

MEMO# 27581

September 20, 2013

OCIE Issues Risk Alert Reminding Registrants of the Need To Comply with the Short Selling Prohibitions in Regulation M

[27581]

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TO: COMPLIANCE MEMBERS No. 41-13

EQUITY MARKETS ADVISORY COMMITTEE No. 19-13

CLOSED-END INVESTMENT COMPANY MEMBERS No. 82-13 RE: OCIE ISSUES RISK ALERT REMINDING REGISTRANTS OF THE NEED TO COMPLY WITH THE SHORT SELLING PROHIBITIONS IN REGULATION M

Earlier this week, the SEC's Office of Compliance Inspections and Examinations (OCIE) published its latest Risk Alert to impress upon registrants the need to have and enforce compliance policies, procedures, and controls to ensure compliance with Rule 105 of Regulation M, which prohibits purchasing securities in follow-on and secondary offerings when the purchaser has effected short sales in the securities within the specified restricted period. [\[1\]](#) The Alert reminds registrants that, in order to advance compliance with the Rule, it is important to provide training to employees regarding the Rule's application, to develop and implement policies and procedures that are reasonably designed to achieve compliance with the rule, and to enforce compliance with those policies and procedures. [\[2\]](#) It notes that a violation of the Rule does not require intent on the part of the short seller to engage in a violation of the Rule and after-the-fact remediation will not absolve a firm or individual from a violation. The Risk Alert is briefly summarized below.

Overview of Rule 105

The Risk Alert notes that the goal of the Rule is to protect the independent pricing mechanisms of the securities markets so that prices are determined by the natural forces of supply and demand and not artificial forces – including short selling that could artificially depress market prices. The Rule's prohibitions were strengthened in 2007 by the adoption of amendments that make it “unlawful for person to purchase securities in a firm commitment equity offering from an underwriter or broker-dealer participating in the offering if that person sold short the security that is the subject of the offering during the Rule 105 restricted period, absent an available exception.” [\[3\]](#) [Emphasis in original.] The

Risk Alert discusses the three available exceptions to the Rule: (1) the “bona fide purchase” provision; (2) an exception for separate accounts; [4] and (3) an exception for investment companies. As regards (3), the Risk Alert notes that this exception “allows a registered fund (or series of such fund) to participate in an offering, even if another series of the registered fund or an affiliated registered fund (or series of such fund) sold short during the restricted period.” [5]

Ensuring Compliance with the Rule

The Risk Alert notes that SEC enforcement actions and examinations have observed deficient practices relating to the Rule. It reminds registrants that:

To be in compliance with Rule 105, a person that for any reason has sold short shares of a security that is the subject of an offering during the restricted period must generally either refrain from purchasing shares of that security in the offering, or rely on an exception. Firms are reminded that, in order to advance compliance with Rule 105, it is important to provide training to their employees regarding the application of the Rule, develop and implement policies and procedures reasonably designed to achieve compliance with the Rule, and enforce those policies and procedures. [6] [Emphasis added.]

It notes that, in determining penalties imposed for violations of the Rule, “the Commission has considered, among other factors, whether the firms implemented remedial efforts, such as developing and implementing policies, procedures, and controls to prevent or detect Rule 105 violations in determining the appropriate resolution in those cases.” It also notes that, in conducting examinations, OCIE has specifically commented on the inadequacy of registrants’ policies and procedures in this area. It reminds registrants that, while they may take prompt remedial steps to address violations of the Rule brought to their attention, “these same remedial steps, had they been proactively implemented, may have prevented the violations.” And, as noted above, after-the-fact remediation will not absolve a firm or individual from a violation of the Rule.

OCIE hopes that the Risk Alert impresses upon registrants the need to comply with the Rule and encourages registrants to both review their policies and procedures in this area and actively monitor their activities to ensure compliance with the Rule.

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endnotes

[1] See Rule 105 of Regulation M: Short Selling in Connection with a Public Offering, National Examination Program Risk Alert (Vol. III, Issue 4), Sept. 17, 2013 (“Risk Alert”), which is available at: <http://www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf>. Appendix A to the Risk Alert provides links to various SEC releases and guidance, including those relating to the Rule’s adoption and implementation.

[2] To impress upon registrants the frequency of SEC actions resulting from violations of the Rule, Appendix B of the Risk Alert lists 43 actions taken by the SEC since 2010 involving

violations of the Rule.

[3] Risk Alert at p. 2. Footnote 4 of the Risk Alert explains the term “restricted period” for purposes of the Rule.

[4] The Risk Alert lists “several indicators that may assist in determining that accounts are separate” for purposes of this exception in the Rule. Risk Alert at pp. 2-3.

[5] Risk Alert at p. 3. Footnote 8 provides an example of how this exception might apply.

[6] Risk Alert at pp. 3-4.

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