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Part II

Securities and Exchange Commission

17 CFR Part 242
Short Selling in Connection With a Public Offering; Final Rule
SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242
[Release No. 34–56206; File No. S7–20–06]
RIN 3235–AJ75

Short Selling in Connection With a Public Offering

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (“Commission”) is amending amendments to Regulation M to further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuer’s offering proceeds and dilute security holder value. The amendments eliminate the covering element of the former rule.

DATES: Effective Date: October 9, 2007.

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SUPPLEMENTARY INFORMATION: We are amending Rule 105 of Regulation M [17 CFR 242.105].

I. Background

Pricing integrity is essential to the capital raising process. A fundamental goal of Regulation M, Anti-Manipulation Rules Concerning Securities Offerings, is protecting the independent pricing mechanism of the securities market so that offering prices result from the natural forces of supply and demand unencumbered by artificial forces. Rule 105 of Regulation M governs short selling in connection with public offerings and concerns short sales that are effected prior to pricing an offering. The rule is particularly concerned with short selling that can artificially depress market prices which can lead to lower than anticipated offering prices, thus causing an issuer’s offering proceeds to be reduced. The rule is intended to foster secondary and follow-on offering prices that are determined by independent market dynamics and not by potentially manipulative activity. Rule 105 is prophylactic. Thus, its provisions apply irrespective of a short seller’s intent.

Former Rule 105 (“former rule”) prohibited covering short sales effected during a defined restricted period with securities purchased in an offering (“offered securities”). “Covering” was the prohibited activity. Specifically, the former rule made it unlawful for any person to cover a short sale with offered securities purchased by 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 pricing.

In recent years, the Commission has become aware of non-compliance with Rule 105 and, in some cases, strategies used to disguise Rule 105 violations. In particular, the Commission has become aware of attempts to obfuscate the prohibited covering. Due to 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, the Commission published proposed amendments to Rule 105 for notice and comment.

The Commission proposed to eliminate the covering requirement in order to end the progression of trading strategies designed to hide activity that violated the rule. In particular, the Commission proposed 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. In effect, the proposal imposed an absolute prohibition against purchasing offered securities in firm commitment offerings by any person that effected a restricted period short sale(s).

We received 13 comment letters in response to the Proposing Release from one self-regulatory agency, one issuer, one academic, one investment company, four associations, and five law firms. Some commenters supported the proposal, others opposed it, and some commenters suggested modifications or alternative approaches. We have carefully considered each of the comments. While the comment letters are publicly available to be read in their entirety, we highlight many of the issues, concerns, and suggestions raised in the letters below.

Some commenters were supportive of the proposal and its goals. Comment letters from an issuer and a self-regulatory organization supported the specific proposal to eliminate the rule’s covering component and instead prohibit purchasing in the offering. One commenter stated that “the proposed amendments to Rule 105 meaningfully address the proliferation of trading strategies and structures, which are designed to disguise prohibited covering activity, by prohibiting any purchase of offered shares by someone who sold short during the restricted period. By eliminating the covering component and expanding the prohibition to all purchases of offered securities, the proposed amendments will efficiently prevent persons from engaging in strategies to avoid the appearance that offering shares are used to cover Rule 105 restricted period short sales.”

In addition, an issuer stated the proposal would “prevent manipulative activity by those short sellers who inappropriately reap economic gains to the detriment of issuers and selling shareholders who receive reduced

See id. at 75003.

Former Rule 105(a) stated, “[i]n 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 applicable Rule 105 restricted period.

See former Rule 105(a).

See Proposing Release, 71 FR at 75002.

See id. at 75004.

See id. at 75002.

See id.

See id.

See id.

See id.

See id.


2See Proposing Release, 71 FR at 75002.

3See Proposing Release, 71 FR at 75002.

4See Reg. M Adopting Release, at 75005.

5See id.

6See Proposing Release, 71 FR at 75002.

7See id. at 75004.

8See id.

9See id.


11See NYSE and Fairfax letters.

12NYSE letter.
of potential investors, price discovery, and investment adviser violations. With respect to the investor pool, commenters believed that the proposal could reduce the number of investors for secondary offerings. One concern was that investors would be forced out of secondary offerings if they effected certain trading strategies that involved short sales during the restricted period. One commenter stated that short sales are “effectuated as part of, among other things, initial and dynamic hedging strategies, long/short strategies, convertible arbitrage, bona-fide market making, and customer facilitation activities.” Some commenters noted that preventing persons that effect these strategies during a restricted period from purchasing in an offering minimizes the pool of potential investors and can have a negative effect on price discovery. A second concern raised by some commenters was that investors who had no knowledge of an offering at the time of a short sale would be prohibited from purchasing in the offering. Commenters generally asserted that short sales effected without knowledge of a secondary offering or takedown, such as an “overnight deal,” would not be manipulative, yet an investor would be prohibited from participating in the offering under the proposed amendments.

Commenters were also concerned about the impact of the proposed amendments on investment companies and investment advisers. Generally, commenters discussed two possible scenarios. First, there would be a violation of the proposed rule if “one fund within a fund complex (or a series of a fund) effects a short sale during the five day period and another fund in the same complex (or another series of a fund) purchases the security in the offering.” Second, commenters were also concerned about proposed rule violations “if a subadviser to a fund enters into a short sale in a security during the five-day period prior to an offering, and a separate subadviser to the same fund purchases the security in the offering.”

Some commenters advocated modifications to the proposed amendments such as confining the rule’s application to equity offerings and incorporating the concept of a “subject” security from Regulation M so that convertible offerings would not be impacted by the amendments. Commenters also suggested amending the restricted period to incorporate the concept of public announcement of an offering. Another suggestion was to create an exception for certain trading strategies. Another proposed
modification was an exception based on the Rule 101 exception for actively traded securities. Many commenters supported an exception raised by a question in the Commission’s Proposing Release to allow restricted period short sellers to participate in an offering if they covered such short sale(s) with a bona fide purchase prior to the offering. However, some commenters were opposed to creating exceptions that would undercut the rule’s prophylactic nature.

Furthermore, in response to questions raised in the Proposing Release, some commenters felt that Rule 105 should not address derivatives, PIPE transactions, long sales, convertible offerings, or best efforts offerings. Many commenters also opposed the question in the Proposing Release as to whether we should require underwriters to obtain certifications from investors stating that they had not sold short during the restricted period.

Other commenters sought additional interpretive guidance with respect to former Rule 105 instead of amending the rule.

After considering the comments received and the purposes underlying Rule 105, we are adopting the amendments with some modifications to refine provisions and address commenters’ concerns as discussed below.

II. Discussion of Amendments

The amendments are carefully and narrowly tailored to further the anti-manipulation goals of Rule 105 by ending the progression of strategies designed to conceal the covering of restricted period short sales with offered securities without unduly expanding the scope of the rule or unnecessarily restricting the pool of secondary and follow-on offering purchasers. The amended rule seeks to achieve this goal by eliminating the covering element of the former rule. However, in response to comments, as adopted, amended Rule 105 refines the amendment as proposed in several aspects, including limiting its application to equity offerings, and adding a “bona fide purchase provision” that allows a restricted period short seller to participate in an offering. The amended rule also includes new exceptions concerning separate accounts and investment companies. The exception for separate accounts allows a person to purchase the offered securities in an account where there was a short sale in another account if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts. The exception for certain investment companies allows an investment company to participate in an offering if an affiliated investment company or any series of such investment company sold short during the restricted period.

