



# Federal Register

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**Part II**

## **Securities and Exchange Commission**

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**17 CFR Part 242  
Short Selling in Connection With a Public  
Offering; Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 242

[Release No. 34-54888; File No. S7-20-06]

RIN 3235-AJ75

### Short Selling in Connection With a Public Offering

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is proposing amendments to Regulation M concerning the anti-manipulation rules for securities offerings that would further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuers' offering proceeds and dilute security holder value. The proposal would prevent a person from effecting a short sale during a limited time period, shortly before pricing, and then purchasing, including entering into a contract of sale for, such security in the offering.

**DATES:** Comments should be received on or before February 12, 2007

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. S7-20-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-20-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change;

we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

#### FOR FURTHER INFORMATION CONTACT:

James A. Brigagliano, Acting Associate Director, Josephine Tao, Branch Chief, Elizabeth Sandoe, Victoria Crane, and Marlon Quintanilla Paz, Special Counsels, (202) 551-5720, Office of Trading Practices and Processing, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6628.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting public comment on proposed amendments to Rule 105 of Regulation M [17 CFR 242.105].

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#### I. Introduction

A fundamental goal of Regulation M, *Anti-manipulation Rules Concerning Securities Offerings*, is protecting the independent pricing mechanism of the securities markets so that offering prices result from the natural forces of supply and demand unencumbered by artificial forces.<sup>1</sup> Price integrity is essential in the offering process. Regulation M is intended to foster price integrity by prohibiting activity that interferes with independent market dynamics, prior to pricing offerings, by persons with a heightened incentive to manipulate.

Regulation M consists of a definitional rule, Rule 100, and five additional rules, Rules 101 through

105.<sup>2</sup> Rule 105, *Short Selling In Connection With A Public Offering*, prohibits a person from covering a short sale<sup>3</sup> with securities sold in the offering, if such person sold short within five days prior to pricing or the period beginning with the filing of the registration statement and ending with pricing, whichever is shorter. This short selling can artificially depress market prices which can lead to lower than anticipated offering prices, thus causing an issuer's offering proceeds to be reduced.<sup>4</sup>

We are aware of non-compliance with current Rule 105, and in some cases, strategies used to disguise Rule 105 violations.<sup>5</sup> Despite interpretive guidance regarding the application of Rule 105,<sup>6</sup> we have witnessed continued violations of the rule, including a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent.

We propose amending Rule 105 to make it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase, including enter into a contract of sale for, such security in the offering. The proposal, like the current rule, provides a bright line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M. In light of evidence of non-compliance with the current rule, we believe the proposal would promote investor and issuer confidence in pricing integrity and in the offering process, which should facilitate capital formation. In addition, the elimination of the current rule's covering component is intended to address attempts to restructure transactions in an effort to evade Rule 105.

The proposal is narrowly tailored to address short sales prior to pricing that can reduce issuers' offering proceeds without restricting other short sales before the offering.<sup>7</sup> Like the current rule, the proposal would permit persons that effect short sales prior to the restricted period to purchase, including to enter into a contract of sale for, such security in the offering and would

<sup>2</sup> 17 CFR 242.100 through 242.105.

<sup>3</sup> A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. See 17 CFR 242.200 (2006).

<sup>4</sup> See Regulation M Adopting Release, 62 FR at 538.

<sup>5</sup> See *infra* n.18.

<sup>6</sup> See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48020-21 (Aug. 6, 2004) ("Regulation SHO Adopting Release").

<sup>7</sup> If the registered offering is on behalf of selling security holders, the proceeds of such selling security holders can be similarly reduced.

<sup>1</sup> Securities Exchange Act of 1934 ("Exchange Act") Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997) ("Regulation M Adopting Release").

permit persons to sell short during the restricted period if they do not purchase, including enter into a contract of sale for, such security in the offering.

We solicit specific comment on our approach and the specific proposals. We encourage commenters to present data on our proposals and any suggested alternative approaches.

## II. Background

The Commission has long been concerned that short sales effected prior to certain offerings that are covered with offering securities can be manipulative conduct harmful to the market and can have a substantial impact on issuers or selling security holders. Rule 10b–21,<sup>8</sup> the predecessor to Rule 105, prohibited covering short sales with offering securities if the short sale took place during the period beginning at the time that the registration statement or Form 1–A was filed and ending at the time that sales may be made pursuant to the registration statement or Form 1–A.<sup>9</sup> The Commission stated that Rule 10b–21 would “help deter a practice that the Commission views as manipulative and destructive of issuers’ capital raising activities.”<sup>10</sup>

Prior to Rule 10b–21’s adoption, the Commission noted the staff’s view about short selling prior to an offering, stating that “it appears that such short selling prior to the offering date has had a substantial adverse impact on the market price of the securities and in some instances has caused the offerings to be postponed temporarily, to be

abandoned completely, or to be made at prices lower than originally intended—prices which do not reflect the market value of the securities, undistorted by artificial factors.”<sup>11</sup>

Generally, the offering prices of follow-on and secondary offerings<sup>12</sup> are priced at a discount to a stock’s closing price (depending on the exchange, the closing transaction price, closing bid price, or last sale price) prior to pricing. This discount provides a motivation for a person who has a high expectation of receiving offering shares to capture this discount by aggressively short selling just prior to pricing and then covering the person’s short sales at the lower offering price with securities received through an allocation. Covering the short sale with a specified amount of registered offering securities at a fixed price allows a short seller largely to avoid market risk and usually guarantee a profit.<sup>13</sup> Short sales during the period immediately preceding pricing an offering can exert downward pressure upon a stock’s price that can result in lower offering prices.

Some persons may decide to sell short prior to the pricing of an offering because they believe the security is overpriced. This activity provides a true price discovery mechanism for the market and should be encouraged. Persons who are attempting to capture the offer price discount are not selling short the security because the security is overpriced; thus, they do not contribute to true pricing efficiency.<sup>14</sup> Instead, by

selling the security short with the knowledge that they are very likely to be able to cover their short positions with offering shares that they are allocated, these persons may drive down the price despite their true belief regarding the appropriate price for that security. The likelihood of being allocated offering shares provides these persons with an advantage over other persons, which they may exploit to the detriment of pricing efficiency. Not only is this conduct harmful to the market and current security holders, but it can reduce the proceeds the issuer or the selling security holder receives from the securities offering.

