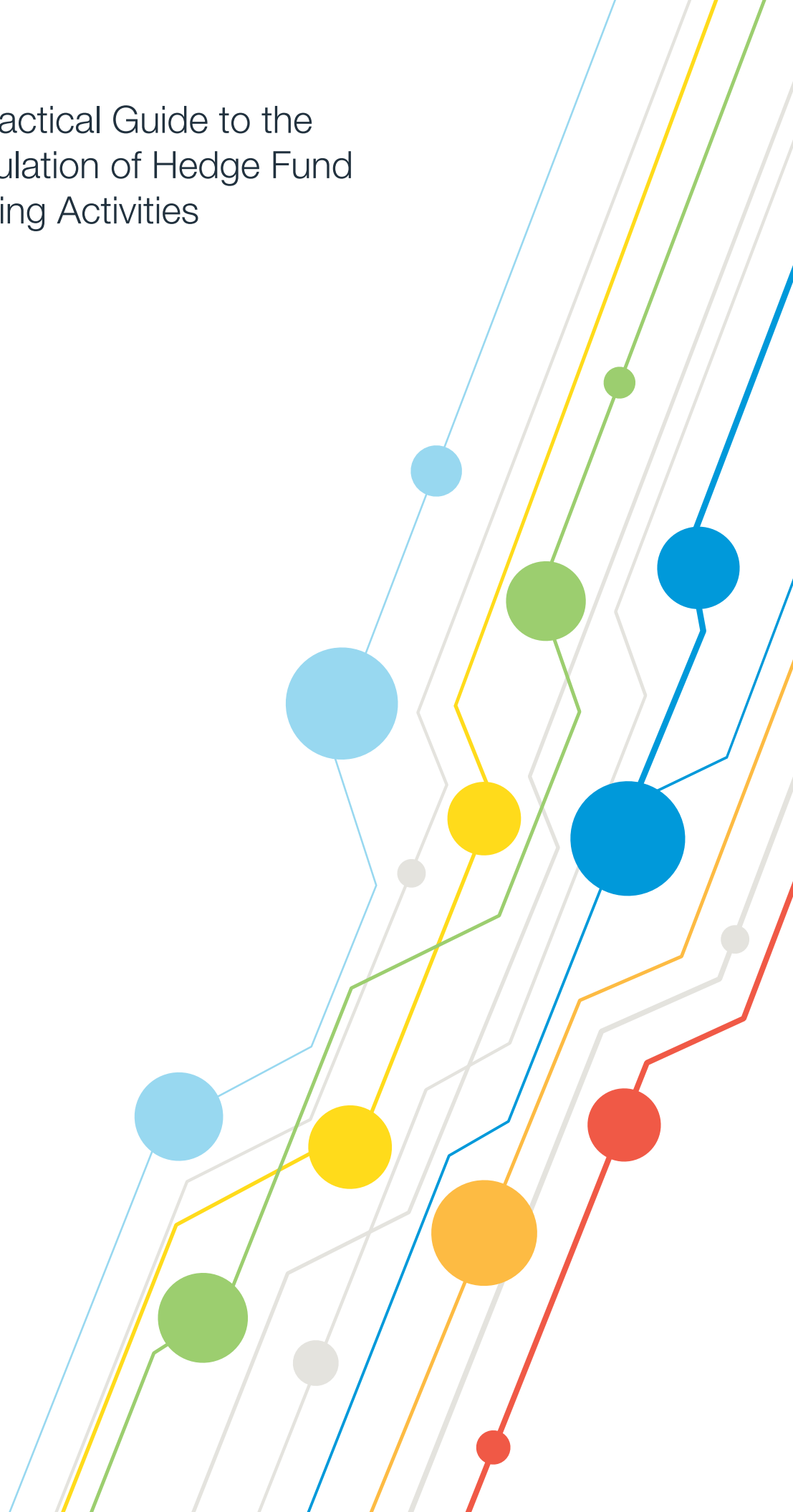
Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities



Team contacts

Robert G. Leonard
Partner
+1.212.969.3355
rleonard@proskauer.com

Christopher M. Wells
Partner
+1.212.969.3600
cwells@proskauer.com

Michael F. Mavrides
Partner
+1.212.969.3670
mmavrides@proskauer.com

Frank Zarb
Partner
+1.202.416.5870
fzarb@proskauer.com

Samuel J. Waldon
Partner
+1.202.416.6858
swaldon@proskauer.com

Edward A. Kwalwasser
Senior Counsel
+1.212.969.3515
ekwalwasser@proskauer.com

Executive Summary

The trading activities of hedge funds raise a number of complex issues under the federal securities laws. Proskauer's **Practical Guide to the Regulation of Hedge Fund Trading Activities** offers a concise, easy-to-read overview of the trading issues and questions we commonly encounter when advising hedge funds and their managers. It is written not only for lawyers, but also for investment professionals, support staff and others interested in gaining a quick understanding of the recurring trading issues we tackle for clients, along with the solutions and analyses we have developed over our decades-long representation of hedge funds and their managers.