The proposed amendments would have imposed an outright ban on purchasing offered securities if a person sold short during a restricted period. The amended rule refines that approach.

As proposed and as adopted, the amendment changes the prohibited activity from covering to purchasing the offered security, in order to put an end to strategies that obfuscated the prohibited covering but replicated its economic effect. However, the amended rule also includes the three exceptions.

Generally, the offering prices of follow-on and secondary offerings are priced at a discount to a stock’s closing 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 prices 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.” Eliminating the covering component and prohibiting a purchase in the offering in amended paragraph (a) reduces a potential investor’s incentive to aggressively sell short prior to pricing solely due to the anticipation of this discount. Such activity can exert downward pressure on market prices for reasons other than price discovery that result in lowered offering prices and therefore reduced offering proceeds to issuers and selling security holders.

The prohibition on purchasing offered securities also provides a bright line demarcation of prohibited conduct consistent with the prophylactic nature of Regulation M.
A. Bona Fide Purchase Exception

In response to commenters’ concerns, the amended rule adds a provision that allows restricted period short sellers to purchase the offered securities if they make a bona fide purchase of the same security prior to pricing. This provision advances the goals of facilitating offering price integrity and protecting issuers from potentially manipulative activity, while not unduly restricting capital formation or short sales. The provision provides that persons can purchase offered securities even if they sell short during the Rule 105 restricted period if they make a purchase equivalent in quantity to the amount of the restricted period short sale(s) prior to pricing. This provides an opportunity for a trader who had no knowledge of an offering at the time of his short sale to participate in the offering. Thus, a person who did not intend to short sell but sold short during an offering has an opportunity to participate in the offering, provided the person complies with the provision. The amendments also preserve a person’s ability to change his or her mind. For example, a person may initially decide not to participate in an offering, and in doing so, may sell short during the Rule 105 restricted period. If that person subsequently decides to participate in the offering after selling short during the Rule 105 restricted period, the bona fide purchase provision provides an opportunity to do so.

In order to take advantage of this exception, the rule requires there to be a bona fide purchase of the security that is the subject of the offering. While the determination as to whether a purchase is a bona fide purchase will depend on the facts and circumstances, we note that any transaction that, while made in technical compliance with the exception, is part of a plan or scheme to evade the Rule, for example, a transaction that does not include the economic elements of risk associated with a purchase for value, would not be bona fide for purposes of amended Rule 105.50

The purchase must be at least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale. Partial purchases are insufficient. This condition is designed to help ensure that the person is making a bona fide purchase rather than simply a purchase to evade Rule 105’s prohibitions. For example, the provision is not available if during a Rule 105 restricted period a person sells short 1,000 shares of common stock, subsequently purchases 500 shares of common stock prior to pricing, and then purchases 500 shares of common stock in the offering. The 500 share pre-pricing purchase is not equivalent in quantity to the entire amount of the Rule 105 restricted period short sale. Thus, the provision is unavailable. In that scenario, the person violated amended Rule 105 by short selling 1,000 shares during the Rule 105 restricted period and purchasing the offered security. The provision also requires that the person effect the bona fide purchase during regular trading hours 52 and that the bona fide purchase is reported pursuant to an effective transaction reporting plan.53 This is designed to ensure transparency of the activity to the market so that the effects of the purchase can be reflected in the security’s market price. Next, the bona fide purchase must be made after the last Rule 105 restricted period short sale and prior to pricing.54 Purchases made during the Rule 105 restricted period but before the last Rule 105 restricted period short sale do not qualify as a bona fide purchase for purposes of this provision. Requiring the bona fide purchase to be made after the last Rule 105 restricted period short sale facilitates the dissipation of downward pressure exerted by short selling and allows any downward pressure to be offset by upward price pressure exerted by the purchase. It also helps to ensure that the person effected additional short sales in advance of pricing would not necessarily cure any manipulative impact of the short sales if the covering purchases have no mitigating effect on an underwriter’s decision to lower an offering’s price.55

The provision is also available to those investors. It would not be available to underwriters after the close of regular trading on Tuesday and underwriters begin to contact potential investors to purchase the offering on Tuesday evening after pricing. The provision would still be available to that person if the person effected additional short sales on Thursday prior to making a bona fide purchase on Thursday. Thus, the bona fide purchase provision is available so long as the conditions specified in the amended rule are satisfied.

The condition that the bona fide purchase occur no later than the business day prior to the day of pricing...
gives the market an opportunity to consider and react to both the Rule 105 restricted period short sales and the bona fide purchase. It provides the market with an opportunity to consider a trading day uninfluenced by a person with a heightened incentive to manipulate.

In addition, a person relying on this provision may not effect a Rule 105 restricted period short sale within the 30 minutes before the close of regular trading hours on the business day prior to the day of pricing. This condition guards against potentially manipulative activity near the close of trading that can lower offering prices and, thereby, reduce an issuer’s offering proceeds, by influencing market price, including the following day’s opening price.

B. Separate Accounts and Investment Company Exceptions

In the proposing release, we asked whether the principles for independent trading unit aggregation that the Commission set out in Regulation SHO Rule 200(f) should be extended to non-broker-dealers, such as investment companies, and asked about appropriate criteria. Under Rule 200 of Regulation SHO and its predecessors, a person has to aggregate all of its positions to determine whether it is net long or short. The Commission, however, permits independent trading unit aggregation within the same broker-dealer under certain conditions.

In the Adopting Release for Regulation SHO, we noted that the conditions required for independent trading unit aggregation were adopted to limit the potential for trading rule violations through coordination among units and are designed to maintain the independence of the units. We believe the principles for independent trading unit aggregation should be used to address concerns expressed by commenters about the proposed rule. Specifically, commenters to the Rule 105 proposing release expressed concerns stemming from the Commission’s use of the term “person” in the proposal. The proposed rule would have prohibited any person from purchasing in an offering if they effect restricted period short sales. Although the former rule also used the word “person,” commenters stated that eliminating the covering element could, for funds with multiple independent accounts, “create difficulties for funds effecting transactions in securities that are the subject of offerings.”

Commenters expressed concern that the term “person,” for purposes of the proposed rule, might encompass each fund within a fund complex, each series of a fund, or each subadvised portion of a single fund. Commenters stated that, as a result, the proposed rule might prohibit one fund within a fund complex (or a series of a fund) from purchasing offered securities if another fund in the same complex (or another series of a fund) sold short within the Rule 105 restricted period even where those funds (or series of a fund) were trading independently. Commenters also stated that the proposal would trigger a Rule 105 violation if a sub-adviser to a portion of a fund purchased offered securities after another sub-adviser to a different portion of the same fund sold short during the restricted period even if those sub-advisers were not coordinating their trading. Thus, commenters stated that we should treat funds within a fund complex, different series of a fund, and separate subadvised portions of a fund as independent for purposes of Rule 105. Commenters also stated Regulation SHO’s concept of independent trading unit aggregation should be expanded to unregistered entities.

