RULE 105 DISGORGEMENT AFTER *LIU*

By Larry E. Bergmann[1]

This article addresses the question of how the Supreme Court's recent decision in Liu v. SEC[2] may affect the ability of the Securities and Exchange Commission to obtain disgorgement in enforcement actions alleging violations of Rule 105 of Regulation M.

A. Background on Rule 105

Rule 105 of Regulation M addresses short selling in advance of a public offering of equity securities.[3] Specifically, it prohibits a person from purchasing securities from an underwriter or other broker-dealer participating in a firm commitment offering of equity securities if the person sold short the security that is the subject of the offering during the "restricted period" specified in the rule, which generally is the five business day period immediately preceding the pricing of the offered security. As discussed below, the current rule was adopted in 2007 and differs significantly from its original incarnation.

B. Disgorgement in Rule 105 Cases prior to *Liu*

1. Scope of disgorgeable "benefits"

In its Enforcement actions, the SEC has taken a very broad view of "benefits" that allegedly resulted from violations of Rule 105. That view is a consequence of the SEC's position that the rule "prohibits [a short seller from] purchasing *any* securities of that issuer in a follow-on and/or secondary offering done on a firm commitment basis."[4] Accordingly, "disgorgeable profits" can exceed the actual realized profits related to restricted period short sales and can include potential (i.e., hypothetical) but unrealized

---

[1] Partner, Murphy & McGonigle, P.C. The analysis and opinions expressed are those of the author and do not necessarily reflect the views of the firm, his colleagues, or clients of the firm. This article is for general information purposes and is not intended to be and should not be taken as legal advice. My thanks to my partners, Stephen Crimmins and Matthew Comstock, for their comments on the draft article.

[2] 591 U.S. __ (2020), https://www.supremecourt.gov/opinions/19pdf/18-1501_8n5a.pdf, 140 S. Ct. 1936,

Liu v SEC - Sup Ct 2020.rtf

("*Liu*") (citations in this article are to the S. Ct. opinion).

[3] 17 CFR 242.105.

[4] SEC v. Siris, (SDNY 2012), https://www.sec.gov/litigation/complaints/2012/comp-pr2012-146-2.pdf (Complaint paragraph 134, emphasis in original). This statement may be overbroad. The rule prohibits the restricted period short seller from purchasing the "offered security" from an underwriter or broker-dealer participating in a firm commitment offering. Purchases by the short seller of other subject securities of the issuer, such as open market purchases, are not prohibited. Moreover, short sales during the restricted period *per se* are not prohibited by Rule 105. The violation occurs when the restricted period short seller purchases shares in a public offering. As discussed below, the SEC seeks disgorgement for "benefits" related to all of a short seller's purchases in a firm commitment offering. For example, if a person sold short 100 shares during the restricted period and purchased 100,000 shares in the offering, the SEC might seek to recover the "benefits" related to the entire purchased quantity. Conversely, where a fund manager sold short 172,405 shares during the restricted period, but purchased only 145,000 shares in the offering, the disgorgement amount was "the difference between [the firm's] proceeds from the first 145,000 shares of short sales and the amount paid for the offering shares …." Gartmore Investment Limited, Release No. 34-63460 (December 8, 2010), https://www.sec.gov/litigation/admin/2010/34-63460.pdf.

"benefits" accruing to the short seller from purchasing shares in the public offering.[5] The SEC achieves that by calculating the "profit" from all shares purchased by the short seller, based on: (1) the price difference between the amount of shares sold short and the equivalent amount of shares purchased in the offering; and (2) the price difference between the amount of shares purchased in the offering in excess of the amount of the short sales (called the "overage" shares) and the market price at the time of the offering.[6] The latter could easily exceed the former.[7]

In at least two settled cases, the SEC went beyond profits and required disgorgement of purported "losses avoided" by a short seller that purchased shares in an offering.[8] In one case, the firm sold short 6,000 shares at $22.67 per share during the restricted period. The firm bought 10,000 offering shares at $22.90. In matching the short sales with the purchases, the firm would have realized a loss. However, the offering was priced at a discount to the market price. The order states that the firm "obtained a discount from the stock's market price and avoided losses of $7,074" on its short sales (apparently the difference between what the firm would have paid to buy stock at the market price to cover the short sales compared with the price that it paid for 6,000 offering shares).[9]

