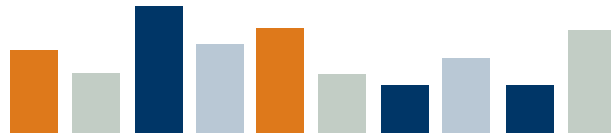


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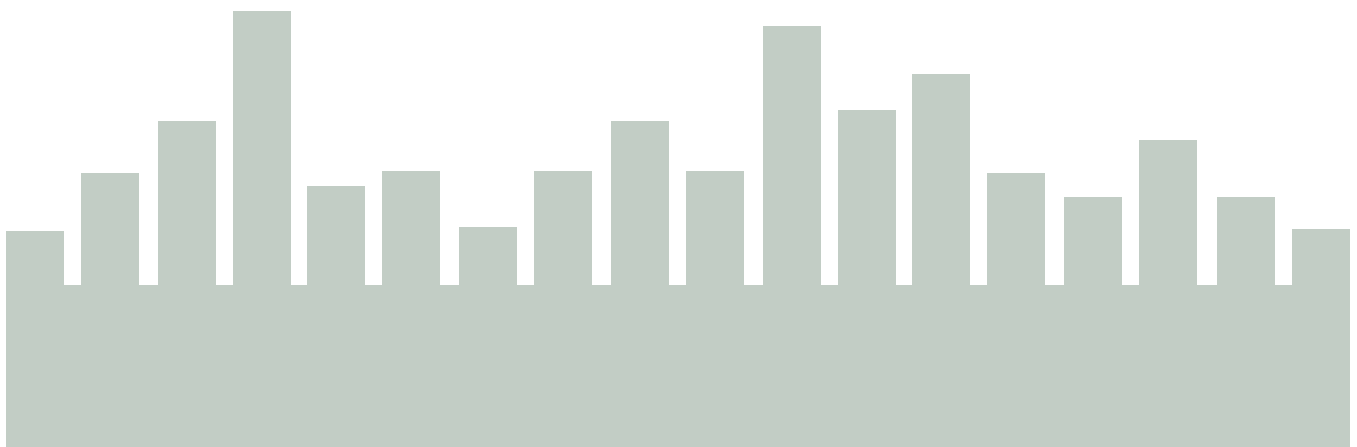
## **Investment Management Hot Topics**

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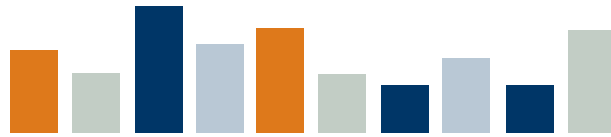
# **How to Comply with Rule 105: A Workshop for Hedge Fund Managers**

May 12, 2011

- 1. About the Speakers**
- 2. PowerPoint Presentation**
- 3. Outline**
- 4. Rule 105 of Regulation M**
- 5. Rule 105 Enforcement Actions**
- 6. Frequently Asked Questions About Regulation M**



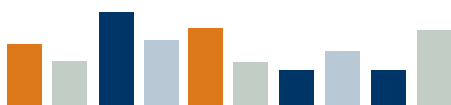
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## **Investment Management Hot Topics**

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### **1. About the Speakers**



## Investment Management Hot Topics

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**Harry S. Davis**  
919 Third Avenue  
New York, NY 10022  
+1 212.756.2222 | [harry.davis@srz.com](mailto:harry.davis@srz.com)

Harry S. Davis is a partner in the firm's Litigation and Regulatory & Compliance Groups, where his practice focuses on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds, private equity funds, prime and clearing brokers, auditors and administrators. Harry has substantial experience in both securities regulatory matters and private litigation, including investigations by the Securities and Exchange Commission, U.S. Attorneys' Offices, the Department of Justice, the Commodities Futures Trading Commission, the Federal Trade Commission, state attorneys general, state securities regulators and self-regulatory organizations.

Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent successful representation of a prime broker in a hotly contested and high-profile fraudulent transfer trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of a career spanning more than 20 years, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, alleged violations of Rule 105 under Regulation M, market timing and late trading, misconduct involving PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty and breach of contract, among other claims. To prevent minor issues from growing into bigger problems, he provides litigation and compliance counseling to many of the firm's clients, and conducts internal investigations.

A sought-after speaker and author, Harry recently served as the editor of the *Insider Trading Law and Compliance Answer Book*, to be published this year by the Practising Law Institute, and authored two chapters: "Introduction to the Law of Insider Trading" and "Materiality." He recently participated in "Hot Button Regulatory Enforcement and Compliance Issues for the Hedge Fund Industry" at GAIM Ops Cayman, "Hedge Funds: Tracking the Progress of Reform" at *The Financial Times* Global Financial Forum and "An In-Depth Look at Recent Trading Revisions and Compliance" at the FRA Hedge Fund Compliance Summit.

Harry graduated with a J.D., *magna cum laude*, from Cornell Law School, where he was editor of the *Cornell Law Review*, and was awarded his B.A., with departmental honors, from Johns Hopkins University.



## Investment Management Hot Topics

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### Ida Wurczinger Draim

1152 Fifteenth Street, NW, Suite 850  
Washington, D.C. 20005  
+1 202.729.7462 | [ida.draim@srz.com](mailto:ida.draim@srz.com)

Ida Wurczinger Draim is a partner in the firm's Investment Management, Litigation and Regulatory & Compliance Groups. Her practice focuses on securities and commodities compliance counseling and the representation of securities industry and corporate clients in regulatory investigations and proceedings. With more than 25 years of experience, Ida is well known for her expertise in investment adviser and broker-dealer compliance and her highly effective representation of industry clients before the SEC, NYSE, FINRA, CFTC, NFA and other regulatory authorities. Some of the areas that Ida regularly addresses on behalf of our investment adviser clients include conflicts of interest, Form ADV disclosure, third-party marketing arrangements, soft dollar practices, personal trading compliance, principal and agency trades, advertising, valuation, best execution, custody, trading restrictions and prohibitions, and commodity pool operator registration and regulatory issues. In the broker-dealer context, Ida regularly deals with Regulations NMS and SHO, best execution, dark pools, prime brokerage functions, institutional and retail sales practices, insider trading and rumors, marketing materials, research, short sale restrictions, supervisory structure, trade surveillance and monitoring, and statutory disqualifications. In addition to compliance counseling and regulatory representation, Ida routinely supervises mock audits, advises clients undergoing regulatory examinations and inspections, provides compliance training and develops supervisory and compliance policies and procedures.

One of Ida's strengths is that she has experienced securities regulation from both sides of the aisle. After several years as a securities litigation associate with a Wall Street law firm, Ida joined the SEC, first serving as staff attorney in the Division of Enforcement, where she earned a Special Achievement award, then as Special Counsel to SEC Chairman John Shad. Ida is a member of the FINRA (formerly NASD) Board of Arbitrators and Board of Mediators and, for 10 years, served as a member of the Nasdaq Listing Qualifications Panel. She is also a panelist and member of the Securities Industry and Financial Markets Association (SIFMA) Legal and Compliance Division and a former Chair of the Corporation, Finance and Securities Law Section of the District of Columbia Bar.

Ida is an active speaker and writer. She co-authored the chapter "Protecting Your Firm Through Policies and Procedures, Training and Testing" in the *Insider Trading Law and Compliance Answer Book* to be published this year by the Practising Law Institute and "Trade Reporting and Compliance" in the *Practitioner's Guide for Broker-Dealers* published by Complinet. She recently participated in the AIFEA Private Equity and Venture Capital Funds Boot Camp and the 25th Annual Fall Investment Adviser and Broker-Dealer Compliance Conference.

Ida received her J.D. from Harvard Law School and her B.A., *cum laude*, from Rutgers University.