The Guide will be published in installments (with previews of future installments) so that our readers may focus on each chapter, ask questions and provide any comments.

Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 5: Rule 105 of Regulation M and Tender Offer Rules

Authors: Frank Zarb, Ed Kwalwasser, Sam Waldon

Chapter 5: Rule 105 of Regulation M and Tender Offer Rules

Rule 105 of Regulation M may create more anxiety among compliance professionals in the hedge fund industry than any other SEC rule. It is a "strict liability" regime, meaning that you can be found in violation even if the infraction was an innocent error resulting in little profit. The SEC has historically brought actions based on such errors, and it has methodically brought a series of new actions every couple of years. This article explains the law of Rule 105, and includes some illustrative examples. It summarizes some of the past enforcement activity, and makes some predictions about the SEC's current approach.

Although unrelated to Regulation M, this article ends with a side note on the federal tender offer rules. We do not mean the "large set" tender offer rules under Section 14(d) of the Exchange Act, which apply to a tender for the shares of publicly-listed securities. Rather, we address the "small set" of rules under Section 14(e), which apply to tenders for private company equity. It is these rules that (sometimes rather unpredictably) become relevant to hedge fund transactions.

What ties these two substantively unrelated sets of rules together? Both are notorious for funds unwittingly drifting into technical violations, and both are practice areas where the SEC has been known to proceed based on unintentional, technical violations.

How Does Rule 105 of Regulation M Work?

The SEC adopted Rule 105 to prevent manipulation in the pricing of a firm commitment registered public offering of equity securities. The concern is that short selling just prior to pricing could artificially depress the offering price. Thus, the rule focuses on restricting short selling during a "restricted period" in advance of pricing. More specifically, the rule only applies under the following circumstances:

1. There is a registered offering of securities for cash, meaning a registration statement was filed with the SEC, and the offering was undertaken on a firm commitment basis, so the underwriter is obligated to purchase the entire offering from the issuer;
2. The hedge fund intends to purchase shares from the underwriter or other offering participant; and
3. The hedge fund wishes to engage in a "short sale" in the "restricted period" immediately prior to the pricing of the registered offering.

In order to fully understand when Rule 105 applies, it is necessary to understand in more detail the meaning, in this context, of "securities," "short sale," and "restricted period." After briefly summarizing the meaning of these terms, we will provide illustrative scenarios.

As to "securities," the short sales and the registered purchases have to involve the same security to trigger the rule, not a derivative involving that security, such as an option or warrant. Thus, for example, if the hedge fund sells short publicly-traded options to acquire the common stock of the issuer, that would not implicate Rule 105.

Practice Point: This part of Regulation M does not "mix and match" equity securities and securities convertible into such equity securities, so that short sales of one does not implicate purchases of the other in connection with a registered public offering.

For the definition of "short sale," the rule borrows the definition from a different regime that regulates short sales, Regulation SHO. For those purposes, a short sale includes:

- Any sale covered with a borrowed share;
- Any assignment of a short position;
- Any sale where the firm is net short or flat; and
- Any sale of a security that the firm does not own, with a few exceptions involving situations where the firm has a right to acquire the security.

Practice Point: Any sale covered by a borrowed share is a short sale, even if the fund and/or its affiliates are net long, looking across the platform, or across the "independent trading aggregation unit" if applicable as explained below.

Although a transaction in a derivative cannot be the basis of a Rule 105 violation, a derivative position (such as an option or warrant) can be relevant to determining whether or not a firm is "net short" at the time of a sale, and could cause an otherwise long sale to be characterized as a short sale.

A firm must look across all of its affiliated funds and managed accounts to determine if it is flat or net short the security in question. This is the case unless it has an "independent trading aggregation unit," which generally means that the unit trades independently of its affiliates outside of the unit. This approach is available only to larger firms as a practical matter. If two funds have a common portfolio manager or team, then they cannot qualify as independent aggregation units.

