

FREQUENTLY ASKED QUESTIONS ABOUT REGULATION M

Understanding Regulation M

What is Regulation M?

Regulation M is intended to protect the trading markets by prohibiting activities by distribution participants that could manipulate the market for a security that is the subject of an offering. Regulation M impacts the activities that may be conducted by issuers, broker-dealers and other distribution participants around the time of a securities offering.

Regulation M consists of the following six rules:

- Rule 100 – Definitions;
- Rule 101 – Activities of Distribution Participants;
- Rule 102 – Activities of Issuers and Selling Security Holders;
- Rule 103 – NASDAQ Passive Market Making;
- Rule 104 – Stabilizing and Other Activities; and
- Rule 105 – Short Selling.

Does conduct need to be fraudulent or manipulative to violate Regulation M?

No. Regulation M is a “prophylactic rule,” and prohibits certain conduct whether or not it violates the anti-fraud provisions of the federal securities laws. In addition (and conversely), Regulation M is not a “safe

harbor” from the anti-fraud rules; conduct can be unlawful, even if it does not violate Regulation M.¹

Rule 101

What is Rule 101 of Regulation M?

Rule 101 prohibits distribution participants and their affiliated purchasers from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security of a distribution during a restricted period. We will explain these provisions, and their exceptions, in more detail below.

What constitutes a “distribution”?

Rule 100 defines a “distribution” as a securities offering that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and methods. The number of shares to be sold and the percentage of outstanding shares of the proposed distribution compared to the public float and the security’s normal trading volume are factors to consider when determining the magnitude of an offering.² Greater than “normal” compensation

¹ SEC Release Nos. 33-7375 and 34-38067, 63 SEC Docket 1141 (1996-1997) (Apr. 1, 1997) (hereinafter referred to as the “Regulation M Adopting Release”), at 521.

² *Id* at 522.

arrangements, delivery of sales documents such as a prospectus, and conducting road shows are generally indicative of special selling efforts and selling methods.³ In the context of a shelf registration that contemplates various selling methods, each takedown needs to be individually assessed.⁴ See “How does Regulation M apply to shelf takedowns?” below.

A “distribution” need not be a registered public offering; a private placement can also be a distribution under Regulation M.⁵ A wide variety of private placement transactions can be “distributions,” depending on the circumstances, including:

- Regulation D offerings; and
- Rule 144A offerings.

What are “covered securities”?

Covered securities are securities that are the subject of a distribution or a “reference security.” A reference security is a security into which the covered security may be converted, exchanged or exercised, or which may impact the value of the covered security. Derivative securities are not subject to Rule 101 and, therefore, bids or purchases of options, warrants, rights, convertible securities or equity-linked securities are not restricted by Rule 101.⁶ However, during a distribution of derivative securities, Rule 101 does apply to the underlying security, the value of which affects the return of the derivative security.⁷

³ Exchange Act Release No. 34-33924, 56 S.E.C. Docket 1302 (Apr. 26, 1994), at 6.

⁴ See Regulation M Adopting Release, *supra*, note 1 at 526.

⁵ SEC Staff Legal Bulletin No. 9, (Oct. 27, 1999, Revised September 10, 2010) (hereinafter referred to as the “SEC Reg M FAQ”).

⁶ See Regulation M Adopting Release, *supra*, note 1 at 524.

⁷ *Id* at 524.

Who is considered a “distribution participant”?

A “distribution participant” includes any person who has agreed to participate or is participating in a distribution, such as underwriters, prospective underwriters, brokers and dealers. However, a broker-dealer that performs only ministerial duties and receives a fixed fee for its limited role is not considered a distribution participant.⁸

What constitutes a “prospective underwriter”?

A prospective underwriter is a person who has either:

- submitted a bid to the issuer or selling shareholder and who knows or is reasonably certain such bid will be accepted; or
- has reached, or is reasonably certain to reach, an understanding that such person will become an underwriter regardless of whether the underwriting terms and conditions have been agreed upon.

Who is considered an “affiliated purchaser”?

An “affiliated purchaser” includes a person acting in concert with or who is controlled by or under common control with a distribution participant. The definition also includes any separate department or division that regularly purchases securities for its own account or the account of others or that recommends or exercises investment discretion with respect to the purchase or sale of securities. For example, an investment advisory subsidiary of an underwriter’s parent company would be considered an “affiliated purchaser.” An affiliate of a direct participant that is a separate entity from the direct participant and purchases securities for its own account

⁸ See SEC Regulation M FAQ, *supra*, note 5.

will not be considered an affiliated purchaser if all of the following conditions apply:

- The direct participant:
 - maintains and enforces policies and procedures that prevent the flow of information to and from the affiliate; and
 - obtains annual, independent assessment of the operation of those policies and procedures.
- The affiliate has no officers or employees (other than certain administrative personnel) in common with the distribution participant.
- The affiliate does not, during the applicable restricted period (as described below), act as a market maker (unless acting as a specialist in compliance with the rules of a national securities exchange) or as a broker-dealer for a covered security.