## Investment Management Hot Topics

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**Marc E. Elovitz**  
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New York, NY 10022  
+1 212.756.2553 | [marc.elovitz@srz.com](mailto:marc.elovitz@srz.com)

Marc E. Elovitz is a partner in the Investment Management, Litigation and Regulatory & Compliance Groups, where he heads up the firm's regulatory compliance work in the private investment funds area. He advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and handling SEC examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers and analysts on complying with insider trading and market manipulation laws.

A member of the American Bar Association's Business and Litigation Sections and the Hedge Funds Subcommittee of the Committee on Federal Securities Regulation, Marc is a frequent speaker at hedge fund industry conferences and seminars. His recent speaking engagements include "SEC Registration, Examination & Audit Regulatory Reform Status Report" for the Managed Funds Association Chief Financial Officer Forum and "Primary Research — Expert Networks, Channel Checking and Compliance" for the National Organization of Investment Professionals Spring Conference. He authored the chapter "Protecting Your Firm Through Policies and Procedures, Training and Testing" for the *Insider Trading Law and Compliance Answer Book* to be published this year by Practising Law Institute. Marc also co-authors the "Market Manipulation" chapter in the leading treatise, *Federal Securities Exchange Act of 1934* (Matthew Bender) and wrote the chapter on "The Legal Basis of Investment Management in the U.S." for the upcoming Oxford University Press book, *The Law of Investment Management*.

Marc is a member of the Private Investment Funds Committee of the New York City Bar Association, the ABA Hedge Funds Subcommittee and the Steering Committee of the Managed Funds Association's Outside Counsel Forum. Marc attended New York University School of Law, from which he was awarded his J.D., and earned his B.A., with honors, from Wesleyan University.



## Investment Management Hot Topics

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### Eleazer Klein

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New York, NY 10022

+1 212.756.2376 | [eleazer.klein@srz.com](mailto:eleazer.klein@srz.com)

Eleazer Klein, a partner in the firm's Business Transactions and Regulatory & Compliance Groups, practices in the areas of securities law, mergers & acquisitions, and regulatory compliance. In addition to his transactional practice, Ele counsels clients in many regulatory and trading areas, including issues relating to short-selling, Sections 13 and 16, Rule 144, insider trading and Regulation M/Rule 105.

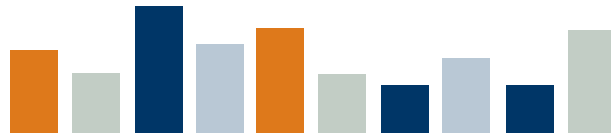
On the transactional side, Ele is best known for his expertise since the early 1990s in the development and implementation of alternative investment structures for private equity investments and, specifically, the structuring and negotiating of private investments in public equity, or PIPEs, and related products including Registered Direct offerings, Convertible 144A offerings, Reverse Mergers, Equity Lines and SPACs.

Ele currently works on approximately 200 PIPE or PIPE market-related transactions every year for some of the largest private investment groups and investment banks in the United States and abroad and advises clients on joint ventures and co-investments, initial public offerings and secondary offerings, venture capital financing, indenture defaults and interpretation, and activist investing.

Because of his extensive regulatory and PIPEs experience, Ele is a contributing author to *Investment Management, Law and Practice*, published by Oxford University Press, and *PIPEs: A Guide to Private Investments in Public Equity*, published by Bloomberg Press, which is a leading treatise in the PIPEs arena. He also co-authored the "Private Investments in Public Equity Securities ('PIPEs')" chapter in the *Insider Trading Law and Compliance Answer Book*, to be published this year by the Practising Law Institute. In addition, he has become a leading source for business journalists and business news organizations, and a much sought-after speaker by sponsors of PIPEs, SPACs and regulatory conferences. Ele served as moderator at DealFlow Media's 2011 PIPEs Conference and presented at the 10<sup>th</sup> China Venture Capital and Private Equity Forum in Shenzhen, China, DealFlow Media's International PIPEs Conferences in Shanghai and Hong Kong, FRA's Annual Industry Summits on PIPEs and guest-lectured at Yale Law School's Chirelstein Colloquium on Contemporary Issues in Law and Business.

Listed in *New York Super Lawyers*, Ele received his J.D. from Yale Law School, where he was senior editor of *The Yale Law Journal*, and his B.S., *summa cum laude*, from Brooklyn College.

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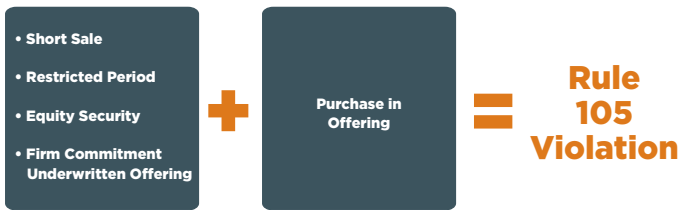


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### **2. PowerPoint Presentation**

## What is Rule 105?



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## Active Enforcement Environment

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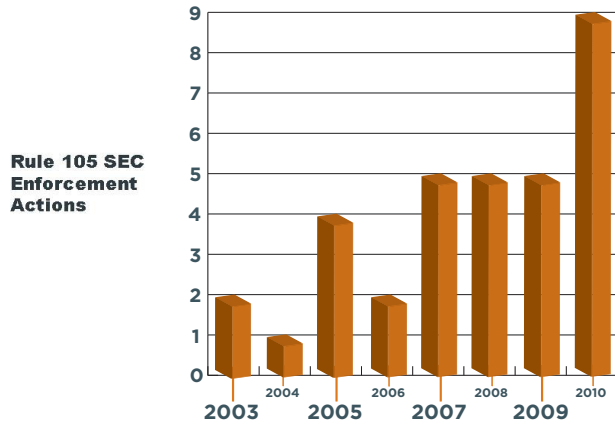
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## Number of Cases 2003-2010



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## 13D Disclosure

**“The SEC accepted our offer to resolve an investigation into four alleged violations of Rule 105. We cooperated immediately and fully with the SEC’s inquiry into this matter and readily agreed to enter into a **cease-and-desist** order requiring us to**

- (a) implement written compliance policies and procedures reasonably designed to prevent violations of Regulation M, review those policies and procedures annually and require the chief compliance officer to administer these policies and procedures;
- (b) pay **disgorgement** and prejudgment interest of \$175,928; and
- (c) pay a civil money **penalty** in the amount of \$169,773.”

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Investment Management Hot Topics

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**Lessons from  
the Cases**

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**Rule 105 Provisions**

- Firm Commitment Underwritten Offering**
- Subject Equity Security**
- Restricted Period**
- Short Sale**

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## Firm Commitment Underwritten Offering

**UNDERWRITING**

Under the terms and subject to the conditions contained in an underwriting agreement dated April 11, 2011, we have agreed to sell to the underwriters named below, for whom Credit Suisse Securities (USA) LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated are acting as representatives, the following respective numbers of Equity Units:

Underwriter	Number of Equity Units
Credit Suisse Securities (USA) LLC	3,400,000
Merrill, Lynch, Pierce, Fenner and Smith Incorporated	3,400,000
Citigroup Global Markets Inc.	1,079,500
J.P. Morgan Securities LLC	1,079,500
UBS Securities LLC	1,079,500
U.S. Bancorp Investments, Inc.	450,000
Hesco Bilhao Viçayay Argemiera, S.A.	586,500

The underwriting agreement provides that the underwriters are obligated to purchase all the Equity Units in the offering if any are purchased other than those Equity Units covered by the over-allotment option described below. The underwriting agreement also provides that if an underwriter declines to purchase its commitment to purchase additional shares that are not covered by the offering, the offering may be terminated.

