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SEC: Zero Tolerance for Short Selling Violations

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On September 17, 2013, the Securities and Exchange Commission (the "SEC") announced enforcement actions against 23 firms for violations of Rule 105 of Regulation M. Rule 105 prohibits the purchase of securities in a follow-on or secondary firm commitment public offering if the purchaser engaged in short sales of the applicable equity security during a specified restricted period (typically the five business days before the applicable offering is priced and ending with such pricing). The SEC's National Examination Program simultaneously issued a risk alert regarding compliance with Rule 105.

Rule 105 is applicable regardless of a trader's intent. In its Risk Alert, the SEC noted:

"Rule 105 does not require intent on the part of the short seller to engage in a prohibited transaction; one violates the rule if such person sells short the security that is the subject of the offering during the restricted period (and does not fit into one of the Rule's three exceptions) and then purchases shares of that security in the offering."

Rule 105 only provides limited exceptions for (i) certain purchasers who have made bona fide purchases of the security in quantity equal to the amount of such restricted short sales, which purchases must have occurred after the restricted short sales and prior to the pricing of the applicable secondary offering, (ii) certain transactions made by separate related accounts where the investment decisions were made separately for each account and without coordination, and (iii) certain transactions by registered investment companies (or series of a registered investment company) notwithstanding short sales in the restricted period by an affiliated registered investment company (or by another series of the registered investment company). The rule promotes offering prices that are set by supply and demand rather than manipulative activity and prevents short sales that can reduce offering proceeds by artificially depressing the market price shortly before the pricing of a public offering.

The SEC has settled over 40 actions involving Rule 105 violations since January 2010. "The benchmark of an effective enforcement program is zero tolerance for any securities law violations, including violations that do not require manipulative intent," according to Andrew J. Ceresney, Co-Director of the SEC's Division of Enforcement. "Through this new program of streamlined investigations and resolutions of Rule 105 violations, we are sending the clear message that firms must pay the price for violations while also conserving agency resources."

The Risk Alert reminds firms to do the following in order to advance compliance with Rule 105:

1. Provide training to employees regarding the application of Rule 105;
2. Develop and implement policies and procedures reasonably designed to achieve compliance with Rule 105, which identify, mitigate and manage risks involving short sales in connection with follow-on or secondary offerings; and
3. Enforce those policies and procedures.

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