Although a firm should always determine its net short status across all of the accounts that it manages as described above, it should also consider whether each individual fund or client purchasing the security is not net short, as the SEC could take the position that the individual fund or client may be deemed to have violated the rule on a stand-alone basis, even though such a position in our view would not be supported by the rule.

Practice Point: In order to rely on the "independent trading aggregation unit" exception, a detailed analysis should be undertaken of the levels of separation between the units in question, particularly with respect to up-the-chain supervisory and investment management functions.

"Restricted period" is the shorter of: (a) the period beginning 5 business days before the pricing of an offering and ending at pricing; and (b) the period beginning at the initial filing of the registration statement and ending at pricing. The period in (a) is the one that typically applies, particularly in the context of a shelf offering where the registration statement had been filed long before. The calculation of the 5-business day period can be tricky, since if the pricing occurs before the market closes, that day does not count toward the 5-business day period.

There is a narrow exception to Rule 105, called the "bonafide purchase exception," if the fund shorted during the restricted period and prior to pricing makes open market purchases of the security in at least the same quantity as the short sale during regular trading hours, subject to other detailed conditions

Rule 105: Illustrative Scenarios

Scenario 1: XYZ, Inc., a company listed on the NYSE, prices a firm commitment underwritten public offering before the market closes on Wednesday, August 11. Momentum Capital Fund, LP, a hedge fund, wishes to participate. Momentum is in aggregate 20,000 shares long the common stock of XYZ, but it nonetheless executed a strategy on August 4th in which it sold 10,000 shares, and covered with borrowed shares. Can it participate in the offering?

The offering is a firm commitment underwritten public offering, which is the type of offering relevant for purposes of Rule 105. The sales of shares settled with borrowed shares on August 4th count as short sales under the rule, even though Momentum was net long at the time by 20,000 shares. That is because any sale of a borrowed share is by definition a short sale. But is a short sale on the 4th a disqualification, or is it outside the 5-business day restricted period? Because the offering priced before market close on the 11th, that day is not counted as the first day of the restricted period look-back. Accordingly, the restricted period runs back to and including August 4, the day of the short sales. Momentum may not participate in the offering.

Scenario 2: ABC, Inc., another NYSE listed company, engages in a PIPE transaction, selling 500,000 shares of common stock in a private placement to three funds, including Momentum. The private placement closes on September 1st, and the resale registration is filed, and becomes automatically effective, on September 2nd. As is common among PIPE transactions, the resale registration permits the investors to resell in the open market, but does not contemplate that they will use an underwriter to resell shares. Momentum engaged in short sales on August 31st. Has Momentum violated Rule 105?

Because the registration is not an underwritten public offering, Rule 105 would not apply, and the short sales do not violate Regulation M.

Scenario 3: PQR, Inc., another NYSE listed company, engages in a firm commitment underwritten primary offering of 1,000,000 shares of common stock. Momentum intends to purchase 100,000 shares in the public offering. ABC files the registration statement, it becomes automatically effective, on December 2nd, and the deal prices the next day. Momentum engaged in short sales on December 1st. Has Momentum violated Rule 105?

It has not violated Rule 105. While the default "restricted period" is usually 5 business days prior to pricing, the rule provides that the period is the shorter of 5 business days or the period between filing the registration statement and pricing. In this case, the registration statement was filed on December 2, and the deal priced on December 3, so the restricted period runs from December 2 to December 3. Short sales on December 1 did not occur during the restricted period.

The answer would be different if, instead of filing a new registration statement on December 2, PQR undertook a shelf takedown on that date, based on a shelf registration statement that had been filed months earlier. In that case, the default of 5 business days would apply.

Practice Point: If the issuer files a new registration statement, the restricted period may be shorter, in some cases as short as one day, between the filing of the registration statement and pricing. However, if the issuer uses an existing shelf and engages in a "take down" instead, the default 5 business days would apply.

Enforcement of Rule 105

As noted above, the SEC historically has focused on Rule 105 nearly every year since it was amended in 2008. It has brought more than 40 actions in the past five years, including against 25 firms as part of an enforcement sweep in 2014 and 2015, focused solely on violations of the Rule. However, its most recent actions were brought in 2017.