To facilitate true price discovery, Rule 105 governs short sales immediately prior to pricing follow-on and secondary offerings where the short sales are covered with offering securities.<sup>15</sup> Currently, Rule 105 prohibits persons from covering a short sale with offering securities if the short sale occurred during a Rule 105 restricted period. Typically, the Rule 105 restricted period begins five business days before the pricing of the offering and ends with pricing.<sup>16</sup> Rule 105 is prophylactic. Thus, its prohibitions apply irrespective of a short seller’s intent.<sup>17</sup> Rule 105 does not ban short sales because certain short sales may be motivated by a short seller’s evaluation of a security’s future performance and contribute to pricing efficiency and price discovery. The rule does not unduly restrict short selling, and thus does not hamper true price discovery, because persons are not prohibited from short selling and persons expecting to receive allocation

that his selling short the same securities prior to the offering may be subject to the registration requirements of Section 5 of the Securities Act [15 U.S.C. 77e] as well as other applicable statutes and rules.’ Exchange Act Release No. 10636 (Feb. 11, 1974). *Accord*, Exchange Act Release Nos. 11328 n. 1 (Apr. 2, 1975) and 9824 (Oct. 16, 1972).’ Exchange Act Release No. 26028 (Aug. 25, 1988), 53 FR 3345, 33457 (Aug. 31, 1988).

<sup>15</sup> 17 CFR 242.105. *Short selling in connection with a public offering*. (a) Unlawful Activity. In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1–A (§ 239.90 of this chapter) filed under the Securities Act, it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the shorter of: (1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) The period beginning with the initial filing of such registration statement or notification on Form 1–A and ending with such pricing.

<sup>16</sup> See *id.*

<sup>17</sup> See Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820, 65822 n.22 (Nov. 21, 2003) (stating that Rule 105 does not require a showing of scienter). Short sales effected during the Rule 105 restricted period can depress market prices and reduce an issuer’s offering proceeds even if the short seller has no manipulative intent.

<sup>8</sup> Rule 10b–21 was rescinded with the adoption of Regulation M. Regulation M Adopting Release, 62 FR at 520.

<sup>9</sup> Exchange Act Release No. 33702 (Mar. 2, 1994), 59 FR 10984 (Mar. 9, 1994) (“Rule 10b–21 Adopting Release”). Rule 10b–21(T) was initially adopted on a temporary basis. Exchange Act Release No. 26028 (Aug. 31, 1988), 53 FR 33455 (Aug. 31, 1988). The Commission proposed the rule for public comment in 1987. Exchange Act Release No. 24485 (May 20, 1987), 52 FR 19885 (May 28, 1987) (“1987 Proposing Release”). The Commission proposed three versions of Rule 10b–21 prior to the 1987 Proposing Release. See Exchange Act Release No. 10636 (Feb. 11, 1974), 39 FR 7806 (Feb. 28, 1974); Exchange Act Release No. 11328 (Apr. 2, 1975), 40 FR 16090 (Apr. 9, 1975); Exchange Act Release No. 13092 (Dec. 21, 1976), 41 FR 56542 (Dec. 28, 1976).

Rule 10b–21 provided that, “It shall be unlawful for any person who effects one or more short sales of equity securities of the same class as securities offered for cash pursuant to a registration statement filed under the Securities Act of 1933 (‘Securities Act’) or pursuant to a notification on Form 1–A under the Securities Act (‘offered securities’), to cover such short sale or sales with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sales or sale took place during the period beginning at the time that the registration statement or Form 1–A is filed and ending at the time that sales may be made pursuant to the registration statement or Form 1–A.” Former Rule 10b–21(a).

<sup>10</sup> 53 FR at 33456.

<sup>11</sup> Exchange Act Release No. 9824 (Oct. 25, 1972), 37 FR 22796 (Oct. 25, 1972). In addition, the Commission noted the staff’s view that “Such investors and broker-dealers, desiring to participate in so-called ‘hot’ issue offerings, agree to accommodate the underwriters and therefore participate in the so-called ‘cold’ issue. Such persons reportedly then attempt to protect themselves against losses by selling the securities short prior to the distribution, intending to cover their position with the securities being offered.” 37 FR at 22796.

<sup>12</sup> The first time an issuer conducts a public offering of its securities, the offering is referred to as an initial public offering (“IPO”). Subsequent offerings by the issuer are referred to as follow-on offerings or repeat offerings. A secondary offering is an offering of securities held by security holders, for which there already exist trading markets for the same class of securities as those being offered. See Exchange Act Release No. 10636 (Feb. 11, 1974), 39 FR 7806 n.1 (Feb. 28, 1974). Of course, IPOs also may include secondary offerings by selling security holders.

<sup>13</sup> Of course, there are additional risks including execution risk, quantity risk and litigation risk that the short seller might consider. Based on our experience, it would appear that many investors perceive these risks as minimal because they do not appear to deter this shorting strategy. The shorting strategy is detailed in a number of enforcement cases concerning Rule 105. See *infra* n.18.

<sup>14</sup> “The Commission has also cautioned that ‘any person intending to purchase securities in any registered secondary offering should be on notice

of offering shares can effect short sales prior to the Rule 105 restricted period. In addition, short sales can be made during the restricted period if the seller does not cover with shares it receives in the offering.

There has been non-compliance with Rule 105 and examples are detailed in numerous recent Commission enforcement cases.<sup>18</sup> We have seen patterns where persons engage in strategies to avoid the appearance that offering shares they were allocated are used to cover Rule 105 restricted period short sales. Whether trading strategies are the product of attempts to avoid application of the rule or attempts to conceal Rule 105 violations, they indicate the presence of activity that the rule is designed to prevent.