This exception accommodates the needs of underwriters and other entities that are part of complex financial services companies.

What is the Rule 101 “restricted period”?

Rule 101 applies only during a restricted period. The length of the restricted period will differ depending on the type of covered security. For securities with an ADTV (as defined below) of \$100,000 or more of an issuer whose common equity securities have a public float value of \$25 million or more, the restricted period begins on the later of one business day prior to the pricing date or such time that a person becomes a distribution participant and ends on the completion of its participation in the distribution. For all other securities, the restricted period begins on the later of

five business days prior to the pricing date or such time that a person becomes a distribution participant, and ends on the completion of its participation in the distribution. In the case of convertible securities, the ADTV used to determine the restricted period is that of the convertible security itself and not the reference security.⁹

What is the Rule 101 “restricted period” for mergers, acquisitions and exchange offers?

In mergers, acquisitions and exchange offers, the restricted period begins on the day proxy solicitation or offering materials are first distributed to security holders, and ends upon the completion of the distribution. If the offering is in connection with an acquisition of a privately held company, the restricted period would commence one or five days (depending on the type of covered security as described above) prior to the day on which the target security holders are first asked to commit to the transaction.¹⁰

If an underwriter joins the underwriting syndicate on the pricing date, will its prior bids or purchases for the covered securities violate Rule 101?

No. For such an underwriter, the restricted period begins when it joins the syndicate. Broker-dealers who become “prospective underwriters” often maintain restricted lists or watch lists in order to monitor bids for or purchases of covered securities, in order to avoid a violation of Regulation M.

⁹ *Id.*

¹⁰ *Id.*

How is “business day” defined for purposes of the restricted period?

A “business day” is the 24-hour period based on the principal market for the covered security, and includes a complete trading day for that market.

For example, if pricing occurs at the close of trading in the principal market on Tuesday, and a one business day-restricted period applies, the restricted period would begin on Monday at the close of trading in the principal market. If pricing occurs prior to the close of trading on Tuesday, the restricted period would begin prior to the opening of trading in the principal market on Monday, because a full trading day is taken into account.¹¹

What constitutes the completion of participation?

The completion of participation in a distribution occurs when all the securities in the offering have been distributed and all stabilization arrangements and trading restrictions in connection with the distribution have terminated. For selling group members who are not part of an underwriting syndicate, the completion of the participation occurs when the selling group member has sold all of its allotment.

When does the distribution period end for an offering with a “green shoe” option?

In transactions where an overallotment option is exercised, the exercise of the option does not affect the completion date, unless the underwriters exercise their overallotment option for more shares than the net syndicate short position at the time that the option is exercised. In such cases, the completion date would be extended to the time at which all the excess shares have

¹¹ *Id.*

been sold. Furthermore, if there are any excess shares, any bids or purchases by the underwriters made before the exercise of the option could violate Rule 101 of Regulation M.¹²

How can an underwriter protect against violations of Rule 101 for market-making activities during a distribution period of debt securities subject to a green shoe option?

Some offerings of listed non-convertible debt securities have a green shoe option. As discussed above, if an underwriter were to exceed the syndicate short position at the time that the green shoe is exercised, any previous market-making bids or purchases of such debt securities would have been deemed to occur during the distribution period and in violation of Rule 101 of Regulation M. There are two options for underwriters to prevent this type of violation: (1) obtain an investment grade rating from a nationally recognized statistical rating organization; or (2) police all sales to ensure that the syndicate short position will not be exceeded at the time of the green shoe exercise.

What happens in “sticky offerings”?

In sticky offerings in which underwriters are unable to sell all of their allotted securities, the syndicate manager could keep the syndicate together and modify the selling concession or engage in unsolicited transactions or offers to sell or solicitations of offers to buy, both of which are exempted transactions under Rule 101. See “*What activities are exempt from Rule 101?*” below. If the securities are taken in for the underwriter’s own investment (referred to as an “unsold allotment”), the underwriter could resell the securities under a current

¹² *Id.*

prospectus or sell the securities after a significant holding period. The SEC usually presumes that an investment bank lacks the requisite investment intent to avail itself of exemptions from registration. As a consequence, most practitioners advise that an underwriter hold securities that form part of an unsold allotment for a substantial period of time.

What is ADTV?

ADTV equals the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of a registration statement. If there is no registration statement or the sale is made on a delayed basis under Rule 415 of the Securities Act of 1933, as amended (the "Act"), it would be prior to the pricing date instead of the registration statement filing date.¹³

What types of securities are exempt from Rule 101?