In light of our solicitation of comment on the questions whether the principles for independent trading unit aggregation should be extended, and under what criteria, and in response to comments received, we have determined to apply the principles to Rule 105 for separate accounts in circumstances where the decisions regarding securities transactions are made separately and without coordination of trading or cooperation.

1. Separate Accounts

We are adopting an exception that will permit a purchase of the offered security in an account of a person 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 the accounts. This exception incorporates the principles of Rule 200(f) of Regulation SHO that permit a registered broker or dealer to treat non-coordinating units separately.

Rule 105 is directed at persons who short sell into an offering because they have a high likelihood of receiving discounted offering shares. These persons have a special incentive to sell short and thus do not contribute to efficient pricing. Where an account that sells short is not the account that purchases shares in the offering, if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts even though the accounts may be affiliated or otherwise related, the incentive that motivates the Rule 105 violation is not present because the short seller cannot lock in a profit by purchasing the discounted offering shares. The exception is, therefore, narrowly tailored to address the abuses that Rule 105 is designed to prevent without triggering inadvertent violations by accounts that do not coordinate their trading activity.

Indicia of Separate Accounts. For purposes of this exception, accounts are separate and operating without coordination of trading or cooperation if:

1. The accounts have separate and distinct investment and trading strategies and objectives;
2. Personnel for each account do not coordinate trading among or between the accounts;
3. Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;
4. Each account maintains a separate profit and loss statement;

Amended Rule 105(b)(3).

For example, two sub-advised portions of the same registered investment company may be separate accounts.
(5) There is no allocation of securities between or among accounts; and

(6) Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decisions for the accounts.

Depending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception if the accounts are separate and operating without coordination of trading or cooperation. Policies and procedures reasonably designed to ensure that the above safeguards are fully implemented would be indications that accounts are separate, as would regular reviews to help ensure that such policies and procedures are up to date and fully implemented. For example, such reviews may include reviewing activities that are indicative of coordination between accounts and reviewing trading activity of a particular account that does not appear to be consistent with the stated strategy or objectives of such account.

We believe that accounts that have separate and distinct investment and trading strategies and personnel that are prohibited from coordinating trading between or among accounts would be considered to make separate decisions regarding securities transactions for purposes of Rule 105.64 These two factors are similar to the requirements of Regulation SHO Rule 200(f)(1) and (3). We believe that these factors are important indicators that accounts are separate for purposes of the exception. Thus, if trading is coordinated between accounts, the accounts will not be considered separate for purposes of this exception.

We believe that to meet the requirements of the exception there can be no communication of securities positions, investment decisions or other trading matters between accounts.65 Information barriers, similar to information barriers required for registered broker-dealers under Section 15(f) of the Securities Exchange Act of 1934 (“Exchange Act”), will also inhibit coordination and help maintain the separation of accounts. Information leakage, which can occur for various reasons such as close proximity of trading desks or because traders are unaware that they should not pass information between or among accounts, can give rise to either deliberate or inadvertent coordination of shorting into an offering. Similarly, the sharing of personnel with decision-making authority regarding trading activities in different accounts may lead to information leakage, whether deliberate or inadvertent, between or among accounts. Information barriers should include, at a minimum, appropriate physical barriers as well as training for all personnel.

In the case of an owner of multiple separate accounts, information barriers may not be necessary so long as the account owner is not influencing the trading decisions, i.e., the owner does not allocate securities between or among accounts; has no authority to execute trades in individual securities in the accounts; and has no authority to pre-approve trading decisions for the accounts.

Another indicator that accounts are separate is the maintenance of separate profit and loss statements for each account. While an entity may also want to ensure that accounts have separate legal identities and separate taxpayer identification numbers, we believe that maintaining separate profit and loss statements indicates that an account is operating separately from other accounts, and is being treated by current management as separate.

Another factor that indicates separateness is restricting personnel with management or oversight responsibilities over the entity from allocating securities between or among accounts. This factor is designed to ensure that when one account receives an offering allocation after the other account sells short, the offering allocation is not transferred to the account that sold short. Such a transfer would be contrary to the exception, which is that accounts be separate and free of coordination or cooperation among or between other accounts.

A further factor that indicates separateness is restricting a person with oversight or managerial responsibility over multiple separate accounts from having authority to execute trades in individual securities in the accounts or the authority to pre-approve trading decisions for the accounts and such person does not execute trades for the account and does not pre-approve trading decisions for the accounts. This is designed to ensure non-coordination by a single person with control over multiple accounts. Thus, such person

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64 See, e.g., Millennium letter; Schiff letter.
65 Commenters believed that information barriers were important to ensure separation of accounts. See, e.g., Millennium and Sullivan letters.
sub-advisers whose activities are subject to the supervision of a single, primary investment adviser. In such instances, each sub-advised portion of that fund or series may be able to rely on the exception in amended Rule 105(b)(2). In particular, if a sub-adviser to a registered fund, or a series of that fund, engages in a short sale of a security while another sub-adviser to the same fund or series goes long in that security through an offering enumerated in the rule, those decisions would be viewed as being made separately and without coordination of trading or cooperation among or between the sub-advised portions, provided that the sub-advisers met the elements of Rule 17a-10(a)(1)–(2) under the Investment Company Act of 1940 (“Investment Company Act”), and provided further that the fund’s, or series’, primary investment adviser does not execute trades in individual securities, and does not pre-approve trading decisions for the sub-advised portions.

We believe the exception provides a carefully honed response to the comments we received on this issue. The factors regarding separateness are provided to assist entities in determining whether they qualify for the exception. We note that these factors are not exhaustive, and persons otherwise may be able to rely on this exception. We understand that there may be other types of structures and entities that have safeguards and protections that fall within the exception. In addition, we will consider specific requests for exemptive relief on a case-by-case basis.

We will closely monitor whether use of the exception in any way undermines the purposes of Rule 105, and will consider whether further guidance or changes to the exception are appropriate. We note that an entity that does not comply with the exception may be in violation not only of Rule 105, but also the antifraud provisions. For instance, evidence of coordination, cooperation, or attempts to circumvent the rule or hide coordinated or cooperative activity could be evidence of fraud or manipulation for purposes of Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.

2. Investment Companies

In adopting Regulation SHO, we noted that the conditions required for independent trading unit aggregation were adopted to limit the potential for abuse associated with coordination among units and are designed to maintain the independence of the units. The fact that brokers and dealers are subject to the oversight of self-regulatory organizations and have compliance responsibilities with regard to supervisory procedures and books and records requirements provided additional assurances that the Commission’s concerns would be addressed.