Certain of the cases illustrate activity meant to obfuscate the prohibited covering. One method of obscuring a Rule 105 violation involves post-offering sales and purchases undertaken to give the appearance that the restricted period short sales were covered with shares other than the offering allocation. For example, a person (1) effects a short sale of 5,000 shares during a Rule 105 restricted period, (2) purchases, including enters into a contract of sale for, 5,000 shares of the security in the offering, (3) following the purchase, or entry into the contract of sale, sells 5,000 shares and (4) contemporaneously or nearly contemporaneously purchases 5,000 shares. The Rule 105 violation may be complete when the restricted period short sale is covered with offering shares at step number 2 above. Once the restricted period short sale is executed and the person purchases, including enters into a contract of sale for, the offered securities, the position is economically flat. A contemporaneous or nearly contemporaneous post-offering purchase and sale does not undo the Rule 105 violation.<sup>19</sup> In that situation, a person may violate Rule 105 despite his

or her claim that the market purchase following the offering, rather than the shares acquired in the offering, covered the short position because there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk.

Certain Commission enforcement cases illustrate variations of this tactic. The following examples illustrate attempted concealments of covering through the use of crossed limit orders and the use of market orders. Persons may claim that a post-allocation shares purchase, rather than the shares from the offering allocation, are used to cover the restricted period short sale. However, this post offering activity may be an attempt to conceal the prohibited covering after the Rule 105 violation has occurred.

The Commission has settled proceedings in which respondents covered restricted period short positions in violation of Rule 105 and placed post-offering limit orders to sell and purchase the offered security at the same price and in the same quantity.<sup>20</sup> For example, 1,000 shares of an issuer's common stock were sold short during the restricted period. Next, the person purchased, including entered into a contract of sale for, 1,000 shares of the security in the offering. Thereafter, buy and sell limit orders were placed to "cross" 1,000 shares of the issuer within the same account. Subsequently, the Commission has settled cases in which the respondents effected a post-offering sale and purchase of securities with market orders filled at nearly the same price.<sup>21</sup>

Another strategy to obfuscate the prohibited covering is a practice known as "collapsing the box." In one Commission settled case, for example, a person created "boxed" positions by maintaining a short position established during the restricted period while simultaneously maintaining a long position in the security with the shares acquired in a follow-on offering.<sup>22</sup> To cover the short sales, the person instructed its prime broker to make journal entries that cancelled out the long and short positions through the use

of riskless, offsetting journal entries.<sup>23</sup> Consequently, the offering shares were used to cover the restricted period short sale.

Each of these structures or strategies we have observed seeks to replicate the economic equivalent of the activity that Rule 105 seeks to prevent. Additional examples of strategies that have developed over the years to conceal conduct prohibited by Rule 105 include arrangements to purchase from third parties and married puts. The Commission reiterated guidance initially issued under Rule 10b-21(T),<sup>24</sup> the predecessor to Rule 105, concerning attempts to obscure violations through indirect covering purchases using an intermediary.<sup>25</sup> In this situation, a short sale is effected during the restricted period and covered with offering securities obtained through an arrangement with a third party who acquires the securities in the offering. Through these types of transactions, the trader is attempting to do indirectly what he cannot do directly, *i.e.*, the covering prohibited by Rule 105.<sup>26</sup> Section 20(b) of the Exchange Act makes it "unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do \* \* \* through or by means of any other person."<sup>27</sup>

Further, the Commission noted its concern about the abusive use of married puts as part of trading strategies designed to hide activity that violates Rule 105. In this strategy, a married put<sup>28</sup> is used to conceal the fact that the sale effected during the restricted period is a short sale. Essentially, this technique is used to give the appearance

<sup>23</sup> *Id.* (alleging Galleon established a 63,310 share short position during the restricted period, received a 95,000 share offering allocation, sold 31,690 shares, leaving a 63,310 share boxed position, and thereafter instructed its prime broker to collapse the 63,310 share box).

<sup>24</sup> *See supra* n.9.

<sup>25</sup> Regulation SHO Adopting Release, 69 FR at 48021 (stating "[in] this transaction, the trader is attempting to accomplish indirectly what he or she cannot do directly, *i.e.*, a type of short sale transaction prohibited by Rule 105."); *See also*, Exchange Act Release No. 26028 (Aug. 25, 1988), 53 FR 33455, 33458 (Aug. 31, 1988) (stating that "covering purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder.").

<sup>26</sup> *Id.*

<sup>27</sup> 15 U.S.C. 78t(b).

<sup>28</sup> The term "married put" is used to describe the underlying transaction, *i.e.*, the linked purchase of securities and a put option to sell an equivalent number of securities.

<sup>18</sup> *See, e.g.*, *SEC v. Solar Group S.A. and James J. Todd*, No. 06-CV-12936 (SDNY Nov. 6, 2006), Litigation Release No. 19899 (Nov. 6, 2006); *SEC v. Graycort Financial, LLC*, No. C 06-6033 (NDCA Sept. 28, 2006), Litigation Release No. 19851 (Sept. 28, 2006); *SEC v. Compania Internacional Financiera SA and Yomi Rodrig*, No. 05-CV-10634 (SDNY Dec. 20, 2005), Litigation Release No. 19501 (Dec. 20, 2005); *SEC v. Galleon Management, L.P.*, Litigation Release No. 19228 (May 19, 2005); *DB Investment Managers, Inc.*, Exchange Act Release No. 51707 (May 19, 2005); *Oaktree Capital Management LLC*, Exchange Act Release No. 51709 (May 19, 2005); *SEC v. Joseph X. Crivelli*, Exchange Act Release No. 50092 (July 27, 2004); *Ascend Capital, LLC*, Exchange Act Release No. 48188 (July 17, 2003); and *SEC v. Ethan H. Weitz and Robert R. Altman*, Litigation Release No. 18121 (Apr. 30, 2003).

<sup>19</sup> The Commission issued interpretive guidance regarding transactions that are engineered to obfuscate a Rule 105 violation. 69 FR at 48021.