The following securities are exempt from Rule 101:

- (i) Actively-traded securities with a worldwide ADTV of at least \$1 million and issued by an issuer with common equity securities with a public float value of at least \$150 million, unless those securities are issued by a distribution participant or its affiliate, in which case, only non-affiliated participants are exempt;
- (ii) investment grade nonconvertible securities and asset-backed securities (see "*Proposed Amendments to Investment Grade Nonconvertible Securities and Asset-Backed*

¹³ *Id.*

Securities Exemption" below for amendment proposals for this exemption);

- (iii) "exempt securities" as defined in Section 3(a)(12) of the Exchange Act, including but not limited to:
 - o any security issued or guaranteed by the United States or issued by a religious or charitable organization or a Section 501(c) tax exempt non-profit corporation;
 - o any security issued by institutions which are supervised and examined by State and Federal authorities;
 - o certain security futures product;
- (iv) face-amount certificates or securities issued by an open-end management investment company or unit investment trust.

Exemption (i) above for actively traded securities may apply to ordinary shares issued by foreign issuers. However, debt securities generally would not qualify for this exemption because of their lack of public trading history.¹⁴

What activities are exempt from Rule 101?

In addition to the exempt securities, the following activities are exempt from Rule 101:

- (i) publishing and disseminating research materials that are in compliance with Rules 138 and 139 of the Act;¹⁵

¹⁴ *Id.*

¹⁵ See also our "Frequently Asked Questions about Separation of Research and Investment Banking," available at: <https://media2.mofo.com/documents/frequently-asked-questions-about-separation-of-research-and-investment-banking.pdf>.

- (ii) engaging in transactions with respect to Rule 144A eligible securities to QIBs and non-U.S. persons;
- (iii) participating in unsolicited brokerage transactions or unsolicited purchases not effected from or through a broker or dealer, securities exchange or inter-dealer quotation system or electronic communications network;
- (iv) engaging in passive market making under Rule 103 or stabilizing transactions under Rule 104 (*see* “Rule 103 – NASDAQ Market Making Transactions” and “Rule 104 – Stabilization” below);
- (v) purchasing a total of less than 2% of the ADTV of a security, if written procedures for Rule 101 compliance are in effect and enforced (the “de minimis exemption”);
- (vi) exercising options, warrants, rights or conversion privileges;
- (vii) transactions in connection with a distribution not effected on a securities exchange or through an inter-dealer quotation system or electronic communications network;
- (viii) offers to sell or the solicitation of offers to buy securities;
- (ix) odd-lot transactions; and
- (x) basket transactions.

and “Frequently Asked Questions about Communications Issues for Issuers and Financial Intermediaries,” available at: https://media2.mofo.com/documents/faq_communications.pdf.

What kind of research reports are exempt from Rule 101?

In the case of exemption (i) above, routine research reports that are in compliance with Rules 138 or 139 of the Act, are permitted under Rule 101.¹⁶ Rule 138 permits a broker-dealer participating in a distribution of securities of an issuer to publish research reports about that issuer if certain conditions are met. Rule 139 permits a broker-dealer participating in a distribution of securities of an issuer to publish research reports concerning that issuer or any class of its securities if certain conditions are met.

What kind of transactions are deemed to be “unsolicited”?

In the case of exemption (iii) above for unsolicited brokerage transactions and unsolicited purchases, participants must be careful; if a market transaction results from an original inquiry by a distribution participant, the original inquiry will be deemed “solicited” and would not fall under this exemption. *See also* “What book-building activities are prohibited by Regulation M?” below.

What book-building activities are prohibited by Regulation M?

In response to Regulation M violations in connection with the book-building activities for “hot” IPOs in 2005, the SEC published an interpretive release clarifying prohibited book-building activities under Regulation M. These prohibited activities include but are not limited to:

- (i) “Tie-in” arrangements where purchasers are induced to purchase securities in the form of

¹⁶ See Regulation M Adopting Release at 62.

“tie-in” agreements or solicitations of aftermarket bids or purchases prior to the completion of the distribution;

- (ii) Solicitation of customers prior to the completion of the distribution regarding immediate aftermarket orders;
- (iii) Accepting or soliciting interest from customers for purchases of shares in the aftermarket in an amount linked to the initial purchase; and
- (iv) Soliciting aftermarket orders before the completion of the distribution or rewarding customers for aftermarket orders by allocating additional securities to those customers in the initial distribution.¹⁷

Are there any proposed amendments to Rule 101?