Similarly, provisions of the Investment Company Act generally prohibit concerted action between funds in a complex and between different series of the same fund. Section 17(d) of the Investment Company Act and Rule 17d–1 thereunder prohibit an affiliated person of a registered investment company, and the affiliates of that affiliated person, acting as principal, from participating in any joint enterprise, or other joint enterprise or arrangement with their affiliated investment company. Funds in the same investment company complex will generally be affiliates of each other. An arrangement by which one fund sells a security short while another affiliated fund intentionally goes long to cover that position would generally be the type of joint arrangement that is prohibited by Section 17(d) and Rule 17d–1. 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.

Rule 105 is directed at persons who sell short into an offering because they have a high expectation of receiving discounted offering shares. These persons have a heightened incentive to sell short to affect the price of the offered securities that they intended to purchase in order to lock in a profit. However, if the account that sells short during the restricted period is prohibited from concerted action with the account that purchases in the offering, the ability to lock in a profit from selling short prior to pricing and purchasing the offered securities is not present.

Thus, in response to comments, we are including an exception in amended Rule 105 related to registered investment companies. Under this exception, an individual fund within a fund complex, or a series of a fund, will not be prohibited from purchasing the offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period.

By applying Regulation SHO’s aggregation unit concept in this manner, we believe we have addressed commenters’ concerns regarding the amended rule’s scope with respect to investment companies registered under the Investment Company Act and accomplished the goals of Rule 105, the prevention of manipulation and the facilitation of offering prices based on the natural forces of supply and demand.

C. Additional Amendments

The amendments modify paragraph (a) of the former rule in several other ways. First, the amendment refines the scope of the rule by restricting its application to offerings of “equity” securities for cash. The former rule was silent as to the rule’s application solely to “equity” securities. However, language in Rule 10b–5 in the predecessor to Rule 105, did limit application of the rule’s prohibitions to short sales of “equity securities of the same class as securities offered for cash” and the Commission, in adopting Rule 105, did not express its intent to alter the reach of the rule beyond equity securities. We received comment on the Proposing Release suggesting that including debt securities in the rule is unnecessary because debt securities are less susceptible to manipulation. According to commenters, this is because debt securities trade more on the basis of factors such as yield and credit rating and are priced on factors such as interest rates, and short sales of debt securities prior to pricing of a debt offering are not common. Although the amendments clarify the scope of the rule to apply only to “equity” securities, the Commission intends to continue to monitor whether trading patterns in debt securities raise manipulative concerns in connection with debt offerings. We also received comment on the Proposing Release suggesting that the proposal be modified to include an exception for actively-traded securities within the meaning of Rule 101(c)(1) of

70 Regulation SHO Adopting Release, 69 FR at 48011.
71 See, e.g., Steadman Security Corp., 46 S.E.C. 896, 920 n.81 (1977) (“the investment adviser almost always controls the fund. Only in the very rare case where the adviser’s role is simply that of advising others who may or may not elect to be guided by his advice * * * can the adviser realistically be deemed not in control.”).
Regulation M. However, many of the securities that were involved in the enforcement cases brought by the Commission alleging violations of former Rule 105 far exceeded the public float value in the Regulation M “actively-traded” threshold level (that is, having an average daily trading volume value of at least $1 million and a public float value of at least $150 million). Moreover, we believe that the bona fide purchase provision will address commenters’ concerns for additional flexibility for actively-traded securities without having to carve out an additional exception for such securities.

The amendments also encompass offerings made pursuant to Form 1–E, Notification under Regulation E. Regulation E exempts from registration under the Securities Act of 1933 ("Securities Act") 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. Regulation E was originally patterned after Regulation A under the Securities Act.

We have long recognized the danger posed by market participants using securities obtained pursuant to an offering under Regulation A to cover short positions. We asked the following question in the Proposing Release: Regulation E under the Securities Act provides certain small business investment companies and 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? We received no public comment arguing against including Regulation E in Rule 105’s purview, or articulating why offerings under Regulation E should not be subject to Rule 105.

In light of the important investor protections that Rule 105 provides, we have determined that it is prudent that offerings under Regulation A and Regulation E should be treated identically under Rule 105. We are concerned that short selling of securities issued pursuant to Regulation E during a Rule 105 restricted period raises the same manipulative concerns to which Rule 105 is directed, and which are present with offerings made pursuant to Regulation A. Subjecting offerings made pursuant to Regulation E to the provisions of Rule 105 is designed to ensure that participants in the secondary market for the securities of small business investment companies and business development companies will enjoy the same protections afforded to participants in the secondary market for the securities of similarly placed non-investment companies. Including offerings made pursuant to Form 1–E will place small business investment companies and business development companies on an equal footing with small issuers that utilize Regulation A. Consequently, we have amended Rule 105 to encompass offerings made on Form 1–E.

We have also amended the language of Rule 105(a) to include the term “subject security” and harmonize it with language used in other Regulation M rules. The amended rule states that it is unlawful for any person to sell short the security that is the “subject” of the offering and purchase offered securities. The term “subject” security is included in Regulation M Rule 100’s definition of covered security. Rule 100 defines a covered security as “any security that is the subject of the distribution, or any reference security.” While amended and former Rule 105 apply to offerings of securities rather than to distributions, the “subject” security language is consistent with Regulation M and, in response to commenters concerns, clarifies that the amended rule does not apply to reference securities. Therefore, in an offering of securities convertible into common equity, even though the convertible securities are themselves equity securities, a person may still sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105. Convertible offerings appear to be priced on many factors in addition to the underlying equity’s price, such as credit rating, which may make convertible offerings less susceptible to manipulation through pre-pricing short sales. However, the Commission will continue to monitor the convertible offerings market and may re-evaluate these offerings.

In response to commenters’ concerns, amended paragraph (a) retains the language of the former rule that the purchase of the offered security is made “from an underwriter or broker or dealer participating in the offering.” Although we stated in the Proposing Release that the language “from an underwriter or broker or dealer participating in the offering” was unnecessary because Rule 105 covers shelf offerings now, three of the commenters stated their belief that retaining this language is necessary in order not to extend the scope of the rule to unnecessarily preclude a broker or dealer from participating in an offering as a distribution participant, and purchasing the offering securities from the issuer as part of the distribution process, in situations where a unit within the same broker-dealer firm may have effected a Rule 105 restricted period short sale. Thus, a broker or dealer is not precluded from participating in an offering as a distribution participant and may purchase the offering securities from an issuer as part of the distribution process if a unit within the same firm effected a short sale(s) during the Rule 105 restricted period.

Amended paragraph (a) also retains the “purchase” language of the former rule. The Proposing Release used the language “purchase, including enter into a contract of sale for, the security in the offering.” We have determined that it is not necessary to include the additional language regarding “enter into a contract of sale” because a purchase or sale under the Securities Act includes any contract of sale. Thus, for purposes of amended Rule 105, the purchase occurs at the time the investor becomes committed by agreement or is committed to buy the

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87 While, for purposes of Regulation M, the underlying common equity is not the subject of the convertible securities distribution, sellers should be aware that the registration provisions of the Securities Act of 1933 may still apply to both the convertible security and the underlying equity security at the time of the offering.