The SEC's disgorgement approach under the current rule, which was adopted in 2007, differs significantly from the recoveries sought under the original rule.[10] There, disgorgement was based on the

---

[5] Contrast the settlement in Appaloosa Management L.P., Release No. 34-62447 (July 2, 2010), https://www.sec.gov/litigation/admin/2010/34-62447.pdf where the order states that the firm did not "cover" its short sales with the purchased offering shares. Nevertheless, the SEC determined that the firm realized "disgorgeable profits" of $842,500 (the difference between its short sale price and the offering price), although the firm sold the shares bought in the offering for a profit of only $53,750. See also, Fontana Capital, LLC, Release No. 34-64839 (July 8, 2011), https://www.sec.gov/litigation/admin/2011/34-64839.pdf (firm did not cover its short sales with offering purchases).

[6] See, e.g., SEC v. Revelation Capital Management Ltd., 14 CV 0645 (SDNY 2014)(Complaint paragraphs 17 & 18), https://www.sec.gov/litigation/complaints/2014/comp22915.pdf.

[7] See, e.g., SEC v. Siris, supra n.4, Complaint paragraphs 134-137 (hedge fund manager purchased 50,000 shares at $9.00 per share in a follow-on offering but sold short only 25,000 shares between $9.91 and $10 per share during the restricted period. The SEC states that the "realized profit" on the shares sold short was $24,247.50, and $73,500 on the "overage" shares (i.e., "shares not sold short during the restricted period but purchased in the offering"). It is unclear how the $73,500 profit was calculated: even if the per share profit were $2 (which is far greater than the profit on any of the shares sold short), that would amount to only $50,000. Even more confusing is the second alleged Rule 105 violation. In that case, the manager bought 180,000 shares at $4.75 per share in a "confidentially marketed" (apparently a shelf take-down) follow-on offering but had sold short only 3,600 shares at $5.68 during the restricted period. The SEC alleged that the realized profit on the 3,600 shares was $3,340.08, and that the profit on the "overage" shares was $26,100. Although the calculated profit on the shares sold short was $0.93 ($5.68 – $4.75) per share, the alleged per share profit on the 176,400 "overage" shares appears to be only $0.15 ($26,100 / 176,400).)

[8] G-2 Trading LLC, Release No. 34-70414 (September 16, 2013), https://www.sec.gov/litigation/admin/2013/34-70414.pdf; Worldwide Capital, Inc., Release No. 34-71653 (March 5, 2014), paragraph III.12.C., https://www.sec.gov/litigation/admin/2014/34-71653.pdf.

[9] G-2 Trading LLC, supra n.8. However, there is no indication that the firm covered its short position with the offering shares. The firm was required to disgorge an additional $4,716 which was the improper "benefit" from purchasing 4,000 shares in the offering at a discount to the market price.

[10] Release No. 34-56206 (August 6, 2007), 72 FR 45094, https://www.govinfo.gov/content/pkg/FR-2007-08-10/pdf/E7-15608.pdf. The original version prohibited a person that had sold short during the restricted period from "covering" the short sale with securities purchased in a public offering. Because of the SEC's concern that traders had sought to evade that rule by various attempts to obfuscate the prohibited "covering" and using

profits realized from the "covering" transactions only.[11] Whereas the original rule was based on a relationship between the short sales and the purchased securities, the present rule operates irrespective of whether the purchased shares are used to "cover" the short sales.[12]

2. Business expenses

Other than the amount paid for offering shares equal to the number of shares sold short, the SEC does not appear to have allowed for deduction of legitimate business expenses related to alleged Rule 105 violations (such as transaction expenses, stock borrowing costs, etc.) in determining a short seller's profit.