Proposed Amendments to Investment Grade Nonconvertible Securities and Asset-Backed Securities Exemption

In April 2011, the SEC proposed amendments to Regulation M to remove the reliance on “credit ratings” in the exemption for investment grade nonconvertible securities and asset-backed securities. These would be replaced with new standards relating to trading characteristics of the covered security. Under these amendments, securities would be exempt from Rule 101 (and Rule 102) if they:

- (i) are liquid relative to the market for their asset class;
- (ii) trade in relation to general market interest rates and yield spreads; and

- (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

Factors that should be considered to determine the liquidity of a security relative to its asset class market include but are not exclusive to:

- (i) the size of the issuance;
- (ii) the percentage of the average daily trading volume by persons other than the persons seeking an exemption;
- (iii) the number of market makers in the security other than the persons seeking an exemption;
- (iv) the overall trading volume of the security;
- (v) the number of liquidity providers who participate in the market for the security;
- (vi) trading volume in similar securities or other securities of the same issuer;
- (vii) the overall liquidity of all outstanding debt issued by the same issuer;
- (viii) how quickly an investor could be expected to sell the security after purchase; and
- (ix) in the case of asset-backed securities, the liquidity and nature of the underlying assets.

Exempt securities must also trade based on changes in broader interest rates (based on their comparable yield spreads) and not on issuer-specific information or credit quality. Lastly, exempt securities should be relatively fungible, in that a portfolio manager should be willing to purchase the security in lieu of another security with similar characteristics, such as similar yield spreads and credit risk. However, in order to satisfy this standard, the security need not be deliverable for a purchase order

¹⁷ Exchange Act Release Nos. 33-8565 and 34-51500, 85 SEC Docket 266 (2005-2006) (Apr. 7, 2005).

for a different security and it need not be completely fungible for all purposes with another security with similar characteristics.

Those seeking to rely on this exemption must use reasonable judgment in conducting their analysis, and the determinations must be verified by an independent third party. However, sole reliance on an independent third party is not considered to be reasonable judgment.¹⁸

Rule 102

What is Rule 102 and how does it differ from Rule 101?

Rule 102 prohibits the same activities during the same restricted period as Rule 101; however, Rule 102 applies to issuers, selling shareholders and their respective affiliated purchasers. Additionally, it provides the same exemptions as Rule 101 except for the following activity-based exemptions listed previously:

- exemption (i) for publishing and disseminating research materials (which is typically not applicable to issuers);
- exemption (v) for de minimis transactions; and
- exemption (x) for basket transactions.

Rule 102 also limits the actively traded securities exemption to cover only reference securities that are not issued by the issuer or any of its affiliates in the actual distribution.

The Rule 102 exemptions are more limited than Rule 101 because the SEC views issuers, selling shareholders and their respective affiliate purchasers as

¹⁸ See SEC Release No. 34-64352, 76 Fed Reg. 26550, (May 6, 2011).

having a more direct stake in the distribution. As a result, they may have greater incentive to engage in manipulative practices.¹⁹ However, Rule 102 does provide three additional exemptions for (i) certain repurchase transactions by closed-end investment companies, (ii) redemptions by commodity pools or limited partnerships and (iii) distribution of securities under securities purchase plans such as direct purchase plans and dividend reinvestment programs under certain circumstances.

Can the issuer, selling shareholder or their respective affiliated purchasers who are also distribution participants comply with Rule 101 instead of the more restrictive Rule 102?

Issuers and selling shareholders who are also acting as distribution participants must comply with Rule 102. However, affiliated purchasers of the issuer or selling shareholders who are also distribution participants may comply with either Rule 101 or Rule 102.²⁰ This is important, because Rule 101 is generally less restrictive than Rule 102, and enables broker-dealer affiliates of financial holding companies to comply with Rule 101 in their parent company's securities offerings.

Can an affiliate of an issuer, such as an officer or director, purchase securities in an offering?

Yes. Rule 102 was not intended to bar these purchases.²¹

¹⁹ See Regulation M Adopting Release, *supra*, note 1 at 530.

²⁰ See SEC Regulation M FAQ, *supra*, note 5.

²¹ See Regulation M Adopting Release, *supra*, note 1 at 532.

Rule 103 – NASDAQ Market Making Transactions

What does Rule 103 permit?

Rule 103 allows broker-dealers who are registered NASDAQ market makers to engage in market making transactions in NASDAQ securities during the Rule 101 restricted period under certain conditions. However, Rule 103 market making is not allowed in at-the-market or “best efforts” offerings, or for a security for which a stabilizing bid subject to Rule 104 is in effect.

The following are the conditions for Rule 103 market making:

- (i) a passive market maker cannot bid for or purchase a covered security at a price exceeding the highest independent bid for that security at the time of the transaction;
- (ii) a passive market maker cannot have net purchases exceeding the greater of its 30% ADTV limitation or 200 shares on each day of the restricted period;
- (iii) a passive market maker must notify FINRA in advance of its intention to engage in passive market making and comply with FINRA requirements (*see also “What are the FINRA reporting requirements for Regulation M distributions?”* below); and
- (iv) in registered transactions, the intention of engaging in passive market making must be disclosed in the prospectus.