88 See SIFMA, Davis, MFA letters.
offered security, whether such agreement is oral or written.\footnote{See Securities Offering Reform at n.391 (referring to Securities Act Section 2(a)(3) and noting, in relevant part, that, “Courts have held consistently that the date of a sale is the date of contractual commitment, not the date that a confirmation is sent or received or payment is made. See, e.g., Radiation Dynamics, Inc. v. Goldman, 464 F.2d 876, 891 [2d Cir. 1972] [holding that a purchase occurs at “the time when the parties to the transaction are committed to one another”]; in re Alliance Pharmaceutical Corp., Secs. Lit., 279 F. Supp. 2d 171, 186–187 (S.D.N.Y. 2003) (following the holding in Radiation Dynamics with respect to the timing of a contract of sale); Puhmer v. Greenberg, 926 F. Supp. 287 (citing Finkel v. Stratton Corp., 962 F.2d 169, 173 [2d Cir. 1992] [“A sale occurs for Section 12(a)(2) purposes when the parties to the transaction are committed to one another”])); Adams v. Covanaugh Communities Corp., 847 F. Supp. 1390, 1402 (N.D. Ill. 1994) (noting that the Seventh Circuit has followed the Radiation Dynamics decision.”)}

The amendments to Rule 105 are targeted and narrow, and thus do not restrict short sales beyond what the Commission believes is necessary to address recent non-compliance and strategies to conceal the prohibited covering of the former rule. While some commenters suggested shortening the rule’s restricted period to incorporate the concept of public announcement of an offering,\footnote{See, e.g., Morgan letter.} we believe that there is a risk that an investor could learn about a potential shelf offering before it is publicly announced and would still be permitted to sell short even with the knowledge of an upcoming offering.\footnote{Proposing Release, 71 FR at 75005.} In addition, the amendments will help promote the process of capital formation. Moreover, in response to commenters, the absolute ban on purchasing offered securities in the Proposing Release has been refined to address many of the commenters’ concerns, while still advancing the goals of the Rule.

The amended rule does not ban short sales. Traders can sell short during a Rule 105 restricted period if they choose not to purchase offered securities. Traders can sell short prior to the restricted period and receive an offering allocation. Compliance with the bona fide purchase provision also allows traders to sell short during the Rule 105 restricted period and receive an allocation. The bona fide purchase provision is designed to promote capital formation while the conditions for the provision are designed to reduce artificial influences on pricing. As such, the bona fide purchase provision advances the Commission’s investor and market protection goals. At the same time, the provision addresses commenters’ concerns regarding not having to make investment decisions before the offering price is determined, allowing issuers and underwriters to price offerings with “market counterbalance,” and not reducing the number of buyers for certain offerings.\footnote{See, e.g., Fairfax letters, supra note 29.} Additionally, while several commenters suggested that a better approach for the Commission would be to simply provide additional interpretive guidance to the investment community as to what constitutes “covering” for purposes of former Rule 105, we believe that the amendments provide a bright line demarcation of prohibited activity that is consistent with the prophylactic nature of Regulation M and that will likely better deter non-compliance with Rule 105. Thus, the amendments provide additional guidance to the investment community in terms of compliance with Rule 105, but while still addressing potentially manipulative activity in a manner that may more effectively bolster issuer and investor confidence in the offering process and thus encourage capital formation.

### III. Derivatives

In the Proposing Release, we stated our understanding that persons may use options or other derivatives in ways that may cause the harm that Rule 105 is designed to prevent and requested comment on trading strategies involving derivatives that may depress market prices and result in lower offering prices to issuers in ways not covered by then current Rule 105 or the proposal.\footnote{Id.} The Commission requested specific detail about particular derivatives used, transactions, and the role of the parties involved in the transactions. Commenters did address the issue of derivatives but only to a limited extent.\footnote{Id.} For example, one commenter requested that the Commission specify which short sales of, and equivalent transactions in, derivative securities from Rule 105.\footnote{Id.} This commenter noted that Commission guidance about the applicability of the general anti-manipulation rules has not been effective in preventing short sellers intent on manipulating an issuer’s securities from using various synthetic shorts, married puts and sham transactions to accomplish indirectly what Rule 105 prohibits directly.\footnote{See, e.g., Morgan letter.} Similarly, another commenter also noted that derivatives strategies, including married puts and sham swap transactions, have been utilized to avoid the prohibitions of Rule 105 and that new creative strategies that involve other derivatives which fall outside these parameters are likely in the future.\footnote{NYSE letter.} One commenter stated its belief that applying Rule 105 to transactions in derivatives “would be another significant departure from the Commission’s philosophy underlying Regulation M and the covering of derivatives in its prophylactic rules.”\footnote{MFA letter.} Another commenter stated its belief that “derivatives” is a term that is both too broad and too vague to properly be addressed as one all-encompassing entity under a rule.\footnote{Morgan letter (noting also that the Commission had previously seen the linkages between prices in these markets and the primary market as too attenuated to be a direct influence and too attenuated to permit effective manipulation of the primary market and that, because of the large number of different types of derivatives and the attenuated price relationship among the derivatives and the underlying stock, a blanket application to derivatives would result in unnecessary and complicated regulation).}

In view of above-referenced comments, the Commission will continue to monitor the use of derivative strategies that may replicate the economic effect of the activity that Rule 105 is designed to prevent. Among the issues we will monitor and evaluate further is whether the link between the derivatives trading and the underlying equities is sufficiently attenuated as not to warrant additional regulation. In addition, we will consider the extent to which alternative regulatory strategies are a functional substitute for the equity trading covered by the rule. We also note that any transaction or series of transactions remain subject to the anti-fraud and anti-manipulation provisions of the securities laws even if they do not implicate Rule 105.

### IV. Paperwork Reduction Act

There is no collection of information requirement within the meaning of the Paperwork Reduction Act for Rule 105.

### V. Cost-Benefit Analysis

We are sensitive to the costs and benefits of Rule 105 and we have considered the costs and benefits of the adopting amendments. To assist us in evaluating the costs and benefits, in the Proposing Release, we encouraged commenters to discuss any costs or benefits associated with the proposal. Commenters were requested to provide analysis and data to support their views on the costs and benefits associated with the proposal. Commenters were encouraged to discuss any additional
costs or benefits or reductions in costs in addition to those discussed in the Proposing Release. The Commission requested comment on potential costs for modification to any computer systems and any surveillance mechanisms as well as any potential benefits resulting from the proposal for issuers, investors, broker or dealers, other securities industry professional, regulators, or other market participants. No comment letters provided estimates of specific costs.

A. Adopted Amendments to Rule 105 of Regulation M

In general, former Rule 105 prohibited persons who sold short prior to pricing certain offerings during a defined restricted period from covering such short sales with offering securities. The prohibited activity was the covering. Under the amendments, the prohibited activity is now purchasing in the offering. As amended, Rule 105 of Regulation M makes it unlawful in connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form 1–A ($239.90) or Form 1–E ($239.200) filed under the Securities Act ("offered securities"), for any person to sell short the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period that is the shorter of the period beginning five business days before the pricing of the offered securities and ending with such pricing or beginning with the initial filing of such registration statement or notification on Form 1–A or Form 1–E and ending with the pricing. The amendments provide, however, that it shall not be unlawful for such person to purchase the offered securities if such person makes a bona fide purchase(s) 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 sales. The purchase must be effected during regular trading hours, reported to an effective transaction reporting plan, and effected after the last Rule 105 restricted period short sale, prior to pricing and no later than the business day prior to the day of pricing. In order to rely on the bona fide purchase provision, a person may not effect a short sale, which is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing.

