiding trouble depends on specific individuals having a thorough technical understanding of the rule, and on procedures and information access enabling those people to intervene quickly when a proposed purchase in an underwritten equity offering requires a Rule 105 analysis.

From an internal education perspective, the most basic task is ensuring that the manager's relevant compliance and legal personnel know the details of Rule 105, and arranging training and clear lines of communication for portfolio managers, analysts and trading staff involved with short sales and public equity investments. In addition, the manager should devote a specific section of its compliance manual to Rule 105. A surprising number of SEC lawsuits and administrative orders state that the manager's written policies did not address the rule.

Adequate communication and procedures mean an internal process that triggers compliance or legal department interaction with the relevant investment and trading personnel whenever prior short sales and an invitation to express interest in an offering combine to make Rule 105 relevant. For example, the process might feature a pre-clearance requirement, requiring approval from the legal and compliance department when a portfolio manager wishes to request an allocation of securities in an upcoming equity offering; the firm also could also seek to augment this process through automated alerts from the firm's order management system.

The legal and compliance department's 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 identifying which of the two possible restricted periods applies and calculating how far back from the pricing date it runs; establishing whether and to what extent the manager has shorted the subject security during the restricted period; and, if short sales have been made, determining whether or not the manager is able to purchase in the offering in reliance on the bona fide purchase exception. Given the complexity of Rule 105, the firm may wish to consult with external counsel when a fact pattern arises that potentially implicates it.

Finally, if the manager regularly shorts and receives allocations of offering securities, it may wish to run periodic back-tests to confirm that the pre-clearance process is working as intended and that any Rule 105 yellow flags are recorded and resolved. If these back-tests reveal any prior violations of Rule 105, the firm should consider consulting with outside counsel as to appropriate remedial efforts.

## FOOTNOTES

([1]) In the Matter of Candlestick Capital Management LP (Feb. 21, 2023); In the Matter of HITE Hedge Asset Management LLC (Feb. 21, 2023).

([2]) For example, assume an offering is priced on Tuesday, February 28 at 6 p.m. That is after the close of regular trading, such that a complete day's trading session has occurred prior to pricing. Tuesday the 28th is therefore Day 1 of the lookback period, meaning that Day 5 of the lookback is Wednesday the 22nd. Accordingly, any short sales made from and including Wednesday the 22nd until the pricing on Tuesday the 28th would fall within the Rule 105 restricted period.

([3]) When an underwritten equity offering is conducted as a shelf takedown, shortly before pricing the issuer often files a preliminary prospectus supplement specifying the terms of the offering. This prospectus supplement is not the registration statement for the offering. If a preliminary prospectus supplement is being filed, an underlying shelf registration statement is already effective.

([4]) An alternative to the bona fide purchase exception is the "separate accounts" exception. This exception is available when the short sales and the purchase in the offering, respectively, are conducted by "separate accounts," which may mean, among other possibilities, different funds advised by the manager. The SEC has suggested various indicia of account separateness, including that the accounts have distinct investment and trading strategies and objectives; personnel for each account do not coordinate trading for the accounts; information about securities positions or investment decisions is not shared between accounts; and personnel with oversight over multiple accounts do not have authority to execute trading in individual securities in the accounts or to pre-approve trading decisions for the accounts. These aspects of the separate accounts exception make it difficult to claim for many fund managers, especially those whose investment program is organized by strategy rather than by fund.

([5]) Put differently, an investor who shorts during the last 30 minutes of trading on the business day prior to the pricing date cannot salvage its ability to participate in the offering by purporting to make a bona fide purchase in the narrow window between that short sale and the market close. The thought here is that if an investor is to be allowed to participate in an offering by virtue of a purchase that essentially neutralizes the market impact of its prior short sales, the market must have time to reflect that purchase in the stock price.

([6]) For example, assume an investor shorts 1,000 shares on the first day of the restricted period; purchases 1,000 shares on the second day; and shorts 2,000 shares on the third day (the investor's last short sale). On the fourth day of the restricted period, the investor decides to make a bona fide purchase to restore its ability to receive an allocation in the offering. The required purchase is at least 3,000 (not 2,000) shares.



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