3. Joint and several liability

The SEC Rule frequently charges defendants in Rule 105 actions with joint and several liability and obtains judgments on that basis.[13]

4. Pre-judgment interest and penalties

In settling Rule 105 cases, the SEC nearly always requires payment of pre-judgment interest based on the disgorgement amount and imposes a civil money penalty in addition to requiring a disgorgement payment.[14] The SEC generally seeks the same relief in civil injunctive actions.[15]

5. Disposition of disgorgement funds

It appears that in every Rule 105 case, the disgorged funds, pre-judgment interest, and penalty amounts are deposited by the SEC into the Treasury. In other words, no individual persons receive the benefits of the disgorgement funds.

C. The Supreme Court's Decision

Although the Supreme Court ruled in Kokesh v. SEC that a disgorgement order in an SEC enforcement action constitutes a penalty for purposes of the applicable statute of limitations,[16] the Court did not address whether disgorgement can qualify as "equitable relief" under Section 21(d)(5) of the Securities

---

strategies and structures attempting to accomplish the economic equivalent of the activity the rule sought to prevent, the SEC adopted "a bright line demarcation of prohibited conduct consistent with the prophylactic nature of Regulation M." Id., 72 FR at 45098.

[11] See, e.g., Perceptive Advisors LLC, Release No. 34-60843 (October 20, 2009), https://www.sec.gov/litigation/admin/2009/34-60843.pdf.

[12] See, e.g., Appaloosa Management, L.P., supra n.5, where the SEC's order acknowledged that the firm "did not 'cover' its short position … with shares bought in the public offering," and "sold the shares that it purchased in the offering for a profit of $53,750." Nevertheless, based upon the price of the short sales and the price of the shares purchased in the offering, the SEC calculated "disgorgeable profits of $842,500."

[13] See, e.g., SEC Litigation Rel. No. 23281 (June 11, 2015) re SEC v. Raymond Langston III, et al., https://www.sec.gov/litigation/litreleases/2015/lr23281.htm.

[14] See, e.g., SEC Press Rel. No. 2015-239 (October 14, 2015), https://www.sec.gov/news/pressrelease/2015-239.html. In some cases, the amount of the penalty far exceeds the disgorged profits. See, e.g., G-2 Trading, LLC, Release No. 34-72231 (May 22, 2014), https://www.sec.gov/litigation/admin/2014/34-72231.pdf (disgorgement of $841, penalty of $75,000).

[15] SEC v. Revelation Capital Management Ltd., 14 CV 0645 (SDNY 2014)(Complaint paragraph 5), https://www.sec.gov/litigation/complaints/2014/comp22915.pdf.

[16] 581 U.S. __, 137 S. Ct. 1635 (2017) ("*Kokesh*").

Exchange Act of 1934 (“Exchange Act”).[17] In *Liu*, the Court has answered that question in the affirmative, but clarified that traditional equitable principles control disgorgement orders to prevent them from becoming penalties. Specifically, the Court said that disgorgement awards must be directed toward:

1. Depriving wrongdoers of their ill-gotten gains;[18]
2. Restricting the remedy to the wrongdoer’s net profits;[19] and
3. Compensating the victims of the wrongdoer’s actions.[20]

Regarding the scope of the disgorgement remedy, the Court stated:

> Courts may not enter disgorgement awards that exceed the gains “made upon any business or investment, when both the receipts and payments are taken into account.” … [Noting] the general rule that a defendant is entitled to a deduction of all marginal costs incurred in producing the revenues that are the subject to disgorgement.[21]

Regarding the disposition of disgorgement amounts, the court flatly rejected the Government’s argument that “the primary function of depriving wrongdoers of profits is to deny them the fruits of their ill-gotten gains, not to return the funds to victims as a kind of restitution,” stating that “the SEC’s equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains.”[22] In this connection, the Court noted the SEC’s frequent practice of depositing disgorgement recoveries into the United States Treasury rather than distributing the funds to victims of the wrongdoing.[23] The Government argued that depositing the funds in the Treasury was justified where it is “infeasible to distribute the collected funds to investors.”[24] In this regard, the Court stated:

> It is an open question whether, and to what extent, that practice nevertheless satisfies the SEC’s obligation to award relief “for the benefit of investors” and is consistent with the limitations of [Section 21(d)(5)]. The parties have not identified authorities revealing what traditional equitable principles govern when, for instance, the wrongdoer’s profits cannot practically be disbursed to the victims.[25]