In addition, the amendments provide exceptions for separate accounts and investment companies. Accordingly, 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. Further, the amendments include an exception for investment companies registered under Section 8 of the Investment Company Act that allow such an investment company to participate in an offering if an affiliated investment company or any series of such company sold short during the restricted period.

The goal of Rule 105 is to promote offering prices that are based upon market prices determined by supply and demand rather than artificial forces. The rule is prophylactic and prohibits the conduct irrespective of the short seller’s intent. The amended rule eliminates the covering requirement of the former rule because there had been non-compliance with the former rule coupled with persons effecting strategies to hide the prohibited covering.

B. Benefits

The amendments are intended to end the proliferation of strategies designed to hide covering restricted period short sales with offered securities. The amendments seek to fulfill this objective by eliminating the covering requirement. Putting an end to activity designed to conceal covering with offered securities but replicate the same economic outcome is expected to better deter those attempting to place artificial downward pressure on market prices, which can lower offering prices and thereby reduce an issuer’s offering proceeds. The amendments are expected to benefit issuers because they likely will receive offering proceeds that are not lower than anticipated due to short sales prior to pricing by persons who would cover such short sales with offering securities and then attempt to conceal the prohibited covering. Academic research shows that prices decline by 1–3% on average during the five days before pricing for follow-on offerings under the current restrictions. See, e.g., Shane A. Corwin, The Determinants of Underpricing for Seasoned Equity Offers, 58 J. Fin 2249 (Oct. 2003). Although the study does not purport to explain why this happened, it is worth noting that the study found that prices did in fact decline during the five-day restricted period prior to the pricing of the offering. Various reasons for this price decline have been posited in the literature of which short selling is only one possible explanation.

Fairfax Financial indicated that the academic literature underestimates the effect of short selling during the Rule 105 restricted period and provided an example of an offering with a larger price decline. No commenters provided arguments suggesting that this price decline is due to factors other than non-compliance with former Rule 105. The amendments will work to safeguard the integrity of the capital raising process by promoting offering prices based on the independent forces of supply and demand rather than artificial prices due to potentially manipulative short sales prior to pricing. This may boost investor confidence that investment decisions can be based on market prices and offering prices that are unencumbered by artificial forces, and thus may facilitate capital formation.

Prohibiting purchasing in the offering when one has sold short during the restricted period provides a bright line demarcation of prohibited activity consistent with the nature of Regulation M. The amended rule likely will better deter non-compliance with Rule 105 because it may be more difficult to conceal an offering purchase than to conceal covering. The amendments also benefit traders who want to comply with Regulation M by providing a bright line delineation of unlawful conduct. This bright line demarcation of prohibited conduct is also a benefit to regulators surveilling for and investigating potential Rule 105 violations.

The amendments clarify the pool of securities offerings to which Rule 105 applies. Application of the rule is limited to offerings of “equity” securities. This precise language benefits persons determining whether or not the rule is applicable in a particular situation. The amended rule also harmonizes its language with other rules of Regulation M by using the term “subject” security. The amendments also benefit traders by making it clear that the rule does not apply to reference securities so that, in a convertible offering, a trader can sell short the underlying common equity and purchase the convertible security in the offering without violating Rule 105.

The new provisions concerning bona fide purchases, separate accounts, and investment companies benefit issuers because they narrowly tailor the rule to address a specific abuse in a manner consistent with the goals of Rule 105 without unnecessarily shrinking the potential universe of offering investors. The bona fide purchase provision also benefits issuers because it requires that the bona fide purchase must occur no
later than the business day prior to the
day of pricing. This benefits issuers
because it provides an opportunity for
market reaction to the purchase prior to
pricing the offering.

The bona fide purchase provision also
benefits short sellers because they are
effective to affect certain short sales without
being precluded from making an
offering purchase where we believe the
price impact of the purchase offsets the
price impact of the short sales. The
separate account exception benefits
short sellers who will not have to
restrict their short sales because of the
possibility of a separate but related
account purchasing offered securities.
Similarly, the investment company
exception benefits investment
companies who sell short because they
will not have to restrict their short sales
do to the possibility of an affiliated
investment company or any series of
such company purchasing offered
securities. The separate account and
investment company provisions also
benefit potential investors who may
want to purchase offered securities. These
potential investors will not be
precluded from doing so because of
restricted period short sales in a
separate account or affiliated investment
compny.

The amendments do not ban short
sales. Rather, the amendments maintain
much of the prior rule’s flexibility for
effecting short sales such as allowing
traders to sell short prior to the
restricted period and receive an
allocation, and to sell short during the
restricted period if they do not
participate in an offering. Persons can
also sell short during the restricted
period and participate in the offering if
they make a bona fide purchase. The
amendments benefit the securities
market generally because they allow for
short sales that may contribute to
pricing efficiency and price discovery.

The amendments also benefit issuers
by expanding the rule’s scope to cover
offerings made pursuant to Form 1–E.
Issuers making such offerings should be
less likely to receive reduced offering
proceeds due to short sales effected
immediately before pricing an offering.
Subjecting offerings made pursuant to
Regulation E to the provisions of Rule
105 will help to ensure that participants
in the secondary market for the
securities of small business investment
companies and business development
companies will enjoy the same
protections afforded to participants in the
secondary market for the securities of
similarly placed non-investment
companies. Including offerings made pursuant to Form 1–E
will place small business investment
companies and business development
companies on an equal footing with
small issuers that utilize Regulation A.

By putting an end to activity designed to
conceal covering with offered
securities but in a manner designed to
replicate the same economic outcome,
the amendments are expected to lead to
a reduction in short sales in violation of
Rule 105 that place artificial downward
pressure on market prices, which can
lower offering prices and thereby reduce
an issuer’s offering proceeds. Therefore,
the amendments will likely strengthen
the ability of underwriters to set offering
prices based on independent supply and
demand without being encumbered by
artifical activity in the market.

C. Costs

We recognize that the amendments to
Rule 105 may result in some costs to
certain market participants. Under the
former rule, persons that effected
restricted period short sales were
prohibited from covering such short
sales with offering securities. Thus,
persons were required to have systems
and surveillance mechanisms for
information gathering, management and
recordkeeping systems or procedures in
order to comply with the former rule.
For that reason, persons are not
expected to incur costs for having to
develop new surveillance mechanisms.
Any existing mechanisms may need to
be modified but we do not anticipate
that any costs associated with such
modification will be significant. We
note, however, that one commentator
stated that in order to comply with the
proposed amendments, a large trading
organization would need to implement
significant changes to its trading
infrastructure to identify and track
offerings subject to Rule 105. However,
while there are some differences in what
persons will have to track under the
amended Rule, including potential
added costs associated with the bona
fide purchase provision, persons needed
to identify and track offerings subject to
the former rule, and thus, such costs
were likely already incurred when the
rule was first adopted and, therefore,
any additional costs are likely to be
minimal.