We have granted to the underwriters a 13-day option to purchase on a pro rata basis up to 2,550,000 additional Equity Units from us at the initial public offering price less the underwriting discounts and commissions. The option may be exercised only to cover any over-allotments of Equity Units.

**“The underwriting agreement provides that the underwriters are obligated to purchase all the Equity Units in the offering if any are purchased...”**

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## Best Efforts Underwriting

**UNDERWRITING**

Midwest Partners & Co., LLC (“Midwest”) has agreed, subject to the terms and conditions of the underwriting agreement among the Company and Midwest as representative of the several underwriters, to act as the sales agent of the Company for the sale of shares offered pursuant to this prospectus at the public offering price of \$6.00, less the underwriting discount set forth on the cover page of this prospectus.

The underwriters have made no commitment to purchase all or any part of the shares of common stock offered pursuant to this prospectus but have agreed to use their best efforts to sell the Minimum Offering of 1,166,667 shares of common stock and the Maximum Offering of 1,333,334 shares of common stock within ninety days of the date of this prospectus, subject to an extension at the underwriters’ option for an additional ninety day period.

**“The underwriters have made no commitment to purchase all or any part of the shares of common stock offered pursuant to this prospectus but have agreed to use their best efforts to sell the Minimum Offering of 1,166,667 shares of common stock and the Maximum Offering of 1,333,334 shares of common stock within ninety days of the date of this prospectus, subject to an extension at the underwriters’ option for an additional ninety day period.”**

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Investment Management Hot Topics

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**Subject Equity Security**

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**Global Offerings and Short Sales Abroad**

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SchulteRothZabel Investment Management Hot Topics

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### Basic 5-day Restricted Period

## APRIL 2011

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
					1	2
3	4	5	6	7	8	9
10	11	12	13	14 SS	15	16
17	18	19	20	21 Pricing After Close	22	23
24	25	26	27	28	29	30

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Investment Management Hot Topics

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### Holiday

## APRIL 2011

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20 SS	21	22 Good Friday	23
24	25	26	27	28 Pricing After Close	29	30

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Investment Management Hot Topics

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## Registration Statement

# APRIL 2011

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21 SS	22 Good Friday	23
24	25 SS	26 Registration Statement Filed After Close SS	27	28 Pricing After Close	29	30

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Investment Management Hot Topics

## Notes:

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## Date of Filings

SEC Home | Search the Full Database | EDGAR System | Company Search | Current Page

**PFL Corp (PFL) 333-158200 (last of company filings)**

SEC ID: ELECTRIC SERVICES  
 File Number: 333-158200-001  
 Primary FPL: 90249923 INC (Filing Image 2000-02-01)  
 Secondary FPL: 90249923 INC (Filing Image 2000-02-01)

File Results:    Filing Type:    Filed On: (YYYYMMDD)    Ownership:    Limit Results Per Page: (100)    (Reset)    (Show All)

Filing	Formal	Description	Filing Date	Filing Number
10-Q	Quarterly report (Sections 13 or 15)	Form: 00002224-11-00001 (24) Act Size: 34 MB	2011-05-08	333-158200
DEF14A	Annual report of proxy materials and Rule 144(c) material	Form: 00000124-11-00003 (24) Act Size: 28 KB	2011-05-05	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00005 (24) Act Size: 3 MB	2011-05-05	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00004 (24) Act Size: 300 KB	2011-05-02	333-158200
CRD19B	Prepack/Notification by the New York Stock Exchange regarding securities for listing	Form: 00009920-11-00003 (24) Act Size: 1 KB	2011-04-28	333-158200
DEF14A	Annual report of proxy materials and Rule 144(c) material	Form: 00002224-11-00002 (24) Act Size: 23 KB	2011-04-28	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00001 (24) Act Size: 619 KB	2011-04-21	333-158200
PA12B	Registration of securities (Section 12(b))	Form: 00002224-11-00003 (24) Act Size: 17 KB	2011-04-21	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00002 (24) Act Size: 416 KB	2011-04-18	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00001 (24) Act Size: 1 MB	2011-04-13	333-158200
A-K	Current report (Form 8-K) (File 8-K)	Form: 00002224-11-00000 (24) Act Size: 488 KB	2011-04-13	333-158200
A-K	Prospectus (Form 333)	Form: 00002224-11-00000 (24) Act Size: 1 MB	2011-04-13	333-158200

**424B5**      **Prospectus**      **2011-04-13**      **CLICK HERE 333-158200**

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Investment Management Hot Topics

## Notes:

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## Definition of Short Sales

- **What are short sales?**

- Any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller
- A person shall be deemed to own securities only to the extent that he has a net long position in such securities

**Example:**

- Long position – 50 shares  
Short position – 50 shares
- In this case, *any* sale of shares will be considered a short sale

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Investment Management Hot Topics

**Notes:**

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## Exceptions

- **Bona fide purchase**
- **Separate accounts**

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Investment Management Hot Topics

**Notes:**

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## Bona Fide Purchase

### APRIL 2011

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21 SS	22 Good Friday	23
24	25 SS	26 SS	27 B	28 Pricing After Close	29	30

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Investment Management Hot Topics

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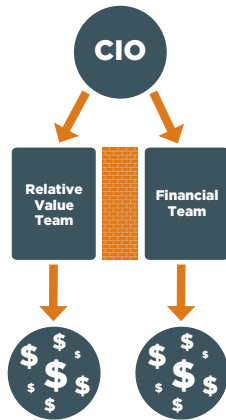
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## Separate Accounts Exception



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**Compliance**

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Investment Management Hot Topics

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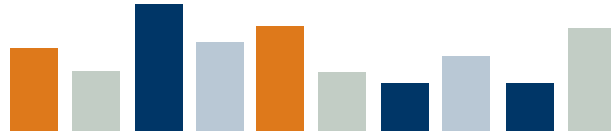
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# Investment Management Hot Topics

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## 3. Outline

## Complying with Rule 105

Harry S. Davis, Ida Wurzinger Draim, Marc E. Elovitz, Eleazer Klein,  
Adriana Schwartz and Megan Hayes Whittaker

### I. Introduction

#### A. Generally: What is Rule 105?

1. Rule 105 makes it unlawful for any person to “sell short” during the “Rule 105 restricted period” an equity security that is being offered for cash pursuant to a registration statement in a firm commitment underwritten offering and purchase the offered securities

### II. Why is Rule 105 significant for your firm? Why does preparation matter?

- A. Rule 105 settlements rose sharply in 2010
- B. Rule 105 is a prophylactic rule, and therefore, 105 actions are easy to bring — once you show a violation, you are done. There is no requirement of any knowledge, let alone scienter
- C. Rule 105 is not intended to catch only systematic “scams” — even a single violation can lead to charges against your firm
- D. Charges can be brought for even trivial amounts, but penalties can constitute a significant percentage of the overall disgorgement
- E. Rule 105 violations are also subject to various reporting requirements (e.g. 13D, ADV)
- F. Rule 105 violations fall under the category of “market manipulation” and can also lead to censure, suspension or a lifetime ban of being associated with an investment advisor or broker-dealer, all of which can cause investor concern and affect your ability to keep and/or raise capital for your funds

### III. What you need to understand about Rule 105 in order to avoid a Rule 105 violation: A checklist of Rule 105 provisions

- A. What types of offerings does Rule 105 apply to? Firm commitment underwritten offerings of equity securities:
  1. How do you distinguish between a firm commitment offering and best efforts offering?
    - Firm commitment underwritten offering: One or more investment banks agree to act as an underwriter and are thereby obligated to purchase a fixed number of securities from the issuer, which they resell to the public
    - Best efforts offering: An investment bank agrees to act as placement agent to do its best to sell the offering to the public but does not buy the securities from the issuer and does not guarantee that it will sell any amount of the securities
  2. What is the subject equity security?
    - Rule 105 only applies to equity securities
    - An offering on non-convertible debt would not fall under the rule. An offering of convertible debt would fall under the rule as convertible debt is itself an equity security. However, the rule prohibits only the selling short of the “security that is the subject” of the offering, therefore a short sale of the underlying common stock would not prohibit participation in an offering of the convertible debt. But be careful, the anti-fraud and anti-manipulation provisions of the federal securities laws still apply