<sup>20</sup> *See, e.g.*, *SEC v. Graycort Financial, LLC*, No. C 06-6033 (NDCA Sept. 28, 2006); Litigation Release No. 19851 (Sept. 28, 2006); *Ascend Capital, LLC*, Exchange Act Release No. 48188 (July 17, 2003).

<sup>21</sup> *See, e.g.*, *SEC v. Graycort Financial, LLC*, No. C 06-6033 (NDCA Sept. 28, 2006); *SEC v. Galleon Management, L.P.*, Litigation Release No. 19228 (May 19, 2005); *Oaktree Capital Management LLC*, Exchange Act Release No. 51709 (May 19, 2005).

<sup>22</sup> *See id.*

that the restricted period sale was a long sale, when in fact it was a short sale.<sup>29</sup>

This proposal is designed to further provide confidence to issuers and investors that offering prices would be determined through the natural forces of supply and demand and would not be reduced by potentially manipulative activity. Moreover, the proposal should further provide confidence to persons that they are making investment decisions based on market prices and offering prices unencumbered by artificial forces.

### III. Discussion of Proposed Amendments

In light of non-compliance with Rule 105, and the various strategies designed to conceal conduct prohibited by Rule 105, we propose to amend Rule 105 to prohibit any person from effecting a restricted period short sale and then purchasing, including entering into a contract of sale for, the security in the offering. A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>30</sup> As we have noted before, a person purchases, including entering into a contract of sale for, a security when the person becomes

irrevocably committed to purchase the security.<sup>31</sup>

Currently, Rule 105 makes it unlawful for a person to cover a restricted period short sale with offered securities. Eliminating the covering component is designed to end the progression of schemes and structures engineered to camouflage prohibited covering. Otherwise, we would have to continue to address each variation on a case-by-case basis, which could increase uncertainty in the marketplace. The proposal fosters the goals of Rule 105 and would be consistent with the objectives of Regulation M—the prevention of manipulation and the facilitation of offering prices based on the natural forces of supply and demand unencumbered by artificial influence. The proposal would promote market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. It would promote price movements that result from natural market forces, undistorted by artificial forces. This would bolster investor confidence in the capital raising process. Further, the proposal would protect issuers and selling security holders from a specific and demonstrated type of activity that can reduce their offering proceeds.

As with the current rule, the proposal would not ban short selling. The proposal, like the current rule, would allow short sales based on a person's view of a security's future performance: persons could effect short sales before the restricted period and still purchase, including enter into a contract of sale for, the security in the offering, and persons could effect short sales during the restricted period and not purchase, including enter into a contract of sale for, the security in the offering. However, the proposal does not provide an exception to allow those that close-out restricted period short sales prior to pricing to participate in the offering.

Finally, the proposal restructures the rule in an effort to promote compliance consistent with the prophylactic nature of Regulation M.

As with current Rule 105, responsibility for compliance with the proposal would rest with the person that effects a short sale during the restricted period and purchases, including enters into a contract of sale for, the security in the offering allocation. However, as with any securities law, rule or regulation,

broker-dealers may be charged, depending on the facts and circumstances, for aiding and abetting or causing securities law violations by their customers.<sup>32</sup> We encourage commenters to discuss compliance issues, including but not limited to, the costs of compliance as well as any other costs.

### IV. Derivatives

In adopting Rule 105, the Commission stated that Rule 105 does not apply to short sales of derivative securities, "because an extension of the rule's prohibitions to derivative securities would be inconsistent with the approach of Regulation M, which is to focus on those securities having the greatest manipulative potential."<sup>33</sup> Nonetheless, we understand that persons may use options or other derivatives in ways that may cause the harm that Rule 105 is intended to prevent. We request comment on trading strategies involving derivatives that may produce similar effects (*e.g.*, depress the market prices of the underlying equity security and result in lower offering prices) in ways not covered by the current or proposed rule. Please provide specific detail regarding the derivatives used, the transactions employed, as well as the roles of the various parties to the transactions. Please describe whether a regulatory approach that covers derivatives is over inclusive or under inclusive and provide alternative suggestions.

As with other rules, we note that the use of derivatives as a part of trading strategies designed to evade the application of Rule 105 does not comply with Commission rules.<sup>34</sup> For example, persons may attempt to circumvent Rule 105 by claiming to have a position in a security by virtue of having entered into a "married put" transaction when in fact their transactions were the equivalent of short sales, for which they used shares acquired in the offering to close-out their restricted period sales.<sup>35</sup> Such conduct is proscribed through the operation of section 20(b) of the Exchange Act.<sup>36</sup> The Commission has

<sup>29</sup> Commission Guidance on Rule 3b-3 and Married Put Transactions, Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820 (Nov. 21, 2003) ("Married Puts Release") (stating "Most recently, we have become aware of certain strategies in which traders may acquire married puts as part of what may be an effort to circumvent the application of Rule 105. In these schemes traders enter into married put transactions during the restricted period 5 days before (or, sometimes, on the day of) pricing in a 'secondary' or 'repeat' offering. Thereafter, the traders aggressively sell the stock portion of the married put as 'long' sales, exercise the puts at the end of the day they are obtained, and then use securities obtained in the offering (sometimes obtained at a discount to the closing price) to cover their restricted period sales. This activity often enables the traders receiving offering shares to profit from the difference between the sales prices and the offering price, where the sales lowered the market price and, as a consequence, the market-based offering price. Not only is this manipulative conduct harmful to the market, but it also may have a substantial impact on the issuer and its security holders that receive reduced offering proceeds as a result of the lower offering price. We find the use of married put transactions as a part of these strategies particularly troubling because they represent an attempt to facilitate the very kind of abuse that" Rule 105 is designed to prevent.)

<sup>30</sup> See 17 CFR 242.200. Although this definition would remain unchanged for purposes of the proposed amendment, for ease of reference, the proposed rule text includes a reference to Regulation SHO. We also removed the phrase "from an underwriter or broker or dealer participating in the offering" because Rule 105 now covers shelf offerings and the phrase is no longer necessary.