The adopting amendments provide
that a person who sells short during the
restricted period cannot purchase in the
offering. We believe that this bright line
demarcation of prohibited conduct may
perhaps even be easier to surveil and
comply with, and which may lead to
reduced costs. Further, we believe that
this bright line demarcation of
prohibited conduct may also lead to a
reduction in costs given the anticipated
reduction in schemes that may currently
be in place to conceal covering.

We anticipate that some entities may
incur costs associated with educating
traders regarding the adopted
amendments and updating compliance
manuals. We do not anticipate that such
costs will be significant.

We do not anticipate that registered
investment companies will incur
significant costs associated with the
amendments. Many registered
investment companies do not effect
short sale strategies. In addition, the
separate account exception may be used
by sub-advisers to the same investment
company. If the sub-advisers’ accounts
are separate, one sub-adviser can
purchase the offered securities if
another sub-adviser sold short during
the Rule 105 restricted period. Further,
the investment company exception can
be used by an individual fund within
the same complex or a series of a fund
so that one fund or series can purchase
an offered security if another fund
within the same complex or a series of
the fund sold short during the
Rule 105 restricted period. Accordingly,
sub-advisers and investment companies
relying on these exceptions will not
incur costs from altering their trading.

There may be some costs to short
sellers relying on the bona fide purchase
provision as they will need to make a
market purchase in order to participate
in the offering. Moreover, under the
amendments, restricted period short
sellers relying on the bona fide purchase
provision must make a purchase prior to
pricing, but the purchase must occur no
later than the business day prior to the
day of pricing. In rare circumstances,
there also may be costs to a person who
sells short near the 30 minutes prior to
close of regular trading hours on the
business day prior to the day of pricing
and is then approached to participate in
an offering. That person may incur some
costs in making the market purchase in
order to participate in the offering as
well as some costs in determining the
exact time of the short sale. We expect
any such cost will be minimal.

We anticipate that many persons will
be able to rely on the separate account
exception based on their current
structures. For example, the exception
would be available to an individual
investor who invests capital in two or
more accounts, grants full discretionary
trading to the respective managers of
each account, does not coordinate
trading between the accounts or make
investment decisions for the accounts
and has managers that do not coordinate
trading. We expect the restrictions on
individual investors with multiple accounts
currently have such a structure in place.
and would not incur costs to comply with this exception. By way of another example, a pension fund that provides capital to two or more advisers may currently fall within the exception and would not incur costs in order to comply with the separate account exception.

We do not anticipate significant costs to be incurred by persons relying on the investment company exception. This exception allows certain investment companies to participate in an offering if an affiliated investment company or any series of such company sold short during the restricted period. We expect that the investment companies at which the exception is directed currently have structures in place that will allow them to take advantage of the exception and thus should not incur significant costs, if any, in relying on the exception.

There may be persons who are unable to rely on the investment company or separate account exceptions. We note that such persons are not required to use the exceptions and thus there is no cost associated with the exception that a person would incur. Rather than rely on these exceptions, such persons may instead choose not to purchase an offered security, refrain from selling short during the restricted period if they choose to purchase the offered security, or use the bona fide purchase exception. A person may however, choose to voluntarily adjust their structures so as to be able to use the investment company or separate account exceptions and may incur costs in doing so.

There may be costs to a person that is unable to rely on the new exceptions and chooses to seek to obtain exemptive relief from the Commission. However, we anticipate the three new exceptions will be used by many persons and accordingly should reduce the need for exemptive relief. Therefore, we do not anticipate numerous requests for exemptive relief. In addition, persons can tailor their trading so as to not run afoul of the rule and eliminate the need for exemptive relief.

In response to the Proposing Release, one commenter noted potential costs associated with the possibility of the proposals impairing trading strategies of hedge funds and other active traders, with likely negative consequences for capital raising. Another commenter noted that the proposals will have an adverse impact on capital raising through secondary offerings and impose greater costs to issuers by: forcing investors to make an investment decision at an earlier point in time before an offering price is determined; allowing issuers and underwriters to price offerings without market counterbalance; and reducing the number of buyers for secondary offerings. However, we believe that modifying the proposal to include the bona fide purchase provision will address commenters’ concerns about the potential negative consequences or impact on capital raising, including concerns about a decrease in the number of potential buyers in an offering and increased costs to issuers. The provision also allows potential buyers to decide to invest at a time much closer to the pricing of an offering than as originally proposed. We do not expect the amendments to result in a major increase in costs. We expect that the amendments likely will curtail the potential for manipulative activity that can reduce offering proceeds. The change will provide a protective measure against abusive conduct that hampers the capital raising process and negatively impacts issuers.

We believe that the proposed amendments will have a positive impact on capital raising. The amendments are expected to promote capital formation through enhanced investor confidence in the integrity of the U.S. securities market because the amendments prohibit conduct that can manipulate market prices and could result in lower offering prices. Capital formation may also be facilitated because issuers may be more likely to offer securities for sale in the U.S. securities market because there are rules in place to deter potentially manipulative conduct that effects offering prices. The bona fide purchase provision will likely contribute to capital formation by helping to ensure that the universe of potential offering investors is not unduly limited.

The amendments also promote pricing efficiency. Short sales contributing to price discovery and efficiency can occur at any time under Rule 105 if a person chooses not to purchase in an offering. Persons can sell short prior to the restricted period and purchase offering securities. In addition, the bona fide purchase provision retains an opportunity for persons to sell short during the Rule 105 restricted period and still participate in certain offerings. The amendments are expected to lessen the incentive to engage in trading activity that could lead to a loss in pricing efficiency prior to when an offering is priced because it is now more

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100 See MFA letter.
101 See Morgan letter.
105 See SIFMA letter.
106 See id.
107 Academic research shows that prices decline during the five days before pricing for follow-on offerings under the current restrictions. See supra note 99. See also Fairfax letter.
difficult to obscure the prohibited activity of making an offering purchase. The amendments are not expected to impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. An individual fund within a fund complex, or a series of a fund, may rely on the investment company exception if the conditions of the exception are met. A separately subordinated portion of a fund may rely on the separate account exception if the conditions of the exception are satisfied. Because of the broad diversity of other fund structures, we will consider individual requests on a case-by-case basis.

The Commission believes that the amendments are in the public interest because of the strategies designed to hide the offering prohibited by former Rule 105 and the resulting artificial downward pressure placed on market prices, which can lower offering prices and thereby reduce an issuer’s offering proceeds.

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. An Initial Regulatory Flexibility Analysis (“IRFA”) was prepared in accordance with the Regulatory Flexibility Act in conjunction with the Proposing Release. The Proposing Release included, and solicited comment on, the IRFA.