Who may rely on Rule 103?

A distribution participant, such as an underwriter that is an affiliate of an issuer or selling security holder, may conduct passive market making in a covered security

under Rule 103. However, a NASDAQ market maker that is affiliated with the issuer or selling security holder, but is not acting as a distribution participant, may not rely on Rule 103.²²

What happens to the highest bids entered prior to the restricted period?

If a market maker enters a bid immediately prior to the restricted period and that bid is the highest bid as of the close of such day, the market maker may not bid at that same level once it becomes passive. It may only bid at a level that is not higher than the current highest independent bid.²³

Are there any exceptions to the Rule 103 conditions?

For condition (i) above, a passive market maker may continue to bid and effect purchases at a bid price exceeding the highest independent bid if it purchases an aggregate amount of the covered security that (a) equals or (b) through the purchase of all securities that form a part of a single order, exceeds the lesser of (x) two times the minimum quotation size for the security as determined by FINRA rules or (y) the remaining purchasing capacity under condition (ii) above.

Rule 104 – Stabilization

What is stabilization and what does Rule 104 permit?

“Stabilizing” is defined in Rule 100 as the placing of a bid or effecting a purchase for the purpose of “pegging, fixing, or maintaining the price of a security.” Rule 104 permits distribution participants under certain conditions to conduct stabilizing transactions that

²² See SEC Regulation M FAQ, *supra*, note 5.

²³ *Id.*

prevent or slow a decline in the market price of a covered security. However, stabilizing activity in at-the-market offerings is prohibited and priority must be given to independent bids, regardless of the size of the bid. Rule 104 provides limits on the prices of stabilizing bids; conditions for initiating stabilizing activity; and requirements for recordkeeping, disclosure and notification.

What are the Rule 104 limits on stabilizing levels?

Stabilizing bid prices must be no higher than the lower of (i) the offering price and (ii) (a) the stabilizing bid for the security in the principal market if the principal market is open or (b) the stabilizing bid in the principal market at its previous close if the principal market is closed.

What are the conditions for initiating stabilizing activity in an open principal market?

If the principal market for the covered security is open, stabilizing may be initiated in any market as long as the price is no higher and the current ask price in the principal market is equal to or greater than the last independent transaction price for the security in the principal market. If neither condition is met, stabilizing may be initiated in any market at a price equal to or lower than the highest current independent bid for the security in the principal market

What are the conditions for initiating stabilizing activity in a closed principal market?

If the principal market for the covered security is closed, stabilizing may be initiated immediately before the opening of quotations for the market where the stabilizing will be initiated at a price no higher than the lower of:

- the price at which stabilizing could have been initiated in the principal market at its previous close; and
- the most recent price at which an independent transaction in the security has been effected since the close of the principal market, if the person stabilizing knows or has reason to know of that transaction.

Stabilizing may also be initiated after the opening of quotations for the market where the stabilizing will be initiated at a price no higher than the lower of:

- the price at which stabilizing could have been initiated in the principal market at its previous close; and
- (a) the last independent transaction price for the security in that market where stabilization is being initiated if (1) the security has traded in that market on the day stabilizing is initiated or on the last preceding business day, and (2) the current asked price in that market is equal to or greater than the last independent transaction price; or
- (b) if conditions (1) and (2) above are not satisfied, a price no higher than the highest current independent bid for the security in that market.

What are the conditions for initiating stabilizing activity where there is no market for the covered security?

If no bona fide market for the covered security exists, the initiating stabilization prices must be equal to or less than the offering price. If stabilization is initiated before the offering price is determined, then stabilizing may

continue after the offering price is determined and at a price at which stabilizing could be initiated at that time.

Can a stabilizing bid be maintained or carried over?

A stabilizing bid initiated in compliance with Rule 104 may be maintained or carried over into another market, irrespective of changes in the independent bids or transaction prices for the covered security.

What are the limits in changing a stabilizing bid, and what adjustments can be made?

After initiating stabilizing bids, those bids may not be increased to a price higher than the highest current independent bid for the security in the principal market if the principal market is open. If the principal market is closed, the stabilizing bid price cannot be higher than the highest independent bid in the principal market at its previous close. A stabilizing bid may be reduced or carried over into another market at a reduced price, irrespective of changes in the independent bids or transaction prices for the security. If the stabilizing is discontinued, it may be resumed only at a price that is higher than the price at which stabilizing could then be initiated.

