

## **SEC Enforcement of Rule 105: The Hits Just Keep on Comin'**

March 10, 2014

Last week, in *In the Matter of Worldwide Capital, Inc. and Jeffrey W. Lynn*, AP File No. 3-15772 (Mar. 5, 2014), the SEC announced the latest—and largest ever—settlement of an administrative enforcement action concerning violations of Rule 105 of Regulation M, 17 C.F.R. § 242.105. *Worldwide Capital* is only the most recent of more than 40 actions concerning Rule 105, which have resulted in tens of millions of dollars in disgorgement, civil monetary penalties and pre-judgment interest, over the past few years. This issue has, and will continue to be, a major enforcement priority for the SEC.

### **The Basics of Rule 105**

Rule 105 generally prohibits short selling an equity security and then purchasing the same security in a secondary offering within a “restricted period,” which is usually the five business days before the pricing of the offering. The point is to prevent potentially manipulative short selling in advance of secondary offerings which, in the view of the SEC, can hurt investors (by depressing prices) and also issuers (by hindering capital raises).

As first promulgated, many years ago, Rule 105 barred only “covering” short sales with shares from secondary offerings. But in October 2007, the SEC amended the regulation to prevent efforts to circumvent its no-covering provision. In its current form, Rule 105 more broadly prohibits “purchasing” offering shares after making short sales, regardless of whether those offering shares are actually used to cover. This no-purchasing provision draws a “bright line,” and it applies regardless of a person’s intent. In other words, as amended, Rule 105 reaches any person who makes both short sales and offering purchases of the same equity security within the restricted period, even if that person did not intend to break the law.

### **A Trio of Exceptions to Rule 105**

There are three limited exceptions to Rule 105: (1) for “bona fide purchases,” (2) for certain investment companies, and (3) for short sales and offering purchases that are made in “separate accounts.” But the SEC has cautioned against the aggressive use of these exceptions, and it has warned that it will pursue persons who try to exploit them.

The “separate accounts” exception, for example, requires a meaningful separation of all trading activity. To make that determination, the SEC looks to such factors as whether there is any coordination or information sharing between accounts and whether there is a combined P&L for them. That was apparently the case with *Worldwide Capital, Inc.*, a proprietary trading firm, and its principal, Jeffrey Lynn.

### ***In the Matter of Worldwide Capital, Inc. and Jeffrey W. Lynn***

According to the SEC, *Worldwide* and *Lynn* violated Rule 105 on 60 occasions between October 2007 and February 2012, generating “ill-gotten gains” of almost \$8.5M, of which *Worldwide* and *Lynn* retained more than \$4M. (They paid their traders about \$4M.) The traders whom *Worldwide* and *Lynn* engaged made the offending trades through various accounts: they executed the short sales through accounts with specialized broker-dealers who cater to small institutional customers and professional traders, and they executed the offering purchases through different accounts with major broker-dealers.

That separation was inadequate for the purpose of Rule 105, because “the *Worldwide* trades, regardless of the account in which the trade was executed, cleared and settled in a *Worldwide* master account at *Worldwide*’s prime broker.” Further, by talking with his traders and back office staff as well as regularly reviewing blotters and the records in the trade management system, *Lynn* kept close tabs, on a daily basis, on all of the relevant activity. Therefore, the use of multiple accounts did not satisfy the “separate accounts” exception or stop the SEC from holding *Worldwide* and *Lynn* liable for dozens of violations.

In the end, to settle with the SEC, Worldwide and Lynn agreed to pay disgorgement of more than \$4.2M, pre-judgment interest of more than \$500,000, and a civil monetary penalty of more than \$2.5M. The SEC also ordered that Worldwide and Lynn cease-and-desist from any future violations of Rule 105.

## What You Need to Know

The facts of *Worldwide* were admittedly extreme—60 violations of Rule 105 over more than 4 years. The resulting disgorgement and penalties were similarly striking—more than \$7M dollars, for which Worldwide and Lynn are jointly and severally liable. That being said, this action serves as a cautionary tale for others who might try to qualify for one of the narrow exceptions to Rule 105. It is best to consult with counsel before making any trades that the SEC might later determine violated Rule 105, because in an enforcement action, a person's good faith—"we didn't know the trades violated Rule 105" or "we thought they qualified for an exception"—will not be a defense.

Moreover, this action and the SEC's comments about it make clear that those who engage in short selling and participate in secondary offerings should expect enforcement activity around Rule 105 to continue for the foreseeable future. In announcing the settlement with Worldwide and Lynn, the Director of the New York Regional Office promised that the SEC will "continue to aggressively pursue violators." The SEC gave a similar warning when it recently announced its year-end enforcement statistics for the 2013 fiscal year. In describing its "forward-looking initiatives," the SEC stated that it will "continue to crack down on violations of Rule 105." It is imperative, therefore, to draft and implement effective policies and procedures to ensure compliance with Rule 105.

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