A. Need for the Amendments

There has been non-compliance with former Rule 105 and persons engaging in strategies to hide that non-compliance. In particular, persons engineered strategies to conceal the prohibited covering. We have observed that these strategies evolved over time. The Commission is adopting these amendments to forestall the continuation of these obfuscating transactions and protect the integrity of the U.S. capital raising process. We believe the amendments are necessary to cut off the likely future development of more complex attempts to disguise violations of the Rule.

B. Objectives of the Amendments

The amendments are designed to facilitate offering prices determined by independent market forces. The amendments enhance market integrity by prohibiting conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by an independent market. The amendments are designed to promote offering prices that are determined by the natural forces of supply and demand. We believe the amendments safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce offering proceeds. The amendments are expected to promote investor confidence in the market which should foster capital formation.

C. Significant Issues Raised by Public Comments

The IRFA appeared in the Proposing Release. We requested comment on the IRFA 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 and how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments.”

We received one comment letter that discussed the IRFA.

D. Small Entities Subject to the Rule

The amendments apply to persons that effect short sales during the restricted period. For purposes of amended Rule 105, the term “person” is unchanged from the former rule. The persons covered by the amendments include small entities. Generally, these entities were already subject to former Rule 105 and were likely to have been monitoring restricted period short sales. For that reason, we do not anticipate that there will be any significant additional costs associated with compliance with the amendments for these businesses. Although it is impossible to quantify every type of small entity that may sell short during a Rule 105 restricted period, we do not anticipate that the personal selling efforts of small entities will exceed the personal selling efforts of large entities.

The amendments are not expected to impose a significant burden on any affected party, including broker-dealers that are small entities. Under the amendments, persons covered by the rule who sell short during the restricted period cannot purchase securities in the offering. While compliance is required to ensure the prohibition is not violated, there are no new recordkeeping or reporting obligations.

Any business, however, regardless of industry, will be subject to Rule 105 if they sell short during the applicable restricted period. The Commission believes that, except for the broker-dealers discussed above, especially in the absence of commenters addressing the issue, an estimate of the number of small entities that fall under the amendments is not feasible.

As with the former rule, the amended rule does not distinguish offerings by whether an issuer is small or large. Its provisions apply equally to any offering that falls within the rule’s conditions regardless of the size of the issuer.

E. Projected Reporting, Recordkeeping and Other Compliance Requirements

The amendments may impose limited new compliance requirements on any affected party, including broker-dealers that are small entities. Under the amendments, persons covered by the rule who sell short during the restricted period cannot purchase securities in the offering. While compliance is required to ensure the prohibition is not violated, there are no new recordkeeping or reporting obligations.

The amendments do not modify the measurement of restricted periods that apply. Therefore, since the former rule also addresses conduct around short selling that occurs during a Rule 105 restricted period, the monitoring that is required of market participants to ensure compliance with the amended rule will not change.

We note that the compliance with the amended rule is expected to be simpler than compliance with the former rule, which prohibited covering. Monitoring for an offering purchase, notwithstanding any additional monitoring that may be needed to help ensure compliance with the bona fide purchase provision, is simpler than monitoring for covering because it is so easily identifiable. As with the former rule, responsibility for compliance with the amendments rests with the person that sells short during the Rule 105 restricted period. The amendments are focused on eliminating schemes to disguise the covering prohibited by the

\[106\] See Proposing Release Section X, 71 FR at 75005.

\[109\] Proposing Release, 71 FR at 75010.

\[110\] See letter from Cleary (disagreeing with the statement that there are no duplicative rules). However, we note that the amendments do not replace, but are designed to work in conjunction with other provisions under the federal securities laws, such as Exchange Act Section 10(b) and Rule 10b–5 and Securities Act Section 5.

\[111\] 17 CFR 240.10b–5(c)(1).

\[112\] These numbers are based on the Office of Economic Analysis’ review of 2006 FOCUS Report filings reflecting registered broker dealers. The number does not include broker-dealers that are delinquent on FOCUS Report filings.
former rule and are not intended to change compliance responsibilities.

There are no new reporting or recordkeeping requirements in the amended rule. The amendments do not contain recordkeeping or reporting requirements for broker-dealers or any recordkeeping or reporting requirements unique to small entities.

F. Agency Action To Minimize Effect on Small Entities

We have considered various alternatives to accomplish our objectives which minimize any significant adverse impact on small entities and other entities. While we proposed a stricter rule, we modified the proposal to include a limited bona fide purchase provision in response to commenters’ concerns. We believe that the amendments are narrowly tailored to address particular conduct, hiding the covering prohibited by the former rule. The amendments apply restrictions where they are most needed and ease the proposed amendments, in light of comments, where the risk of potentially manipulative activity is not as great. The amendments are not expected to adversely affect small entities because they do not impose any new recordkeeping, or reporting requirements.

VIII. Statutory Basis and Text of Amendments

Pursuant to sections 7, 17(a), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), and 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 Exchange Act [15 U.S.C. 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78q(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37].

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 amended as follows:

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITIES 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, 78m, 78n, 78o(b), 78o(c), 78q(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:

(a) Adding new paragraph (b).

(b) Redesignating paragraphs (b) and (c) as paragraphs (c) and (d); and

(c) Adding new paragraph (e).

The revision and addition reads as follows:

§242.105 Short selling in connection with a public offering.

(a) Unlawful Activity. In connection with an offering of equity securities for cash pursuant to a registration statement or a notification on Form F–1 (§239.90 of this chapter) or Form 1–E (§239.200 of this chapter) filed under the Securities Act of 1933 (“offered securities”), it shall be unlawful for any person to sell short (as defined in §239.200(a)) the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period (“Rule 105 restricted period”) that is the shorter of the period:

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

(2) Beginning with the initial filing of such registration statement or notification on Form F–1 or Form 1–E and ending with the pricing.

(b) Exempted Activity—(1) Bona Fide Purchase. It shall not be prohibited for such person to purchase the offered securities as provided in paragraph (a) of this section if:

(i) Such person makes a bona fide purchase(s) of the security that is the subject of the offering that is:

(A) At least equivalent in quantity to the entire amount of the Rule 105 restricted period short sale(s);

(B) Effected during regular trading hours;

(C) Reported to an “effective transaction reporting plan” (as defined in §242.600(b)(22)); and

(D) Effected after the last Rule 105 restricted period short sale, and no later than the business day prior to the day of pricing; and

(ii) Such person did not effect a short sale, that is reported to an effective transaction reporting plan, within the 30 minutes prior to the close of regular trading hours (as defined in §242.600(b)(64)) on the business day prior to the day of pricing.

(2) Separate Accounts. Paragraph (a) of this section shall not prohibit the purchase of the offered security in an account of a person 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 the accounts.

(3) Investment Companies. Paragraph (a) of this section shall not prohibit an investment company (as defined by Section 3 of the Investment Company Act) that is registered under Section 8 of the Investment Company Act, or a series of such company (investment company) from purchasing an offered security where any of the following sold the offered security short during the Rule 105 restricted period:

(i) An affiliated investment company, or any series of such a company; or

(ii) A separate series of the investment company.

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By the Commission.

Nancy M. Morris,
Secretary.

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