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- Options and other derivatives are not considered equity securities under the rule. However, again, the SEC has made clear that the anti-fraud and anti-manipulation provisions of the federal securities laws still apply in this context
3. Global offerings and short sales abroad
    - A person cannot participate in an offering in the United States if they sold the subject securities short on a foreign exchange during the Rule 105 restricted period. Rule 105 also applies to multinational offerings of securities occurring in part in the United States, and the rule applies to all distribution participants and their affiliated purchasers, wherever they are located or effect transactions
    - In an entirely foreign distribution of a security that has no market in the United States, but whose reference security does have a market in the United States, the foreign distribution is not subject to Regulation M. For example, Rule 105 does not prohibit a short sale of common stock during the Rule 105 restricted period and participation in an offering for ADRs because they are not the same subject security. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws apply to any transaction effected in the United States. Be especially careful here because the ADR can essentially be seen as a re-packaging of the common stock
- B. Rule 105 Restricted Period — the shorter of the period (i) beginning five business days before the pricing of the offered securities and ending at pricing; and (ii) beginning at the initial filing of the registration statement and ending at pricing
1. How do you calculate the five business day period?
    - “Business day” refers to a 24-hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market. If pricing occurs after the principal market closes, then the day of pricing is included in the 5 business day period. For example, if pricing occurs on a Thursday after the principal market closes, then the restricted period would begin at the close of trading on the previous Thursday and end at pricing on the following Thursday
    - Problems with holidays: If the principal market is closed for a holiday, then such date will not count as a business day within the five business day period
  2. How do you calculate the period beginning from the initial filing of the registration statement?
    - Start with the issuer’s initial filing of a registration statement for secondary offerings. Oftentimes this is done well in advance (sometimes years) before the secondary at hand. But sometimes it is done by WKSIs (because they can file an automatic shelf registration statement) right before the offering, in which case, this period may be shorter than the five business day period
    - A prospectus supplement containing the specific information with respect to the offering might be filed right before the offering. This is not the initial registration statement
- C. What is a short sale? Definition under § 200(a) of Regulation SHO
1. “The term short sale shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller”
    - When does a person own a security?
      - (i) The person has title to it
      - (ii) The person has purchased it pursuant to an unconditional contract, binding on both parties, to purchase it but has not yet received it
      - (iii) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange
      - (iv) The person has an option to purchase it and has exercised the option

- 
- (v) The person holds a security futures contract and received notice that it will be physically settled and is irrevocably bound to receive the underlying security

2. Unexpected situations where you could end up having a short sale:

- You will only be deemed to own a security if you are net long. So, if you have a pre-existing short position and think you are making a sale of your long securities, be careful, you will actually be selling short if you are flat or net short
- If you are party to a call contract where the counterparty can force you to sell and you don't already own the underlying security, an exercise by the counterparty can cause you to have a short sale
- A pre-existing short position can be increased by your broker to the extent stock dividends are issued by the issuer and the party you have borrowed from has the right to receive those dividends. It isn't clear whether the SEC would consider such an increase in your short position to be an actual short sale
- The movement of a short position from one fund to another as part of an internal rebalancing could be deemed to be a short sale, but it isn't clear if the SEC could consider such a transaction to be an actual short sale

D. Exceptions to Rule 105

1. Bona fide purchases

- Even if a person has shorted during the Rule 105 restricted period, they can still participate in the offering if they have a "bona fide purchase" of the subject security:
  - (i) A purchase of, or purchases that total to, a number of securities at least equal to the number of securities shorted during the restricted period
  - (ii) During regular trading hours
  - (iii) That is reported
  - (iv) Effected after all short sales that occurred during the Rule 105 restricted period (all purchases must be after the last short sale to count!) and no later than the business day prior to the day of pricing. For example, if pricing occurs on Wednesday after the close of regular trading, the bona fide purchase could not be made during regular trading on Wednesday, it would have had to be made during regular trading on Tuesday
- A person relying on the bona fide purchase exception cannot have effected a short sale within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing. Continuing with the example above, the person could not have shorted in the last half hour of trading on Tuesday

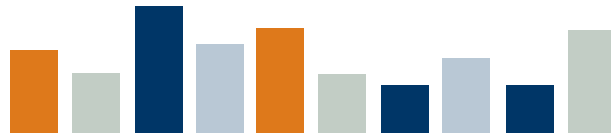
2. Separate accounts: A person is not prohibited from purchasing the offered securities if the person sold short during the Rule 105 restricted period in a separate account. What is a separate account?

- Accounts that operate without coordination of trading or cooperation. The accounts should have separate and distinct investment and trading strategies and objectives; personnel for each account do not coordinate trading among or between the accounts; information barriers should be in place so investment decisions are not shared between accounts; accounts should maintain separate profit and loss statements, no allocation of securities between or among accounts and persons with oversight over the accounts do not have authority to execute trades or pre-approve trading decisions and do not in fact do so
- Similar to Regulation SHO's independent trading unit exception, but it is available to anyone, not just broker-dealers
- An advisor that operates a black box using a trading algorithm will have separate accounts if the black box is separate from another black box or another trading unit

- 
- The SEC has denied the “separate accounts” exception, even though there was two separate accounts with different strategies and portfolio managers, where information about securities positions and investment decisions was available to all of the firm’s employees and sometimes communicated between strategies, the chief investment officer exercised oversight over the firm’s multiple strategies and influenced trading decisions within the strategies, and the firm did not prohibit its personnel from coordinating trading between or among strategies
- E. Compliance: How do you ensure that you are not facilitating violations?
1. There needs to be a robust compliance policy in place, discrete from a general anti-manipulation policy
  2. Portfolio managers, analysts and traders should have training regarding Rule 105
  3. Policies and procedures should provide for pre-clearance of all secondary offering allocation requests. At a minimum, pre-clearance should entail:
    - A determination whether the secondary offering is within the scope of Rule 105
    - If so, the delineation of the “restricted period” for purposes of Rule 105
    - The identification of any short sales in the subject security during the restricted period
  4. If the separate accounts exemption is being relied upon, both training and policies and procedures should focus upon adherence to the above-mentioned conditions for the exemption
  5. Consider conducting a quarterly review of selected secondary offering allocations and Rule 105 compliance as a means of back-testing the efficacy of your Rule 105 procedures



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## **Investment Management Hot Topics**

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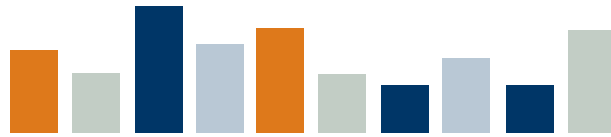
### **4. Rule 105 of Regulation M**

# Rule 105 of Regulation M

## § 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 1-A (§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 §242.200(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 1-A or Form 1-E and ending with the pricing.
- b. *Excepted 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.
- c. *Excepted offerings.* This section shall not apply to offerings that are not conducted on a firm commitment basis.
- d. *Exemptive authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

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## **Investment Management Hot Topics**

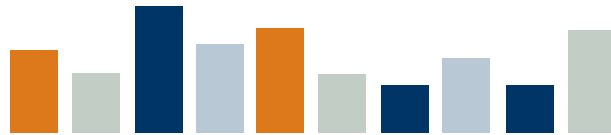
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### **5. Rule 105 Enforcement Actions**