Although the issue before the Court in *Liu* was focussed on disgorgement in civil actions brought by the SEC in Federal court pursuant to Section 21(d), it seems clear that the same equitable principles apply to

---

[17] 15 USC 78u(d)(5). That section provides that the SEC may seek, and Federal courts may grant, “any equitable relief that may be appropriate or necessary for the benefit of investors.”
[18] 140 S. Ct. at 1942-1943.
[19] Id. at 1942-1943, 1945-1946, 1949-1950. The Court noted an exception to this principle when “’the entire profit of a business or undertaking’ results from the wrongful activity.” Id. at 1945.
[20] Id. at 1944-1945; 1947-1948.
[21] Id. at 1949-1950 (citations omitted).
[22] Id. at 1948.
[23] Id. at 1947.
[24] Id. at 1948. The Court noted that in the “Dodd-Frank Wall Street Reform and Consumer Protection Act” provides that disgorgement collections may be deposited in a fund at Treasury and used to pay whistleblowers reporting securities fraud and to fund the activities of the Inspector General. Id. at 1947.
[25] Id. at 1948-1949.

SEC administrative proceedings.[26] The Court commented on the SEC's express authority to seek "disgorgement" in administrative actions in cease-and-desist proceedings pursuant to Exchange Act Section 21C(e).[27] The Government argued that Congress had tacitly endorsed the SEC's wider interpretation of the equitable disgorgement remedy, "even if it exceeds the bounds of equity practice."[28] The Court also rejected that interpretation:

> Congress does not enlarge the breadth of an equitable profit-based remedy simply by using the term "disgorgement" in various statutes. … At bottom, even if Congress employed "disgorgement" as a shorthand to cross-reference the relief permitted by [Section 21(d)(5)], it did not silently rewrite the scope of what the SEC could recover in a way that would contravene limitations embedded in the statute. After all, such "statutory reference[s]" to a remedy grounded in equity "must, absent other indication, be deemed to contain the limitations upon its availability that equity typically imposes." … Accordingly, Congress' own use of the term "disgorgement" in assorted statutes did not expand the contours of that term beyond a defendant's net profits – a limit established by longstanding principles of equity.[29]

D. <u>Disgorgement in Rule 105 Cases after *Liu*</u>

Will the principles enunciated in *Liu* affect the "disgorgement" recoveries that the SEC can obtain in enforcement cases alleging violations of Rule 105?[30] The Court commented that, in some historical applications, "[t]he SEC's disgorgement remedy … is in considerable tension with equity practices."[31]

1. "*Ill-gotten* profit."

The fundamental premise for ordering disgorgement is that a person realized "ill-gotten" profit from his securities transactions. "Ill-gotten" implies that the profits resulted from a violation of the law, *i.e.,* there was a "wrongdoer." Rule 105 currently is a relatively straightforward prohibition: if a person sold short during the restricted period, he cannot purchase any shares in a covered offering(absent an exception).[32] The first point to note is that the SEC maintains that Rule 105 is a prophylactic provision and a violation can occur irrespective of the person's intent.[33] Secondly, a person can be charged with a violation of the rule as a result of short sales that occurred even before it was possible to know that the issuer would conduct an offering. This is the so-called "gotcha" situation: an offering could be

---

[26] Id. at 1946-1947. But see Justice Thomas's dissenting opinion, id. at 1954.

[27] Id. at 1946-1947 (citation omitted). See also Exchange Act Section 21B(e) containing the same authority in administrative proceedings.

[28] Id. at 1946.

[29] Id. at 1947.

[30] As discussed above, the same principles likely apply to the equitable remedy of disgorgement in court proceedings and administrative proceedings. It is also assumed that the same principles apply whether a case is resolved in litigation or pursuant to a settlement.

[31] Id. at 1946.

[32] As discussed in n.10 supra, the rule was amended significantly in 2007. Whereas the rule previously prohibited "covering" purchases with offered securities, the SEC interprets the present rule to prohibit a short seller from purchasing any offered securities from an underwriter or broker-dealer participating in a covered offering.