In addition, stabilizing bids may be adjusted to take into account currency exchange rates and adjustments for a security going ex-dividend, ex-rights or ex-distribution.

What are the conditions of stabilizing activity conducted outside of the United States?

Rule 104 allows for stabilizing activity outside of the United States to facilitate a securities offering in the United States as long as the following conditions are met:

- there is no stabilizing activity in the United States;
- the jurisdiction in which stabilizing activity will occur must have statutory or regulatory provisions governing stabilizing that are comparable to Rule 104;
- all stabilizing prices must be above the U.S. offering price, without taking into account currency exchange rates or adjustments from a security going ex-dividend, ex-rights or ex-distribution.

What are the disclosure and notification requirements under Rule 104?

Any person who displays or transmits a bid and knows that bid is for stabilizing must provide prior notice to the market that stabilizing will be effected and disclose the purpose to the person with whom they are entering a stabilizing bid. A person effecting a syndicate covering transaction or that imposes a penalty bid must provide prior notice to the self-regulatory organization with direct authority over the principal U.S. market of the covered security. Any person who sells or purchases a security for which the price may be or has been stabilized must send the purchaser at or before the completion of the transaction, the offering document containing information required under Item 508(l) of Regulation S-K and a confirmation for the related offering. Any person conducting stabilizing activity must also maintain records for the stabilizing activity and provide notification to the manager in the case of a syndicated transaction.

Are there any exemptions to Rule 104?

Rule 144A securities sold under Section 4(a)(2), Rule 144A, or Regulation D and sold only to QIBs and non-U.S. persons under Regulation S are exempt from Rule 104. “Exempted Securities” as defined under Section 3(a)(12) of the Exchange Act are also exempt from Rule 104. However, unlike Rules 101 and 102, Rule 104 does not have exemptions for actively traded securities, nonconvertible debt, nonconvertible preferred or asset-backed securities.²⁴

Rule 105 – Short Selling

What does Rule 105 prohibit?

Under Rule 105, any person who has shorted an equity security that is subject to a public offering made on a firm commitment basis cannot purchase those securities from a distribution participant in the offering if the short sale was effected during a restricted period beginning either five business days before the pricing of the offering or the initial filing of the registration statement and ending with the pricing, whichever period is shorter. Such a practice can artificially decrease the price of the security, which would then reduce the issuer’s net proceeds from the offering. Rule 105 does not apply to debt securities, as they are less susceptible to manipulation, traded based on the yields and spreads of comparable securities and are generally fungible with other similarly rated securities.²⁵

Are there any exceptions to Rule 105?

The following are exempt from Rule 105:

- bona fide purchases if:

- the purchaser buys an amount of securities that equals or is greater than the entire amount of short sales made in the restricted period under Rule 105;
 - the purchase is effected during regular trading hours;
 - the purchase is reported to a transaction reporting plan approved by the SEC;
 - the purchase is effected after the last Rule 105 restricted period short sale and no later than the business day prior to the pricing; and
 - the purchaser did not effect a short sale within 30 minutes prior to the close of regular trading hours on the business day prior to the pricing date.
- short sales and purchases in the offering of the covered security, if the transactions were for separate accounts and the transaction decisions were made separately and without coordination; and
 - purchases by a registered investment company in the offering of the covered security, if the short sale was made by its affiliated investment company or separate fund.

What should participants in an offering be aware of based on the September 2013 settlement of enforcement actions regarding Rule 105 violations?

In 2013, the SEC launched its Rule 105 Initiative to address Rule 105 violations and to promote a zero tolerance message for Rule 105 offenses. Since 2013, the SEC has brought a total of 49 enforcement actions

²⁴ *Id.*

²⁵ SEC Release No. 34-56206, 72 Fed. Reg. 45094 (Aug. 6, 2007).

against a wide range of regulated entities that violated Rule 105, including registered investment advisers, asset management firms, money management firms, hedge fund advisers and registered broker-dealers. The relief in these proceedings included monetary sanctions, with disgorgement in some of the cases exceeding \$1 million, and civil monetary penalties in some of the cases exceeding \$500,000. In a couple of these cases, like in some previous Rule 105 settlements, the SEC was willing to bring claims even when relatively small numbers of shares and, consequently, small amounts of disgorged profits, were involved.

On September 17, 2013, the SEC's National Examination Program (the "NEP") and the Office of Compliance Inspections and Examinations issued a National Exam Program Risk Alert ("Risk Alert")²⁶ directing investment advisers, investment companies and broker-dealers to review their compliance programs to promote compliance with Rule 105 of Regulation M. The Risk Alert reminds firms that training their employees regarding the application of Rule 105 and developing, implementing and enforcing policies and procedures reasonably designed to achieve compliance with the rule are important to ensuring compliance with the rule. In addition, although robust procedures can help prevent and detect violations, implementation of these procedures after the SEC identifies Rule 105 violations will not necessarily avoid liability. However, the Risk Alert emphasized the importance of having adequate procedures in place when it observed that, in determining the penalties associated with the violations in previously settled

²⁶ See National Exam Program Risk Alert, Volume III, Issue 4 (Sept. 17, 2013), available at: <http://www.sec.gov/about/offices/ocie/risk-alert-091713-rule105-regm.pdf>.