CASE	DATE	NUMBER OF ALLEGED VIOLATIONS	DISGORGEMENT	PENALTY (% OF DISGORGEMENT)	PREJUDGMENT INTEREST
<b>Aristeia</b>	5/2/11	4	\$1,221,571	\$400,000 (33%)	\$141,205
<b>Horseman Capital</b>	1/24/11	1	\$1,295,138	\$65,000 (5%)	\$124,814
<b>Gartmore</b>	12/8/10	1	\$928,117.83	\$375,000 (40%)	\$44,134.68
<b>New Castle</b>	11/22/10	2	\$183,084	\$100,000 (55%)	\$9,980
<b>Carlson</b>	9/23/10	4	\$2,256,386	\$260,000 (12%)	\$136,848
<b>Appaloosa</b>	7/2/10	1	\$842,500	\$421,250 (50%)	\$40,733
<b>Adams</b>	5/11/10	94	\$331,387	\$165,693 (50%)	\$16,613
<b>Grabler</b>	5/11/10	119	\$636,123	\$318,061 (50%)	\$35,232
<b>GPS Partners</b>	3/16/10	6	\$1,151,271	\$575,635 (50%)	\$132,900
<b>AGB Partners</b>	1/26/10	2	\$38,444	\$20,000 (52%)	\$2,921
<b>Palmyra</b>	1/26/10	1	\$225,500	\$105,000 (47%)	\$10,901.58
<b>First New York Securities</b>	10/29/09	2	\$39,544.35	\$20,000 (51%)	\$9,464.37
<b>Perceptive</b>	10/20/09	5	\$245,902.34	\$125,000 (51%)	\$68,852.92
<b>Liongate Capital</b>	10/16/09	14	\$100,000	\$50,000 (50%)	Unspecified
<b>Colonial Investment Management</b>	7/7/09	18	\$1,478,036.76	\$450,000 (30%)	Interest at IRS underpayment rate
<b>Diamondback</b>	2/20/09	4	\$94,014	\$47,000 (50%)	\$21,154
<b>Victoire Finance Capital</b>	9/29/08	18	\$168,139.50	\$85,000 (51%)	\$47,491.53
<b>Sirios Capital</b>	9/4/08	2	\$198,069	\$50,000 (25%)	\$38,989.69

CASE	DATE	NUMBER OF ALLEGED VIOLATIONS	DISGORGEMENT	PENALTY (% OF DISGORGEMENT)	PREJUDGMENT INTEREST
<b>Moon Capital</b>	9/15/08	1	\$88,100	\$30,000 (34%)	\$20,971.67
<b>DKR Oasis</b>	6/12/08	1	\$185,000	\$60,000 (32%)	\$37,413.06
<b>Quogue Capital</b>	5/8/08	4	\$782,902	\$390,000 (50%)	\$161,154
<b>Armstrong</b>	11/8/07	57	\$1,263,000	\$325,000 (26%)	\$207,000
<b>Swiss Re Financial Products Corp</b>	9/18/07	13	\$380,517	\$0 (0%)	\$77,088
<b>GLG Partners</b>	6/6/07	14	\$2,214,180	\$500,000 (23%)	\$489,455.94
<b>Amaranth</b>	5/9/07	5	\$507,627	\$150,000 (30%)	\$59,192
<b>Imperium Advisors</b>	3/15/07	3	\$75,192	\$37,596 (50%)	\$7,176
<b>Solar Group</b>	11/6/06	176	\$1,100,000	\$500,000 (46%)	Not specified
<b>Graycort Financial</b>	9/28/06	5	\$105,465	\$100,000 (95%)	Not specified
<b>Compania Internacional Financiera</b>	12/19/05	85	\$4,776,786.89	\$1,400,000 (30%)	Not specified
<b>Galleon Management</b>	5/19/05	17	\$1,040,882	\$870,247 (84%)	\$109,321
<b>Oaktree Capital</b>	5/19/05	4	\$169,773	\$169,773 (100%)	\$6,155
<b>Deutsche Bank Investment Managers</b>	5/19/05	3	\$15,585	\$15,585 (100%)	\$1,989
<b>JC Management</b>	7/7/04	1	\$25,788	\$0 (0%)	\$2,203.94
<b>Ascend Capital</b>	7/17/03	3	\$19,033.50	\$25,000 (131%)	\$2,252
<b>Weitz &amp; Altman</b>	4/30/03	15	\$511,367.39	\$255,683.70 (50%)	Not specified

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## **Investment Management Hot Topics**

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### **6. Frequently Asked Questions About Regulation M**



## U.S. Securities and Exchange Commission

### Frequently Asked Questions About Regulation M

#### Division of Market Regulation: Staff Legal Bulletin No. 9

Revised September 10, 2010

**Action:** Publication of Division of Market Regulation Staff Legal Bulletin.

**Date:** October 27, 1999.

**Summary:** This staff legal bulletin sets forth the views of the Division of Market Regulation in response to questions raised about various provisions of Regulation M.

**Supplementary Information:** The statements in this legal bulletin represent the views of the staff of the Division of Market Regulation. This legal bulletin is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). Further, the Commission has neither approved nor disapproved its content.

**Contact Persons:** For further information, please contact the Office of Trading Practices, Division of Trading and Markets, at (202) 551-5720.

#### I. Introduction

Regulation M was adopted by the Commission on December 10, 1996 and was accompanied by an adopting release (See Securities Exchange Act [Release No. 38067](#) (December 20, 1996), 62 FR 520 ("Adopting Release")); the Adopting Release may also be found on the Commission's Internet website (<http://www.sec.gov>). Regulation M became effective on March 4, 1997.

Regulation M replaced Exchange Act Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 with a set of six new rules. Rule 100 is a definitional rule. Rule 101 covers the activities of underwriters, broker-dealers, and others participating in a distribution. Rule 102 governs the activities of issuers and selling security holders. Rule 103 pertains to Nasdaq passive market making. Rule 104 governs stabilization transactions and certain post-offering activities by the underwriters, and Rule 105 governs short selling in anticipation of a public offering.

The following questions and answers regarding Regulation M have been compiled by the staff of the Division of Market Regulation to assist in the understanding and application of this regulation. The questions and answers do not necessarily contain a discussion of all the material considerations necessary to reach the conclusions stated. Therefore, these questions and answers are intended to provide general guidance, but do not constitute formal interpretations of Regulation M. Further, facts and circumstances of particular offerings may differ, and the staff notes that even slight variations may require different responses. The Commission is not bound by these statements and may interpret Regulation M in any manner that it deems necessary or appropriate in the public interest or for the protection of investors.

These questions and answers are premised on several important assumptions. First,

the discussions assume familiarity with Regulation M and the Adopting Release. The responses are a complement to, and not a substitute for, these sources. Second, the terms have the meanings as defined in Rule 100 or elsewhere in Regulation M.

The Division of Market Regulation will update these questions and answers periodically. In each update, the questions added after publication of the last version will be marked with "**NEW!**".

## Order of Contents

- 
- ▶ [Rule 100](#)
  - ▶ [Rule 101](#)
  - ▶ [Rule 102](#)
  - ▶ [Rule 103](#)
  - ▶ [Rule 104](#)
  - ▶ [Rule 105](#)
  - ▶ [Miscellaneous](#)
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## II. Questions and Answers

### Rule 100

#### Affiliated Purchasers

**Q:** Are affiliated purchasers of the issuer, a selling security holder, or of a distribution participant permitted to purchase the issuer's securities that are being distributed?