[33] See, e.g., <u>Fontana Capital, LLC</u>, supra n.5, at paragraph III.7, *citing* Release No. 34-56206, 72 FR 45094 ("Rule 105 is prophylactic and prohibits the conduct irrespective of the short seller's intent.") That situation must be distinguished from short sales that are intended to depress the market price on which the offering price will be based; the SEC can pursue that conduct pursuant to a variety of statutory and regulatory provisions.

announced and sold on the same day, but the restricted period may be five business days preceding the date of pricing of the offering.[34] If a person sold short during the restricted period but before the offering was announced and the short seller purchased shares in the offering, a violation of Rule 105 could be alleged.[35] Finally, as a prophylactic provision, the SEC does not need to show that the short sales adversely affected the offering.

Legally, violations of Rule 105 might be alleged upon facts showing a short sale during the restricted period and a subsequent purchase in an offering.[36] But, without more, are all or any gains "ill-gotten" profit from an equitable relief point of view?

2. The disgorgement amount must be limited to ill-gotten *net profits*.

As can be seen from descriptions above of pre-*Liu* SEC cases, the disgorged amounts frequently related to: (1) the difference between the price at which the respondent sold shares short and the price at which the securities were purchased in the offering; and (2) the difference between the market price of the security and the price at which the "overage" shares were purchased in the offering.[37]

Both of these amounts may represent unrealized, theoretical, gains. As discussed above, the original rule focussed on purchases that "covered" the short sales, and so there was a realized profit. But today, even in cases where the SEC acknowledges that the short seller did not use the offering shares to cover its short position, the SEC nevertheless demands disgorgement of the profit that *could have been realized* if the short seller covered its position.[38] The context of the overage shares is even more in tension with the notion that disgorgement must be limited to net profits: unless the short seller sells the overage shares at the current market price upon acquisition, he has no realized profit.

It appears that in no Rule 105 case has the SEC or the courts taken into account the defendant's or respondent's legitimate business expenses in effecting its short sales or offering purchase, except giving credit for the cost of acquiring the offering shares.[39] That practice is in clear tension with the equitable

---

[34] The restricted period may begin fewer than five business days before the pricing of the offering, because it is the *shorter* of the period beginning five business days before pricing, *or* beginning with the *initial filing* of the registration statement or notification on Form 1-A or Form 1-E pertaining to the offering. Rule 105(a).

[35] See, e.g., Appaloosa Management, L.P., supra n.5 (firm sold short in the days before and offering was announced and conducted on the same day). This situation can occur more frequently at present than in the past, because certain issuers can file offering documents with the SEC that become effective upon filing. See, e.g., Rule 462 under the Securities Act of 1933, 17 CFR 230.462.

[36] See the discussion above of the multiple ways that the SEC has used to calculate alleged disgorgeable gains and other "benefits."

[37] The SEC occasionally also collected disgorgement amounts based on "losses avoided." See text at nn.8-9 above.

[38] See, e.g., Fontana Capital, LLC, supra n.5. Where the purchased offering shares are not used to cover the short position, but instead are separately sold into the market at a profit or loss, the hypothetical profit based on the short sales would never be realized. See Appaloosa Management, L.P., supra n.5, paragraphs III.6 & 7 (although the firm did not cover its short position and sold its offering shares in the market at a profit of $53,750, the SEC calculated that the firm had $842,500 "disgorgeable profits.")

[39] In Worldwide Capital, Inc., Release No. 34-71653 (March 5, 2014), https://www.sec.gov/litigation/admin/2014/34-71653.pdf, the SEC required the firm to disgorge the profits that it retained after deducting amounts paid out to traders. See also, "SEC announces largest monetary sanction for Rule 105 short selling violations," SEC Press Rel. No. 2014-43 (March 5, 2014), https://www.sec.gov/news/press-release/2014-43 (noting total settled amount of $7.2 million, including $4.2 million in disgorgement). However,

disgorgement principles in *Liu.*[40] In the context of Rule 105 transactions, net profits would account for legitimate business expenses in addition to the cost of the shares and could include transaction costs, stock borrowing costs, legal costs, and payments to employees, such as traders.[41]

3. The disgorged funds must be applied as "appropriate and necessary for the benefit of investors."

In many Rule 105 contexts it is difficult if not impossible to show that the offering price was in fact influenced by the short sales. Proof of such an effect is not part of the SEC's cause of action; it makes its case simply by showing short sales during the restricted period and purchases in the offering. Nor does the SEC attempt to show what investors were harmed by a Rule 105 violation. But without a showing that the market was adversely affected, can the SEC claim that "investors" were harmed?