<sup>31</sup> See Securities Offering Reform, Exchange Act Release No. 52056 (July 19, 2005), 70 FR 44722, 44765 n.391 (Aug. 3, 2005).

<sup>32</sup> See, generally, Exchange Act sections 15(b)(4), 20(a), 20(e), and 21C. See also *Sharon M. Graham and Stephen C. Voss v. SEC*, 222 F.3d 994, 1007 (D.C. Cir. 2000).

<sup>33</sup> Reg. M Adopting Release, 62 FR at 538.

<sup>34</sup> See, *e.g.*, Reg. M Adopting Release, 63 FR 538 (citing to Rule 10b-21 Adopting Release, 53 FR at 33457); Married Puts Release, 68 FR at 65820.

<sup>35</sup> Married Puts Release, 68 FR at 65822 (discussing the operation of Rule 3b-3 with respect to sellers who may claim to have a position in a security by virtue of having entered into a "married put" transaction).

<sup>36</sup> 15 U.S.C. 78t(b); see also, *supra* n.25.

also noted that, “purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder.”<sup>37</sup>

#### V. Request for Comment

Q. The proposal provides that a person who effects a restricted period short sale cannot purchase, including enter into a contract of sale for, the security in the offering. As proposed, the rule does not provide an exception to allow those that cover restricted period short sales prior to pricing to participate in the offering. Should the proposed rule provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person closes-out the entire short position in an offered security with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media? Please discuss any alternatives, including whether the rule should provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person can demonstrate, using required books and records, that the person closed-out the restricted period short sales (but not necessarily the person’s entire short position) with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media. What would be the appropriate time period in which to close-out a person’s entire or restricted period short position, *i.e.*, 2 business days before pricing? Would a shorter or longer period be appropriate? If so, please explain. Would such an alternative address the abuses that the rule is designed to prevent? Would such an alternative prevent potential transactions designed to disguise rule violations? What is the frequency of such trading? What difficulties would be presented by not providing an exception to allow persons to close-out the short position? If the proposed rule provides for such an exception, should it also require that the person claiming the exception be able to demonstrate

compliance? Are there other ways, instead of an open market purchase executed during regular trading hours that is reflected on the consolidated tape or other reporting media that a person could use to close-out their entire or restricted period short position that would be transparent to the market prior to pricing and should be considered? What are the benefits of allowing a person to close-out his entire or restricted period short position after effecting a restricted period short sale but prior to pricing of the offering?

Q. Is the restricted period sufficient to dissipate the effects of any manipulative short selling on the price of the offered security? Is there a longer or shorter time frame or alternative measure that would be more effective?

Q. Should the Rule 105(b) exception for offerings that are not conducted on a firm commitment basis be eliminated or retained? If you believe that the exception should be retained, please describe why the manipulative abuse that Rule 105 is designed to prevent is not present in offerings conducted on other than a firm commitment basis.

Q. In recent cases involving “Private Investment in Public Equity” (“PIPEs”) transactions, persons are alleged to have agreed to invest in PIPE offerings, sold short the issuer’s securities, and closed-out the short position using shares acquired from the issuer in the PIPE transaction that are registered for resale by such persons. Should the Rule address short sales effected during the period following the entering into of a PIPE transaction and before a registration statement for resale of the restricted securities acquired in the PIPE transaction is declared effective, or short sales that are effected at any time in connection with the PIPE transaction? Is there an alternative period for which the Rule should restrict short sales that persons intend to close-out by using shares acquired from the issuer in PIPE transactions? What would be the impact on issuers concerning short sales effected in connection with PIPE transactions if the Rule applied to securities registered for resale in connection with PIPEs transactions? For example, what would be the effect on issuers’ ability to attract PIPE investors and the effect on the market for the issuers’ securities?

Q. We are aware that short sales effected prior to the exercise of conversion rights, such as those under a convertible debenture, can depress stock prices and result in the issuance of more shares upon the exercise of the conversion rights. For example, a convertible security such as a convertible debenture may grant an

investor the right to convert all or a portion of the debenture into common stock based on a formula using the price of the common stock at the time of conversion with the investor receiving more shares on conversion if the market price of the common stock declines. A person may be liable under the anti-fraud provisions of the federal securities laws if that person seeks to manipulate the stock price downward to enhance the economic interests in a convertible security.<sup>38</sup> Should Rule 105 address short sales effected prior to the exercise of conversion rights?

Q. Should Rule 105 apply to issuances of rights to an issuer’s existing security holders to buy a proportional number of additional securities at a given price (usually at a discount) within a fixed period (a rights offering). Is there a similar potential for persons to influence the offer price through a rights offering?

Q. Should the Rule address short sales effected in connection with equity line financing arrangements in which an investor and a company enter into a written agreement under which the company has the right to put its securities to the investor in an offering in which the securities are registered for sale or resale?

Q. Under the current and proposed rule, an investor with a long position can legally sell all or part of the position during the five days prior to the offer and still purchase shares in the offering. We request comment on whether an investor with a long position may have the same economic incentives to attempt this arbitrage or to manipulate the price of the offer as a short seller. Aside from legal risk, are the risks and returns of the long strategy any different from the risks and returns of the short strategy? Can this strategy harm issuers? Should the Commission consider broadening Rule 105 to include long sales?

Q. Rule 200(a) defines the term “short sale” as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Should the Commission consider modifying this definition in order to further the goals of this proposal?

Q. Should Rule 105 apply to offerings not made pursuant to a registration statement on Form 1-A?

Q. Regulation E under the Securities Act of 1933 provides certain small business investment companies and

<sup>38</sup> See, e.g., *SEC v. Rhino Advisors, Inc. and Thomas Badian*, No. 03-CIV-1310 (SDNY 2003), Litigation Release No. 18003 (Feb. 27, 2003).