**A:** Yes. The definition of "completion of participation in a distribution" clarifies that affiliated purchasers of an issuer, a selling security holder, or of a distribution participant may purchase in the distribution, provided that the securities are acquired for investment purposes. However, consideration may need to be given to other requirements, depending on the nature of the offering or the extent of purchases. For example, disclosure in the registration statement may be necessary, if information regarding such purchases would be material to investors' decision to buy in the offering. Also, affiliated purchasers must comply with the requirements under Exchange Act Rule 10b-9 if applicable to the offering and the Free-Riding and Withholding Interpretation, IM-2110-1 (Interpretation) contained in National Association of Securities Dealers, Inc. ("NASD") Conduct Rule 2110, if the offering involves a "hot issue."

**Q:** A broker-dealer is an affiliate of an issuer (or selling security holder) and it is a distribution participant in a distribution of the issuer's securities. The securities qualify for the actively-traded securities exception under Rule 101. Under Regulation M, does Rule 101 or Rule 102 apply to the broker-dealer?

**A:** Rule 101 applies. Note, however, that a distribution participant that is an affiliate of the issuer may not rely on the actively-traded securities exception of Rule 101. Of course, if the broker-dealer engages in stabilization activity, Rule 104 applies also.

**Q:** An acquiror and a target company have signed a merger agreement. Would the target be an "affiliated purchaser" of the acquiror?

**A:** Yes. The restrictions of Rule 102 apply to the target company with respect to purchases of the acquiror's securities.



## Business Day

**Q:** At what point in the day does a restricted period start?

**A:** "Business day" refers to the 24 hour period based on the principal market for the securities to be distributed, and includes a complete trading session 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 at the close of trading in the principal market on Monday. If, however, pricing occurs prior to the close of trading on Tuesday, the restricted period would then begin prior to the opening of trading in the principal market on Monday, because the restricted period requires a full trading day.

## Completion of Participation in a Distribution

**Q:** When is an underwriter's participation in a distribution completed? Furthermore, when is the participation in a distribution completed for a selling group member that is not part of the underwriting syndicate?

**A:** Generally, each syndicate member's participation in a distribution is completed when all of the shares in the offering have been distributed and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. For a selling group member that is not part of the underwriting syndicate, its participation in a distribution is completed when the selling group member has sold its entire allotment.

**Q:** If the managing underwriter of a distribution intends to exercise an overallotment option granted in connection with the offering, when is the distribution considered completed?

**A:** A syndicate member's participation in the distribution is completed when all of the securities have been distributed and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. A later exercise of an overallotment option does not affect the "termination" of the distribution, unless it is exercised for an amount exceeding the syndicate short position at the time of exercise. In this case, the distribution would be deemed to continue until the time that all the excess shares were sold. If the syndicate agreement is terminated before all of the shares have been sold, a syndicate member's participation would be completed once its remaining shares are distributed and its financial interests in the offering are terminated.

## Distribution

**Q:** Does the existence of outstanding exercisable warrants place an issuer in distribution? If not in distribution now, would the issuer be in distribution just before the warrants expire if it anticipates that a large number of warrants will be exercised before their expiration? Similarly, does the existence of outstanding convertible securities that can be converted into an issuer's common stock cause the issuer to be deemed in distribution of its common stock?

**A:** No. Neither the existence of exercisable warrants (or convertible securities) nor the approaching expiration date of such securities alone would cause the issuer to be deemed in distribution. However, a distribution could be present if special selling efforts, such as the solicitation to exercise the warrants or the payment of a soliciting dealer's fee, are used to encourage the exercise of the securities.

**Q:** Can a private placement of securities be a distribution under Regulation M?

**A:** Yes, if the offering satisfies the "magnitude" and "special selling efforts and selling methods" criteria of the definition of distribution.

#### Distribution Participant

**Q:** Rule 101 applies to distribution participants and their affiliated purchasers. The definition of a distribution participant includes any "other person who has agreed to participate or is participating in a distribution." Can an issuer or a selling security holder ever fit within the definition of a distribution participant?

**A:** No. Issuers and selling security holders are always subject to the provisions of Rule 102.

**Q:** Is a broker-dealer considered a distribution participant if its sole responsibility with respect to a call for redemption of warrants is to send notices to warrant holders of the call for redemption and it receives a fixed fee for its services?

**A:** No. If the broker-dealer performs only ministerial duties and receives a fixed fee consistent with its limited role (*i.e.*, its compensation is not based on the success of the offering and is a customary amount), it will not be deemed a distribution participant.

#### Reference Security

**Q:** In an exchange offer, the market price of the target's securities will be used as a factor in determining the exchange ratio for the offer. In other words, the relationship between the target's and acquiror's securities is solely a result of an external factor (*i.e.*, the exchange offer terms). Would the target's securities be considered reference securities for the acquiror's securities?

**A:** No. The target's securities would be reference securities only if the relationship between the two securities was a feature of the acquiror's securities themselves.

**Q:** In a distribution in which an issuer will exchange publicly-traded securities for restricted securities, and the publicly-traded and restricted securities are otherwise identical in all material respects, would Regulation M apply to transactions in the restricted securities?

**A:** Yes. They would be considered the same security.

#### Restricted Period

**Q:** When is the price of an offered security "determined" for purposes of applying the Regulation M restricted period? Is the price determined when the underwriter and issuer orally agree on the price or when the underwriters formally contract to underwrite the offering, which may occur later?

**A:** The determination of the offering price occurs when the parties agree on the price, whether or not the agreement is memorialized in writing.

**Q:** A security in distribution is convertible into an actively-traded security. Is the security in distribution subject to a restricted period under Rule 101?

**A:** Yes. The ADTV value of the subject security determines the restricted period. The ADTV value of a reference security does not affect the restricted period of a subject security.

**Q:** How is ADTV calculated?

**A:** As defined in Rule 100 of Regulation M, ADTV is worldwide average daily trading volume as measured during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement. If the offering is made without a registration statement or involves the sale of securities on a delayed basis pursuant to §230.415, ADTV would be measured during the two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price.

**Q:** A security in distribution is an actively-traded security and thus excepted from Rule 101. It is convertible into a security (a reference security) that is not an actively-traded security. Is the reference security subject to a restricted period under Rule 101?

**A:** No. The restricted period for a reference security is never greater than that of the subject security.

**Q:** When does the restricted period for a distribution through a call for redemption of "in-the-money" convertibles or exercisable securities commence?

**A:** The restricted period commences upon mailing of the notice and continues through the end of the period in which the security holders can decide whether to convert.

**Q:** What is the restricted period for a security to be distributed through a merger or an exchange offer? If the valuation period extends after the vote, how does this affect the restricted period?

**A:** The restricted period begins on the day of mailing the proxy solicitation materials and continues through the end of the period in which the target shareholders can vote on the merger or exchange. The restricted period includes the valuation period as well. For instance, if the valuation period occurs outside of the proxy solicitation period, an additional restricted period would commence one or five business days prior to the commencement of the valuation period and continue until the valuation period ends.

**Q:** In a merger, is the restricted period based on both the target company's and acquiror company's shareholder votes?

**A:** No. The restricted period is based solely on the target company's shareholder vote.

**Q:** What is the restricted period for a security to be distributed in connection with the acquisition of a privately held company when the shareholders will not be solicited through proxies?

**A:** The day most comparable to the day of mailing the proxy solicitation materials is the day the target security holders are first asked to commit to the transaction, which would be the day the acquiror sends a definitive acquisition agreement to the target security holders for their execution. The restricted period would commence on the earlier of one (or five) business day(s) prior to (i) the time the acquiror furnishes the definitive acquisition agreement for execution to the security holders of the privately held target company or (ii) the commencement of the valuation period. The restricted period would continue until the later of (i) execution of the definitive acquisition agreement or (ii) the end of the valuation period.

**Q:** If an issuer purchases its securities before the Regulation M restricted period begins for the security in distribution, may the settlement of this trade occur during the restricted period without violating Regulation M?

**A:** Yes. The settlement may occur during the restricted period as long as the trade occurred outside the restricted period.