What investors might be the victims as a result of a Rule 105 violation? Not other purchasers in the offering: if the short sales had no effect on the offering price, purchasers of the offered shares were not harmed. Even assuming that the short sales lowered the market price on which the offering was priced, other purchasers presumably got their shares cheaper than if the short sales had not been made.

Perhaps issuers can be considered "investors" that are eligible to be recompensed by disgorgement funds. It is possible that the issuer received fewer offering proceeds if the market price had been influenced by the short sales.[42] As noted, however, proof of market impact and investor harm are not elements of a Rule 105 violation. Without proof of harm, it could be said that there are no identifiable investor victims in Rule 105 cases.

If victims cannot be identified or compensated, is it equitable to collect disgorgement and deposit it into the Treasury? In future cases, the SEC can be expected to reprise the Government's position in *Liu* that depositing disgorgement funds into the Treasury is "appropriate and necessary for the benefit of investors" where specific investor victims cannot be identified or where it is otherwise infeasible to distribute the collected funds to investors. The *Liu* Court left those issues for lower courts to consider, but there is some indication in the opinion that diffuse investor benefit is not a proper equitable remedy, because it would mean that extracting disgorgement would simply be depriving the "wrongdoer" of "ill-gotten gains."[43]

---

the SEC also separately charged the traders with violating Rule 105 and collected their "ill-gotten gains" in connection with their settlements. See "SEC charges five traders with short selling violations," SEC Press Rel. No. 2014-131 (July 2, 2014), https://www.sec.gov/news/press-release/2014-131. In other words, the deductions were not made because the SEC viewed the payments to the traders as legitimate business expenses.

[40] The *Liu* Court cited SEC v. Brown, 658 F.3d 858, 861 (CA8 2011), where the court "declin[ed] to deduct even legitimate expenses like payments to innocent third-party employees and vendors" as "inconsistent with the ordinary principles and practice of courts of chancery." 140 S. Ct. at 1950.

[41] To the extent that the disgorgement amount is lower than under the SEC's pre-*Liu* approach, the amount of pre-judgment interest also would be reduced.

[42] The SEC has noted that short sales prior to pricing an offering "*can* exert downward pressure on market prices for reasons other than price discovery that result in lowered offering prices and therefore reduced offering proceeds to issuers and selling shareholders." Release No. 34-56206, 72 FR at 45096 (emphasis added). In other words, the rule does not require any demonstrated impact on market prices resulting from the short sales.

[43] "But the SEC's equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains." 140 S. Ct. at 1948.

E. Concluding thoughts

The equitable principles enunciated in *Liu* can be expected to be raised by proposed defendants and respondents in connection with SEC claims for disgorgement in Rule 105 cases. For example:

a. Are profits "ill-gotten" if they relate to activity that contravenes only a prophylactic, non-intent-based rule?
b. Is it consistent with equitable principles to require disgorgement of unrealized or theoretical profits?
c. What legitimate expenses should be deducted from the ill-gotten profits?
d. Is it appropriate to demand disgorgement if no investor harm can be shown or harmed investors cannot be identified?
e. When is it ever appropriate to collect disgorgement to deposit the funds into the Treasury?
f. What limitations period applies to such equitable disgorgement claims?

If a disgorgement order does not satisfy the *Liu* equity principles, then essentially it would be a penalty. That would bring the SEC full circle to *Kokesh*: if extracting disgorgement is not a proper equitable remedy, then the SEC must comply with the requirements for imposing a penalty. But if such disgorgement claims would be deemed penalties, might the SEC forego those claims and in lieu (one might say ex-*Liu*) seek to increase the amount of civil penalties pursuant to Sections 21(d)(3)(B) and 21B(a)(2) and (b), or seek a combination of *Liu* disgorgement and penalties?