Rule 105 enforcement actions, the SEC considered, among other factors, the firms' remedial efforts, including developing and implementing policies, procedures and controls to prevent or detect Rule 105 violations.²⁷

Regulation M and FINRA

What are the FINRA reporting requirements for Regulation M distributions?

FINRA members must notify FINRA when participating in a distribution of an exchange-listed security or an OTC equity security that meets the definition of "distribution" under Regulation M and is not subject to an exemption under Rule 101. FINRA Rule 5190 requires member firms to provide information related to the distribution, such as the determination of the restricted period, whether they are relying on the "actively-traded securities" exemption and pricing information.

Since June 2012, broker-dealers have been required to effect these notices electronically through the FINRA "Firm Gateway."²⁸

²⁷ See also our client alert "Renewed Focus on an Old Rule: SEC Steps Up Rule 105 Enforcement Efforts," available at: <http://media.mofo.com/files/uploads/Images/130918-SEC-Rule-105-Enforcement-Efforts.pdf>.

²⁸ For more information, see FINRA's "SEC Regulation M-Related Notice Requirements Under FINRA Rules Frequently Asked Questions," available at: <http://www.finra.org/Industry/Regulation/Guidance/P118758>.

Application of Regulation M to Specific Transactions

Does Regulation M apply to private placements and PIPE transactions?

Regulation M may apply to private placements and PIPE transactions if the transaction is considered a “distribution.” Generally, most PIPE transactions will be considered “distributions” because they involve substantial sales of securities and involve special selling efforts. However, the restricted period for PIPE transactions may be more difficult to determine than traditional public offerings. Practitioners typically advise that the issuer and placement agent determine the restricted period using the anticipated pricing date (the date on which the first purchase agreement is executed), and that once the purchase agreements have been executed and delivered, the “distribution” would be complete. The restricted period would not depend on the filing and effectiveness of the resale registration statement, as it does not involve an offering.

When does Regulation M apply to Rule 144A offerings?

As discussed above, Rule 144A securities offerings to QIBs and/or non-U.S. persons are exempt from Rules 101, 102 and 104 of Regulation M. For Rule 101 and 102, this exemption also covers the underlying securities for Rule 144A convertible securities. Since Rule 144A offerings are not registered, Rule 105’s prohibition on shorting activity is not applicable to such offerings.

Are pure Regulation S offerings exempt from Regulation M?

Many Rule 144A offerings are conducted in conjunction with a Regulation S offering and benefit from the

Rule 144A exemptions in Regulation M. However, in a pure Regulation S offering without a Rule 144A tranche, the transaction would not benefit from these exemptions and a determination must be made whether the Regulation S offering is a “distribution” subject to Rules 101 and 102. Participants in that offering would also need to consider whether Rule 104 stabilization requirements and Rule 105 shorting prohibitions would apply.²⁹ However, in pure Regulation S offerings, if the subject security is a convertible security for which there is no U.S. market but for which there is a U.S. market in the reference security, the distribution would not be subject to Regulation M. Instead, the anti-fraud and anti-manipulation provisions of the federal securities laws would apply.³⁰

How does Regulation M apply to shelf takedowns?

Under Regulation M, each takedown off of a shelf registration statement must be separately analyzed to determine if the particular transaction is a “distribution.” In block trades effected off of a shelf-registration, the sale of a block may or may not constitute a “distribution” for Regulation M purposes. For example, if the number of shares being sold as part of a block is relatively small compared to the issuer’s market capitalization and ADTV, the offering would not fall under the definition of “distribution” under Regulation M. Also, financial intermediaries may not use “special selling efforts” in connection with a sale of the block.

Overnight shelf takedowns or bought deals conducted with little to no advance public disclosure prior to pricing will generally be considered a distribution

²⁹ See SEC Regulation M FAQ, *supra*, note 5.

³⁰ Staff Legal Bulletin No. 9 (Rev. Apr. 12, 2002), available at: www.sec.gov/interp/leg/mrslb9.htm.

under Regulation M, as they would meet the magnitude and special selling efforts prongs of the test. Generally, larger, more sophisticated issuers with significant market capitalizations will conduct these transactions, as they may meet the ADTV exemption. For smaller issuers who do not meet the ADTV exemption, the applicable restricted period would foreclose the participation of many financial intermediaries who are market makers in the issuer's stock. Moreover, because neither an overnight transaction nor a bought deal would be a "best efforts" offering, these offerings would not be exempt from Rule 105. Thus, institutional buyers who in the regular course of business engage in hedging transactions in the issuer's security would be prohibited by Rule 105 from participating in such an offering.