**Q:** Rule 100 of Regulation M states that in the case of a merger, acquisition or exchange offer, a restricted period commences on the day proxy solicitations or offering materials are first disseminated to security holders. Is a restricted period triggered when a third party solicits proxies in opposition to a proposed merger on the basis of its proposed alternative to exchange its stock for the target company stock (alternative stock transaction)?

**A:** In some cases, the answer is yes. "Distribution" is defined in Rule 100 as an "offering of securities . . . that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts." The application of Regulation M to the opposition proxy solicitation involves an analysis of the three elements of a distribution: (1) is there an "offering of securities;" (2) does the amount offered satisfy the "magnitude" test; and (3) will "special selling efforts and selling methods" be employed.

For purposes of this question, it is assumed that the alternative stock transaction will satisfy the "magnitude" and "special selling efforts and selling methods" elements because a large quantity of shares will be offered in exchange for the target company, and because of the use of a proxy solicitation.

Where the alternative stock transaction is presented to target shareholders in such specific terms so as to constitute an offering of securities under the Securities Act of 1933 (Securities Act), then the offering element is satisfied. In such circumstances, Securities Act Rules 165 and 425 permit the company presenting the alternative proposal to publicly disclose information about its counteroffer before filing a registration statement.

When an alternative investment transaction is presented to target shareholders at the time they are to vote on the proposed merger and specific details about the proposed alternative are presented so as to invite comparison with the terms of the pending proposed merger, the investment decision (i.e., the vote) necessarily requires shareholders to consider both transactions. Consequently, the company offering the alternative stock transaction has an incentive to manipulate its stock price to facilitate its offering. Therefore, the restricted period with respect to the alternative transaction would commence with the dissemination of materials soliciting proxies against the proposed merger that contained the terms of the proposed alternative.

Example: B solicits the target's shareholders to vote against A's proposed stock merger with the target. In conjunction with B's solicitation against the merger, B states that it intends to propose its own stock merger with the target. B's solicitation against the target's merger with A contains detailed information about B's proposal (such as a fixed exchange ratio and a prospective dividend payout). B's proposal constitutes an offer of securities under the Securities Act and a distribution under Regulation M. The restricted period for B's distribution begins when it sends its proxy solicitation and continues through the vote on A's merger proposal.

B's distribution continues until B's offering is concluded or abandoned. Therefore, B will be in distribution at least until the shareholder vote on B's alternative stock merger proposal or until B's offering is abandoned.

In the staff's view, however, B's restricted period need not be co-extensive with B's distribution period. Instead, it should apply when the target company's shareholders are requested to make an investment decision affected by B's counteroffer and B has an incentive to manipulate the price of its securities. Therefore, after the vote for or against A's merger proposal (and implicitly on B's counter offer), the restricted period for B would terminate. B would have another restricted period if and when it sends out the proxy solicitation for its merger proposal, and this restricted period would end upon that shareholder vote. Note that other restricted periods may apply if the offer involves an election or a valuation period separate from the proxy solicitation periods.

## Rule 101

### Actively-Traded Securities Exception

**Q:** The actively-traded securities exception from Rule 101 requires the public float value of the issuer's "common equity securities" to be at least \$150 million. Are ordinary shares issued by a foreign issuer treated as "common equity securities" for purposes of this calculation?

**A:** Yes. The phrase "common equity securities" includes the equivalent type of stock of a foreign issuer.

**Q:** A distribution participant for an actively-traded Nasdaq security is also a Nasdaq market maker for the security. Can the distribution participant obtain an excused withdrawal from the NASD so that it may temporarily stop making a market in the security in distribution?

**A:** No. The NASD has amended its rules to permit excused withdrawals for Nasdaq market makers if the withdrawal is necessary for the market maker to comply with the restricted period under Rule 101 or with its obligations when it stabilizes the price of a security or acts as a passive market maker. See NASD Notices to Members 97-10 and 98-06 concerning NASD Marketplace Rule 4619. Such excused withdrawals are not applicable to actively-traded securities because these securities are not subject to a restricted period under Rule 101.

**Q:** If a syndicate manager is an affiliate of an issuer, it is subject to Rule 101 and cannot avail itself of the actively-traded securities exception under Rule 101. Are syndicate members (*i.e.*, all syndicate members not affiliated with the issuer) able to avail themselves of the actively-traded securities exception?

**A:** Yes. The non-affiliated syndicate members are subject to Rule 101 and may rely on the actively-traded securities exception.

**Q:** Can debt securities qualify for the actively-traded securities exception?

**A:** As a practical matter, the absence of public information regarding the debt security's trading history generally would prevent reliance on this exception for most debt issues.

### De Minimis Exception

**Q:** Is the ADTV used to calculate the restricted periods the same ADTV used to calculate the 2% de minimis exception?

**A:** Yes.

### Mergers/Exchange Offers

**Q:** Have restrictions on purchases of target company securities by an acquiror during an exchange offer been eliminated?

**A:** Regulation M generally does not apply to purchases of the target security by an acquiror or target during a merger or exchange offer. Purchases of the target stock are restricted, however, where the acquiror's securities have a feature that ties its value directly to the price of the target securities. We also note that Rule 14e-5 under the

Exchange Act generally will prohibit purchases of the target security by the bidder during an exchange offer.

### Unsolicited Purchases Exception

**Q:** If a syndicate member solicits an indication of interest from a client to purchase in a distribution, and the client instead wishes to buy immediately in the market, are the market transactions considered unsolicited?

**A:** No. Any market transactions during the restricted period resulting from the original solicitation would be deemed solicited.

### Rule 102

#### Shelf Offerings

**Q:** A shareholder that has shares registered on a shelf plans to make periodic sales of those shares. Does Rule 102 apply from the time the shares are registered on the shelf until they are all sold?

**A:** No. The shareholder should analyze each takedown off the shelf to determine whether it constitutes a distribution for purposes of Rule 102.

**Q:** Is the method for determining whether a particular sale off of a shelf constitutes a distribution different under Rule 102 from that under Rule 101?

**A:** No. The distribution analysis is the same under both Rules 101 and 102: each takedown off the shelf must be analyzed to determine whether it constitutes a distribution. Moreover, when sales off a shelf by an issuer, or by any affiliated purchaser, constitute a distribution of securities, an issuer and all its affiliated purchasers are subject to the applicable restricted period under Rule 102. Similarly, when sales off a shelf by a selling security holder constitute a distribution, all other security holders who are affiliated purchasers of the selling security holder are subject to the applicable restricted period under Rule 102.

#### Concurrent Distributions

**Q:** An issuer conducts different but concurrent distributions of the same securities, such as an offering of its common stock for cash while it is offering its common stock to security holders of another company in connection with a merger or exchange offer. Is the issuer (or distribution participant) permitted to solicit investors to purchase the common stock in the cash distribution without violating Rule 102 (or Rule 101 in the case of a distribution participant) as it applied to the merger or exchange offer distribution, and vice versa, or would selling activity in one distribution be deemed an impermissible inducement to purchase with regard to the other distribution?

**A:** Paragraph (b)(5) of Rule 102 provides an exception for "offers to sell or the solicitation of offers to buy the securities being distributed." Similarly, Rule 101(b)(9) allows distribution participants and their affiliated purchasers to conduct bona fide selling activities in connection with the securities being distributed. However, neither Rule 101(b)(9) nor Rule 102(b)(5) explicitly allows any inducements to purchase otherwise than for offers to sell the securities in a specific distribution. Accordingly, these provisions do not extend to inducements to purchase in one distribution while the issuer or distribution participant is engaged in another distribution of the same security or a reference security. We do not believe, however, that solicitation activity qualifying for the Rule 101(b)(9) and Rule 102(b)(5) exceptions necessarily creates an

impermissible inducement to purchase in a concurrent distribution. Therefore, absent additional factors, bona fide offers to sell or the solicitation of offers to buy the securities being distributed in one distribution would not be impermissible inducements with respect to a concurrent distribution.