<sup>37</sup> Rule 10b-21 Adopting Release, 53 FR at 33458.

business development companies with a registration exemption that is similar to Regulation A. Should Rule 105 apply to offerings made pursuant to Form 1-E, Notification under Regulation E?

Q. Would this proposal be more effective than the existing rule in deterring attempts to obscure violations of Rule 105 and limiting manipulation of offering prices?

Q. Rule 200(c) of Regulation SHO states that, “[a] person shall be deemed to own securities only to the extent that he has a net long position in such securities.” In order to determine the net long position, a seller of an equity security must aggregate all of that person’s positions in that security. Under Rule 200(f) of Regulation SHO, however, a registered broker-dealer may qualify for independent trading unit aggregation. We seek comment about the application of the aggregation principles in the context of Rule 105 to non-broker-dealers, including, for example, investment companies. Should non-broker-dealers be provided an exception similar to that provided to broker-dealers under Rule 200(f) of Regulation SHO based on these aggregation principles, *e.g.*, should there be a requirement that the non-broker dealer be a registered investment adviser, or be a client of a registered investment adviser for purposes of the excepted transaction? If so, what criteria would be appropriate?

Q. Are there alternative approaches to revising Rule 105 that should be considered?

Q. Beyond selling short, are there other types of trading strategies that Rule 105 should address that similarly exert untoward downward pressure on a stock’s market price and thus lower market prices prior to the pricing of follow-on and secondary offerings? How should such trading strategies be addressed?

Q. Should potential investors in an offering be required to give an underwriter a certification that they have not effected and will not effect a short sale during the Rule 105 restricted period? What are the costs and benefits of such a requirement for investors and underwriters? Would this impact the costs of underwriting? Should any such certification instead be provided to the broker-dealer through which the person is purchasing the shares?

Q. We request comment on any liquidity or market efficiency impact that the proposal may raise.

Q. Empirical evidence shows that, on average, issuers decline in value by about 3% when they announce an impending public equity offering. Later, issuers’ value declines another 1% to

3% in the five days prior to the offer. Following the offer, issuers’ value recovers but the value five days after the offer is still about ½% lower than the value five days before the offer.<sup>39</sup> We request comment on any effect the proposal will have on such price patterns, *i.e.*, the price of a security declining prior to an offering and not fully recovering. Is this price pattern due to a type of evasion of Rule 105 that the proposed amendment would eliminate? Would these price patterns change as a result of the proposal? Can the ½% loss in issuers’ value be considered an economic benefit of the proposed amendment to Rule 105? Can any of the 3% value decline at the announcement of a public equity offer be considered an economic benefit of the proposed amendment to Rule 105?

Q. We request comment on any impact the proposal may have on trading and trading strategies.

Q. We request comment on any impact the proposal may have on dynamic hedging activities.

Q. To what extent, if any, will the proposal increase or decrease the potential for other types of manipulation?

Q. Are there any technical or operational challenges that would arise in complying with the proposal?

Q. Does the proposal present any special compliance difficulties or other issues?

Q. How much would the amendments affect specific compliance costs or other costs for small, medium and large entities?

Q. We request comment concerning any effects that the proposal may have on market participants, including underwriters as well as specific effects that the proposal may have on the underwriting process.

Q. We request comment concerning any effects that the proposal may have on issuers, including the ability of issuers to attract investors to their securities offerings and the costs to issuers of completing offerings.

Q. Would the proposed amendment create additional costs for or otherwise impact short sellers, issuers, investors, underwriters, or others?

Q. What are the economic costs or other costs associated with the proposal?

#### *General Request for Comments*

The Commission seeks comment generally on all aspects of the proposed

<sup>39</sup> Several empirical studies report these price patterns both before and after the application of Rule 10b-21. See, *e.g.*, Shane A. Corwin, *The Determinants of Underpricing for Seasoned Equity Offers*, 58 J. Fin. 2249 (Oct. 2003).

amendment to Rule 105 of Regulation M. Any interested persons wishing to submit written comments on the proposal, as well as other matters that might have an impact on the proposal, are requested to do so. Commenters are requested to provide empirical data to support their views and arguments related to the proposal herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendment to Rule 105. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposal where appropriate.

#### **VI. Paperwork Reduction Act**

We have not prepared a submission to the Office of Management and Budget regarding the amendments to Rule 105 of Regulation M because the proposals do not contain a collection of information requirement within the meaning of the Paperwork Reduction Act of 1995.

#### **VII. Consideration of Proposed Amendments to Rule 105 of Regulation M’s Costs and Benefits**

The Commission is considering the costs and benefits of the proposed amendments to Rule 105. The Commission is sensitive to costs and benefits, requests data to quantify the costs and the value of the benefits provided, and encourages commenters to discuss any additional costs or benefits or reductions in costs beyond those discussed here. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendment. If applicable, the Commission requests comments on the potential costs for any modification to computer systems and surveillance mechanisms as well as any potential benefits resulting from the proposal for issuers, investors, broker or dealers, other securities industry professionals, regulators or other market participants.

##### *A. Benefits*

The proposal is intended to further safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce issuers’ offering proceeds. The proposal also is designed to provide confidence to persons that they are making investment decisions based on market prices and offering prices unencumbered by artificial forces. Specifically, the proposal would

prohibit a person who effects a short sale during the Rule 105 restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The benefits of the proposed modifications to Rule 105 would be realized by many market participants, including investors, issuers, selling security holders, underwriters, short sellers and regulators.

The proposed amendments to Rule 105 are intended to further facilitate market prices and offering prices that can be fairly determined by the natural forces of supply and demand undistorted by artificial forces.

Currently, Rule 105 makes it unlawful for a person to cover a short sale effected during the Rule's restricted period with certain offering securities. The proposed amendment would eliminate the covering component and instead prohibit a person who effects a short sale during the Rule's restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The proposal is intended to halt schemes designed to conceal the prohibited covering. It also provides a bright line demarcation of prohibited activity consistent with the prophylactic nature of Regulation M.