Does Regulation M apply to registered direct offerings?

Registered direct offerings may or may not be subject to Regulation M depending on whether the transaction is considered a "distribution" under Regulation M. Rule 103 would not be available for such transactions and given that they are conducted on a best-efforts basis, Rule 105 restrictions do not apply.

How does Regulation M apply to at-the-market offerings?

Generally, at-the-market transactions are conducted by issuers who meet the ADTV exemption under Rules 101 and 102. For at-the-market transactions that do not meet this exemption, participants need to determine whether the transaction is a "distribution" subject to Regulation M. Furthermore, each "take down" or "dribble out" would need to be analyzed separately. As a practical matter, if each "take down" is subject to Regulation M and no exemption applies, it would be difficult for an underwriter to attempt to comply with

Regulation M requirements, as takedowns may occur daily. As a result, some broker-dealers attempt to limit their participation in these programs to securities that qualify for the actively traded security exemption.

Rule 104 prohibits any stabilization activity in an at-the-market offering. However, because at-the-market offerings are conducted on a best-efforts basis, they are exempt from the short sale restrictions of Rule 105.³¹

How does Regulation M apply to continuous offering programs?

Continuous offering programs, such as medium-term note programs, may be exempt from Regulation M, depending on whether the type of the subject security is covered by an exemption from Rules 101 and 102. When determining if Regulation M applies, each issuance off the program must be assessed separately.

How does Regulation M apply to share repurchase programs?

Under Rule 102 of Regulation M, with certain exceptions, an issuer cannot repurchase its common stock and must suspend its share repurchase program during certain restricted periods if at the same time the issuer or an affiliate is engaged in a "distribution" of the same class of equity securities or securities convertible into the same class of equity securities.³² Regulation M requires repurchase activity to be discontinued one business day prior to the determination of the offering price for the securities in distribution until the issuer's

³¹ See also our "Frequently Asked Questions About At-The-Market Offerings," available at: <https://media2.mofo.com/documents/faqatthemarketofferings.pdf>.

³² If the issuer is using a 10b5-1 plan, the plan can be written to automatically suspend purchases during the relevant restricted period. For more information regarding 10b5-1 plans, see our "Frequently Asked Questions About 10b5-1 Plans," available at: <https://media2.mofo.com/documents/faq10b51.pdf>.

completion of its participation in distribution. The term “distribution” in this context covers more than conventional public offerings and includes any offering which is distinguished from any ordinary trading transaction by the magnitude of the offering and the presence of special selling efforts and methods. This definition may include certain offerings in connection with acquisitions or exchange offers. Such a distribution might also take place if a major stockholder of the issuer were engaged in significant sales of the issuer’s stock.³³

How does Regulation M apply to exchange-traded notes (“ETNs”)?

Unlike most debt securities, the distribution of ETNs does not end until the ETN is called or matures. Issuers of ETNs are constantly “creating,” or issuing new ETN units, and reselling ETN units that have been previously redeemed (or repurchased) by the issuer’s affiliated broker-dealer. The affiliated broker-dealers of ETN issuers engage in market-making activities in the ETNs, constantly purchasing and selling ETNs in the market. Normally, these activities would be violations of Rules 102 and 101, respectively, and would be viewed by the SEC as manipulative and potentially creating a price difference between the ETN and the underlying reference asset.

In 2006, Barclays Bank PLC received a no-action letter from the SEC’s Division of Market Regulation (Barclays Bank PLC, Jul. 27, 2006) (the “iPath Letter”), under which the Staff of the SEC granted relief from Rules 102 and 101 for the redemption of ETN units by the issuer

³³ For more information regarding share repurchase programs, see our “Frequently Asked Questions About Rule 10b-18 and Stock Repurchase Programs,” available at: <https://media2.mof.com/documents/faq-rule-10b-18-stock-repurchases.pdf>.

and the market-making activities of its affiliated broker-dealer. Counsel for Barclays argued, and the Staff agreed, that the availability of real-time pricing information for both the ETNs (due to their NYSE listing) and the underlying reference asset (index levels publicly available in real time), plus the ability of arbitrageurs to redeem ETNs and purchase new ETNs, would prevent any significant differences between the price of the ETNs and the underlying reference asset.³⁴

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³⁴ Barclays Bank PLC, SEC No-Action Letter (July 27, 2006) available at <http://www.sec.gov/divisions/marketreg/mr-noaction/ipathetn072706.pdf>.