For example, Company A conducts an offering of A common stock for cash. At the same time, Company A conducts an exchange offer in which it distributes A common stock and purchases Company B's common stock. Assuming the cash offering and exchange offer are distributions of A's common stock, Company A may solicit offers to purchase the common stock in the cash offering at same time it solicits offers to exchange securities in the exchange offer, and vice versa.

However, a distribution may rise to the level of an impermissible inducement to purchase when a distribution participant engages in sales efforts that go beyond bona fide offers to sell or the solicitation of offers to buy the securities in distribution.

### **Rule 103**

#### **Passive Market Making Conditions**

**Q:** May a passive market maker that, just prior to the beginning of the restricted period, is quoting the highest bid as of the Nasdaq close carry over its bid to the restricted period?

**A:** No. Once a market maker becomes passive, Rule 103 requires that its bids and purchases be no higher than the current highest independent bid. A passive market maker may submit a bid at the same level that it previously was quoting only if the bid is no higher than the current highest independent bid.

#### **Application to Affiliated Purchasers**

**Q:** May a distribution participant (*e.g.*, an underwriter) that is an affiliate of an issuer or selling security holder conduct passive market making in a covered security pursuant to Rule 103?

**A:** Yes. 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.

### **Rule 104**

**Q:** Does Rule 104 apply only to distributions?

**A:** No. Rule 104 applies to all offerings, not just distributions. This means that a person placing a stabilizing bid for an offering not satisfying the definition of "distribution" is nonetheless subject to Rule 104.

**Q:** Is the exercise of the overallotment option considered a syndicate covering transaction?

**A:** No.

**Q:** Does an underwriter stabilizing the price of a security have to comply with Rule 104 even though the securities qualify for the actively-traded securities exception under

Rule 101?

**A:** Yes. Rule 104 does not contain an exception for actively-traded securities.

#### Notification

**Q:** When should notice of penalty bids be submitted to the relevant SRO under Rule 104?

**A:** Notice of penalty bids need only be furnished when the penalty bid will be assessed. If notice of a penalty bid is given at the time of pricing because an agreement among the underwriters contains a penalty bid provision, but the penalty bid is not in fact imposed, an amended notice should be filed to reflect that no assessments were made.

The Commission has granted an exemption from the notification requirement contained in Rule 104(h)(2) for nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that are rated investment grade.

**Q:** A company's debt is listed on an exchange, but a majority of the debt is expected to trade in the over-the-counter market. Where should the company's underwriter give notice of its syndicate covering transactions, as required by Rule 104?

**A:** The underwriter should give notice to the NASD, the self-regulatory organization that has direct oversight authority over the principal market for the security.

#### **Rule 105 — Applicable to pre-Oct. 9, 2007 rule text**

**Q:** If a person has a short position and makes short sales during the five business day period prior to the pricing of a distribution of that security, may it purchase shares in the distribution to cover securities sold short prior to the five day window?

**A:** No. In order to avoid the abuse at which Rule 105 is directed, a person cannot purchase securities in a distribution to cover any short position where it made short sales of the security during the five business days before pricing.

#### **Miscellaneous**

##### Exemption and No-Action Letters

**Q:** Are exemption and no-action letters issued under the former trading practices regulations still valid?

**A:** No. Any recipient or beneficiary of such a letter who believes that the relief granted by a particular letter is still necessary or appropriate under Regulation M should contact the Office of Risk Management and Control at (202) 942-0772.

##### Foreign Distributions

**Q:** Does Regulation M apply to affiliated purchasers located outside the United States?

**A:** Yes.



**Q:** In an entirely foreign distribution of a security that has no market in the United States, but whose reference security does have a market in the United States, is the foreign distribution subject to Regulation M?

**A:** No. However, the general anti-fraud and anti-manipulation provisions of the federal securities laws apply to any transactions effected in the United States.

### Rights Offerings

**Q:** What is meant by the statement that Regulation M deregulates rights offerings?

**A:** There no longer is a separate rule covering rights offerings. Rather, rights offerings will be treated under Regulation M like any other offering. Therefore, if the rights offering involves a distribution, as defined in Rule 100, the applicable restricted period of Rules 101 and 102 applies to bids for or purchases of the security being distributed (*i.e.*, the security acquired through the exercise of the rights) and any reference security. Transactions in the rights themselves are not subject to Rules 101 or 102. However, Rule 104 applies to stabilization transactions in any security, including the rights.

### Exchange Traded Funds **NEW!**

**Q:** Is the Rule 101(c)(4) exception available to permit persons who may be deemed to be participating in a distribution of actively managed exchange traded fund (ETF) shares (Shares) to bid for or purchase such Shares during their participation in a distribution?

**A:** Yes, if the following conditions are met: (i) the Shares are issued by a registered open-end investment company; (ii) the Shares are exchange listed and exchange traded; (iii) the ETF continuously redeems the Shares at net asset value (NAV); (iv) a close alignment between the Shares' secondary market price and the ETF's NAV is expected; (v) on each day the Shares trade, prior to commencement of such trading, the ETF discloses on its website the identities and quantities of the securities and assets held by the ETF which will form the basis of the calculation of the ETF's NAV at the end of such day; (vi) the exchange listing the Shares or other information provider disseminates every 15 seconds throughout the trading day, through the facilities of the Consolidated Tape Association, an amount representing on a per Share basis the sum of the current value of the securities, assets, and cash required to create new Shares (intraday indicative value or IIV); (vii) arbitrageurs are expected to take advantage of price variations between Shares' secondary market price and the ETF's NAV; and (viii) the arbitrage mechanism will be facilitated by the transparency of the ETF's portfolio, the availability of the IIV, the liquidity of the ETF's portfolio securities, the ability to access such securities, and the arbitrageurs' ability to create workable hedges.

**Q:** Does the redemption of creation unit sized aggregations of exchange traded fund shares (Shares) and the receipt of securities in exchange therefor by persons who may be deemed to be participating in a distribution of Shares constitute an "attempt to induce any person to bid for or purchase" a covered security during an applicable restricted period for purposes of Rule 101?

**A:** No, but only if the redemptions are not made for the purpose of creating actual, or apparent, active trading in or raising or otherwise affecting the price of Shares or the securities received in exchange for the Shares redeemed.

**Q:** Is the Rule 102(d)(4) exception available to permit an open-end investment company to redeem actively managed exchange traded fund (ETF) shares (Shares)?

**A:** Yes, if the following conditions are met: (i) the Shares are issued by a registered

open-end investment company; (ii) the Shares are exchange listed and exchange traded; (iii) the ETF continuously redeems the Shares at net asset value (NAV); (iv) a close alignment between the Shares' secondary market price and the ETF's NAV is expected; (v) on each day the Shares trade, prior to commencement of such trading, the ETF discloses on its website the identities and quantities of the securities and assets held by the ETF which will form the basis of the calculation of the ETF's NAV at the end of such day; (vi) the exchange listing the Shares or other information provider disseminates every 15 seconds throughout the trading day, through the facilities of the Consolidated Tape Association, an amount representing on a per Share basis the sum of the current value of the securities, assets, and cash required to create new Shares (intraday indicative value or IIV); (vii) arbitrageurs are expected to take advantage of price variations between Shares' secondary market price and the ETF's NAV; and (viii) the arbitrage mechanism will be facilitated by the transparency of the ETF's portfolio, the availability of the IIV, the liquidity of the ETF's portfolio securities, the ability to access such securities, and the arbitrageurs' ability to create workable hedges.

<http://www.sec.gov/interps/legal/mrslb9.htm>

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