Issuers and selling security holders should benefit from the proposal because it is designed to promote the goals of the current rule, enhancing market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. The proposal should help issuers and selling security holders realize proceeds that are not artificially low due to short selling. The proposal also would promote investor confidence in the offering process, which should foster capital formation. In turn, these benefits should encourage issuers to conduct capital formation in the U.S. market.

Moreover, the proposed Rule 105 modifications retain much of the flexibility of the current rule for traders because persons continue to be able to sell short during the restricted period if they do not purchase, including enter into a contract of sale for, the securities. Persons also retain the ability to sell short prior to the Rule 105 restricted period and then purchase, including enter into a contract of sale for, the securities.

We believe the proposed modification may reduce activity designed to disguise rule violations. We believe this would lead to a reduction in the number of instances of aggressive short sellers attempting to place artificial downward

pressure on market prices. Therefore, the proposal would strengthen the ability of underwriters to set offering prices without being encumbered by artificial activities in the market.

We believe short sellers would benefit from the proposal because it provides a bright line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M. The proposal does not ban short selling. Indeed, it would allow short sales that may contribute to pricing efficiency and price discovery. The bright line demarcation is important because it would provide clear guidance for short sellers seeking to comply with Rule 105.

We believe the proposal may decrease the level of non-compliance with the Rule. The proposed elimination of the Rule's covering component should reduce attempts to disguise the covering activity through convoluted trading structures. This would save significant regulatory resources that would otherwise be spent pursuing evolving strategies to disguise conduct that violates the Rule.

#### *B. Costs*

In complying with the proposed modifications to Rule 105, a person that effects a short sale during a defined period could not purchase, including enter into a contract of sale for, the security in the offering. Under current Rule 105, persons that effect short sales during a restricted period cannot cover their short position with the offering securities. Thus, we believe any costs currently associated with persons reviewing their restricted period short sales would remain the same, as a person would use the current systems and surveillance mechanisms for information gathering, management, and recordkeeping systems or procedures. Indeed this proposal is intended to provide a more straightforward means of compliance.

As an aid in evaluating costs and reductions in costs associated with the proposed Rule 105 modifications, the Commission requests the public's views and any supporting information. The Commission believes that the proposed amendments would impose negligible costs, if any, on traders and issuers and that the proposed amendments are appropriate for the protection of investors and issuers and to promote the integrity of the capital raising process.

The Commission staff has noted that investors desiring to participate in hot issue offerings may improperly accommodate an underwriter by participating in a cold issue. Investors may attempt to protect themselves against losses in a cold issue by selling

securities short in the Rule 105 restricted period intending to cover with offering securities in violation of Rule 105.<sup>40</sup> We seek comment about any impact the proposal may have on the underwriting process. If the proposal impacts the underwriting process, would it make it easier or more difficult for underwriters to sell offerings and what, if any, impact would there be on efficiency of the pricing of an offering or competition among underwriters?

The Commission encourages commenters to discuss all costs. In particular, the Commission requests comment on the potential costs for any modification to systems and surveillance mechanisms, and for information gathering, management, and recordkeeping systems or procedures. Commenters should provide analysis and data to support their views on any costs associated with the proposed amendment.

#### **VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking that requires it to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.<sup>41</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the anti-competitive effects of any rules it adopts.<sup>42</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the proposed amendment would promote capital formation through improved integrity of the U.S. securities markets by precluding conduct that can depress security prices during a critical period of time in the capital raising process. Preventing the type of potentially manipulative activity targeted by the proposed amendment would help protect the pricing process so that the forces of supply and demand are not undermined. The proposal would promote price determinations and movements that result from natural market forces, undistorted by artificial influences. We request comment on the

<sup>40</sup> See *supra* n.11.

<sup>41</sup> 15 U.S.C. 78c(f).

<sup>42</sup> 15 U.S.C. 78w(a)(2).



impact of the amendment on capital formation.

Short sales based upon a person's evaluation of the issuer's fundamentals (products, earnings, management, etc.) and a security's future performance may contribute to pricing efficiency and price discovery. Such short sales reflect the value that a trader assigns to an issuer's security. However, short sales prior to pricing an offering by a person who expects an offering allocation and anticipates making a quick profit from effecting the short sale and then purchasing, including entering into a contract of sale for, the security in the offering, may not similarly reflect the trader's evaluation of the issuer's fundamental value.

The Commission staff has noted that investors desiring to participate in hot issue offerings may improperly accommodate an underwriter by participating in a cold issue. Investors may attempt to protect themselves against losses in a cold issue by selling securities short in the Rule 105 restricted period intending to cover with offering securities in violation of Rule 105.<sup>43</sup> We seek comment about any impact the proposal may have on the underwriting process. If the proposal impacts the underwriting process, would it make it easier or more difficult for underwriters to sell offerings and what, if any, impact would there be on efficiency of the pricing of an offering or competition among underwriters?

The Commission has considered the proposal in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, the proposed amendments would not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Specifically, the proposed version of the Rule would continue to allow short sales based on a person's view of a security's future performance. Traders could sell short before the restricted period. Alternatively, traders could sell short during the restricted period if they do not purchase, including enter into a contract of sale for, the securities. The proposal would provide a bright line approach designed to prevent improper conduct and to provide a bright line demarcation regarding conduct that is prohibited for persons wishing to comply with the rule.

The Commission generally requests comment on the competitive or anticompetitive effects of the proposed amendments to Rule 105. The Commission also requests comment on what impact the proposed amendments

to Rule 105 would have on efficiency and capital formation. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposal.

#### **IX. Consideration of Impact on the Economy**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or (SBREFA),<sup>44</sup> we must advise the Office of Management and Budget as to whether the proposed amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

#### **X. Initial Regulatory Flexibility Analysis**

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA)<sup>45</sup> regarding the proposed amendment to Rule 105 of Regulation M.