In one case in 2015, the fund's adviser implemented new software for identifying short sales, and the results were transmitted to the fund's prime broker. The prime broker based its compliance with Rule 105 on those communications from the fund's adviser. However, trades were routinely misidentified as "short" or not "short." Even though the trades were the result of a software error, the SEC pursued the matter, and the fund's adviser settled for a $4.25 million penalty, and disgorged over $240,000 of trading gains and interest.

In 2017, the SEC settled a case against the adviser to a large hedge fund that had apparently relied on separate "aggregation units" among separate accounts with separate portfolio managers and portfolio personnel, each of which maintained its own accounts. However, the adviser maintained several firm accounts for trading activity, including risk management and hedging in relation to the entire platform. Compensation for the management personnel over the firm accounts was premised, in part, on the performance of individual accounts. Management personnel had the ability to review each

separate account's portfolio holdings and trading activity and also had the authority to set the trading strategies with respect to the firm accounts.

The SEC can learn of violations of the rule in a number of ways, but the most common way is through its inspections of a prime broker or registered investment adviser. While Rule 105 regulates the broker and not the fund or its adviser, the SEC typically would charge the adviser for "causing" the broker's violation.

As noted above, the SEC has brought a steady stream of enforcement actions based on violations of Rule 105 dating back to the amendment of the Rule in 2008. More recently, however, the SEC has brought far fewer Rule 105 actions, with the last such action being filed in 2017. This likely reflects the attitude of Chairman Clayton that strict liability for technical violations of the federal securities laws, where it is difficult to discern investor harm, like Rule 105 violations, are often better handled by a deficiency notice from the SEC's Office of Compliance Inspections and Examinations (OCIE), which inspects registered investment advisers and is not part of the SEC's Enforcement Division, rather than an enforcement action.

We expect that, under Chairman Clayton, the SEC will likely focus its enforcement actions on larger or intentional violations, and decide not to expend resources on small, unintentional violations. However, a fund adviser involved in the latter category of violations – and hoping to avoid formal agency enforcement action – should formulate a strategy for addressing the violations, which may involve updates to compliance procedures and, in very rare circumstances, self-reporting to the SEC. Moreover, keep in mind that the SEC has a five-year statute of limitations to seek penalties or disgorgement. Even if the current Commission is less likely to bring a Rule 105 action, a future Commission may take a different, more aggressive approach

Practice Point: While we believe that the current SEC is less likely to bring formal charges based on small, unintentional violations, it is important to carefully consider a strategy for updating compliance procedures and communicating with the agency. Even in the current regulatory environment, even a small, technical violation can result in an enforcement proceeding if it is not handled optimally.

The firm's response should be carefully tailored based on the details of a given violation. Questions to ask when a violation is detected include:

- What was the profit from the related trading activity?
- Are our current compliance procedures effective?
- Can we tell regulators with assurance that there have been no prior violations, and that there is no pattern?
- Are there improvements to our procedures that we can implement now to assure regulators that the most recent violation is unlikely to recur?
- While very rare and subject to an intensive facts-and-circumstances analysis, should we consider reporting the violation to the SEC staff? Have we recently completed an OCIE exam, or is there one forthcoming, and if so should we contact our lead examiner?

The Tender Offer Rules

The tender offer rules that at times apply to hedge fund firms are the "small set" tender offer anti-fraud rules, not the "large set" tender offer rules that apply to tenders for generally exchange-traded equity. The "small set" Regulation 14E rules, established under Exchange Act Section 14(e), are relatively skeletal, and are designed prophylactically to avoid actions that could violate the general anti-fraud rule. These rules can be triggered when a fund's adviser offers to purchase limited partnership or other equity interests from its own investors or from the investors in another fund, where the offer amounts to a "tender offer." Whether or not there is a "tender offer" depends on a number of factors, including whether the fund adviser offers a single price and imposes a short deadline for responding. The most significant of the rules (if applicable) would require:

- The tender offer to remain open for at least 20 business days;
- The fund adviser and its affiliates not to purchase any shares outside of the tender offer during its pendency; and
- The tender offer to remain open for 5 or 10 business days (depending on the facts) following a material change in its terms.

If in doubt, many fund advisers comply with these requirements, because they typically are not burdensome. The general anti-fraud rules also apply, so fund advisers should be careful about avoiding misleading disclosures, material omissions, or terms that exert pressure on investors, such as “first come, first served” acceptances of tenders.

Practice Point: If a fund adviser is offering to purchase equity interests from even a small number of its own investors or those of another fund, it should consider the applicability of the “small set” tender offer rules.