MEMO# 21447

August 13, 2007

SEC Approves Rule Proposal Relating to Short Selling

[21447]

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TO: SEC RULES MEMBERS No. 109-07
EQUITY MARKETS ADVISORY COMMITTEE No. 48-07
CLOSED-END INVESTMENT COMPANY MEMBERS No. 51-07
ETF ADVISORY COMMITTEE No. 29-07 RE: SEC APPROVES RULE PROPOSAL RELATING TO SHORT SELLING

The Securities and Exchange Commission has approved a proposal to amend Rule 105 of Regulation M relating to short selling in connection with a public offering. [1] The adopted proposal incorporates recommendations by the Institute designed to avoid inadvertent violations of the rule by investment companies stemming from their organizational structure. [2]

Amendments to Rule 105

Rule 105 of Regulation M currently prohibits a person from covering a short sale with securities sold in an offering, if such person sold short within (1) five days prior to pricing or (2) the period beginning with the filing of the registration statement and ending with pricing, whichever is shorter. The proposed amendments to Rule 105 would have eliminated the covering requirement, making it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase the security in the offering. In a February 12, 2007 comment letter to the Commission, the Institute expressed concern that the proposal was unclear whether a "person" for purposes of Rule 105 would include each fund within a complex, each series of a fund, or each subadvised portion of a single fund, which could create difficulties for funds effecting transactions in securities that are the subject of an offering. [3]

In adopting the proposal, the Commission not only eliminated the covering requirement, as proposed, but also created three exceptions to the amended rule including one for investment companies and one for separate accounts. [4] The proposal also includes several amendments to Rule 105 concerning the scope of the rule, such as restricting its application to offerings of “equity” securities for cash, excluding reference securities, and including offerings made on Form 1-E. [5]

New Exceptions to Rule 105

The amendments to Rule 105 include new exceptions to the rule for investment companies and separate accounts. [6] The investment company exception extends to investment companies registered under Section 8 of the Investment Company Act. It thus permits a fund (or series) to participate in an offering even if an affiliated fund (or series) sold short during the restricted period. The release explains that an arrangement by which one fund sells a security short while another affiliated fund goes long to cover that position would generally be the type of joint arrangement that is prohibited by Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder. As a result, Section 17(d) and Rule 17d-1 would prevent these persons from engaging in activities that the amended Rule 105 seeks to prohibit.

The separate account exception provides that the purchase of the offered security in an account of a person shall not be prohibited where such person sold short during the Rule 105 restricted period in a separate account, if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between accounts. The Release explains that in such circumstances, where accounts do not coordinate their trading activity, the incentive that motivates a Rule 105 violation is not present because the short seller cannot lock in a profit by purchasing the discounted offering shares. The Release provides several examples of persons eligible for the separate account exception. It also sets forth the following list of indicia of separate accounts, noting that the determination of such status may depend on the facts and circumstances surrounding the creation and operation of the accounts so the satisfaction of all six criteria may not be necessary for purposes of using the exception.

In addition, the Release explains that a fund of funds, that owns shares of each fund rather than shares of each fund’s underlying investments, “will likely not need to rely on the separate account exception when one of the multiple funds sells short during the Rule 105 restricted period and another one purchases offered securities because the shares of each fund are different securities from the underlying securities.” Further, the Release states that where there are multiple subadvisers to the same fund (or series), each subadvised portion of that fund (or series) may be able to rely on the separate account exception, even if the subadvisers’ activities are subject to the supervision of a single, primary investment adviser.

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endnotes

[1] SEC Release No. 34-56206 (August 6, 2006) (“Release”). The Release can be found on the SEC’s website at http://www.sec.gov/rules/final/2007/34-56206.pdf. The amendments will become effective 60 days after publication in the Federal Register.

[2] For a summary of the Institute’s comment letter, see Institute Memorandum to SEC Rules Members No. 20-07, Equity Markets Advisory Committee No. 8-07, Closed-End Investment Company Members No. 12-07, and ETF Advisory Committee [20874] dated February 16, 2007.

[3] Id.

[4] The third exception is for a bona fide purchase, described in the Release “as a purchase of the security that is the subject of the offering that is at least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale.” The Release outlines requirements necessary to satisfy the exception and provides several examples as well.

[5] Regulation E exempts from registration under the Securities Act of 1933 securities issued by registered small business investment companies or by investment companies that have elected to be regulated as business development companies pursuant to Section 54(a) of the Investment Company Act of 1940.

[6] The Release and the amended Rule use the term “separate account” to refer, generally, to circumstances in which a person has more than one account, as described further below.