##### *A. Reasons for the Proposed Action*

The proposal is intended to safeguard the integrity of the capital raising process and further protect issuers from potentially manipulative activity that can reduce issuers' offering proceeds. There have been a number of Rule 105 cases brought by the Commission over the last few years.<sup>46</sup> The proposal would provide a bright line test for Rule 105 compliance, which would be consistent with the prophylactic nature of Regulation M. The bright line demarcation is important because it provides clear guidance for persons seeking to comply with Rule 105. We believe the proposed bright line

demarcation would reduce Rule 105 violations.

Certain of the Commission's recent cases involved violations of Rule 105 that involved a complex series of trading activity designed to obfuscate the prohibited covering of restricted period short positions with offered shares. We have observed continuously evolving strategies to obscure conduct prohibited under Rule 105. Each scheme seeks to replicate the economic equivalent of the activity that Rule 105 seeks to prevent. We believe it is important to eliminate the covering component of the rule to cut off the likely future development of more complex attempts to disguise violations of the Rule.

##### *B. Objectives*

The proposed amendments to Rule 105 would prohibit a person who effects a short sale in the restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The proposal is designed to promote the goals of the current rule, enhancing market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. The proposal would promote price movements that result from natural market forces, undistorted by artificial forces. Accordingly, we believe the proposal would further safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce issuers' offering proceeds. The proposal also would promote investor confidence in the offering process, which should foster capital formation.

##### *C. Legal Basis*

The Commission is proposing to amend Rule 105 pursuant to the authority set forth in sections 7, 17(a), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), 77s(a)]; sections 2, 3, 7(c)(2), 9(a), 10, 11A(c), 12, 13, 14, 15(b), 15(c), 15(g), 17(a), 17(b), 17(h), 23(a), 30A, and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm]; and sections 23, 30, 38 of the Investment Company Act [15 U.S.C. 80a-23, 80a-29, and 80a-37].

##### *D. Small Entities Subject to the Rule*

The proposed rule applies to any person that effects a short sale during the restricted period. This is unchanged from the current rule. The entities

<sup>44</sup> Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. and as a note to 5 U.S.C. 601).

<sup>45</sup> 5 U.S.C. 603.

<sup>46</sup> See *supra* n.17.

<sup>43</sup> See *supra* n.11.

covered by the proposed rule would thus include small broker-dealers, small businesses, and any investor eligible to effect a short sale that qualifies as a small entity.

Generally, these entities are already subject to the current rule, which contains requirements similar to those in the proposed rule. As a result, the marginal cost of compliance with the proposed rule for these businesses is likely to be minimal.

Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10<sup>47</sup> states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2005, the Commission estimates that there were approximately 910 broker dealers that qualified as small entities as defined above.<sup>48</sup>

Any business, however, regardless of industry, could be subject to the proposed rule if it effects a short sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the proposed rule is not feasible.

#### *E. Reporting, Recordkeeping and Other Compliance Requirements*

The proposed amendments to Rule 105 may impose limited new compliance requirements on any affected party, including broker-dealers that are small entities. Under the proposed amendments, market participants could not purchase, including enter into a contract of sale for, the securities if they acquired a short position in the security during a restricted period. This proposal would not modify the measurement of restricted periods that apply, therefore, since the current rule also addresses conduct around short selling that occurs during a restricted period, the monitoring that would be required of market participants to ensure compliance with the amended Rule would not change. The proposal does

not contain recordkeeping or reporting requirements for broker-dealers.

#### *F. Duplicative, Overlapping or Conflicting Federal Rules*

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed amendments.

#### *G. Significant Alternatives*

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,<sup>49</sup> the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the Rule, or any part thereof, for small entities.

With respect to the proposed amendments to Rule 105, the Commission believes that, in order to preclude conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand, uniform rules applicable to all market participants (regardless of size) are necessary. The Commission believes that the establishment of different requirements for small entities is neither practicable nor in the public interest because small entities can conduct the same type of manipulative trading as others. The proposed amendments would likely impose minimal additional costs, if any; therefore, establishing different compliance requirements or clarifying, consolidating, or simplifying compliance or reporting requirements for small entities would yield little or no additional benefit. With regard to the proposed amendments to Rule 105, and clarification of the application of the regulation, small entities would not be specifically exempted, since all securities may be subject to the type of manipulation the amendments seek to prevent. Finally, the proposed amendments to Rule 105 would impose performance standards rather than design standards.

#### *H. Solicitation of Comments*

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on (1) the number of persons that are subject to Rule 105 and the number of such persons that are small entities; (2) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact (commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact); and (3) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves. As discussed above, for purposes of SBREFA, the Commission is also requesting information regarding the potential impact of the proposed amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

#### **XI. Statutory Basis**

The Commission is proposing to amend Rule 105 pursuant to the authority set forth in sections 7, 17(a), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), 77s(a)]; sections 2, 3, 7(c)(2), 9(a), 10, 11A(c), 12, 13, 14, 15(b), 15(c), 15(g), 17(a), 17(b), 17(h), 23(a), 30A, and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm]; and sections 23, 30, 38 of the Investment Company Act [15 U.S.C. 80a-23, 80a-29, and 80a-37].

#### **Text of Proposed Amendments**

##### **List of Subjects in 17 CFR Part 242**

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, Part 242 of the Code of Federal Regulations is proposed to be amended as follows:

#### **PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES**

1. The authority citation for part 242 continues to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l,

<sup>47</sup> 17 CFR 240.0-10(c)(1).

<sup>48</sup> These numbers are based on the Office of Economic Analysis' review of 2005 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

<sup>49</sup> 15 U.S.C. 603(c).

78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Section 242.105 is amended by revising paragraph (a) to read as follows:

**§ 242.105 Short selling in connection with a public offering.**

(a) *Unlawful Activity.* In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (§ 239.90 of

this chapter) filed under the Securities Act of 1933, it shall be unlawful for any person to effect a short sale (as defined in § 242.200) and then purchase, including enter into a contract of sale for, the security in the offering if that person effected such short sale in the offered security during the shorter of:

(1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or

(2) The period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing.

\* \* \* \* \*

Dated: December 6, 2006.

By the Commission.

**Nancy M. Morris,**

*Secretary.*

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