

# The Long and Short of It

**SEC-regulated entities can learn some lessons from the Reddit-linked short-squeeze and its fallout.**

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In January 2021, commentary by members of the social news aggregator Reddit may have contributed to unprecedented trading activity that led some online brokerages to freeze trading of certain securities for a prolonged window of time. The unforeseen freeze angered traders, lawmakers and regulators. All of this culminated in a hearing conducted by the House Financial Services Committee in February.

While much of this hearing focused on the internet's influence in January's trading events and the decision of brokerages to suspend trading, private equity managers should take notice of the heightened scrutiny lawmakers and regulators have placed on the securities market, the owners of the securities and the roles assumed by managers. Regulators will conduct their own diligence (whether through reviewing public company filings or scouring interviews of market players) looking for connections to PE managers in board seats, stock positions and underlying holdings all while looking for signs of market anomalies.

For private equity shops that hold publicly traded securities exposure, this may lead to a period of heightened exposure or regulatory scrutiny. At this time, an exam priority has not emerged from the US Securities and Exchange Commission Staff, as the fallout from January's unprecedented trading activities is currently unfolding. However, it is hard to imagine that areas such as trading policies, blacklists, grey lists and internal compliance procedures regarding checking and verifying of trades and pre-clearance will not be hot topics. In addition, social media procedures and protocols, along with reviewing the presence of a private equity shop (or their affiliated persons) on one or more social news aggregators, will likely be reviewed.

Private equity shops may hold publicly traded securities from time to time. An obvious example is where a PE fund under a de minimis exemption in its governing documents purchases public company securities. A less obvious example is where a PE fund receives publicly traded stock in an exit transaction. A PE fund may receive publicly traded securities as consideration when one of its portfolio companies is sold to a public company or when one of its portfolio companies is taken public in an IPO. In both instances, it is possible for the GP to receive a portion of its carry with an in-kind distribution of publicly traded stock. Depending on the level of ownership, PE managers

and funds may be required to disclose their public company holdings in public filings with the SEC. As a result, they may find themselves under the SEC's radar.

## **Market Participation**

When PE funds acquire public company securities, they are typically holding the securities in a 'long' position hoping the securities will rise in price. However, market participants may seek to make money in the market by taking a 'short' position in which the market participant borrows the security from a broker and immediately sells it. By taking a 'short' position, the market participant is betting the security's price will drop, so it can then buy the security at a lower price in the future and return the 'borrowed' security to the broker. However, the price of the security could rise, and the participant would then be forced to buy it at a price higher than it sold it for and would then incur a loss.

A market event that causes a security's value to jump higher when investors thought the value would decrease would force short sellers to run to the market to purchase the position to forestall even greater losses. Based on simple supply and demand, the frenzy to buy only increases the security's price. This pressure cooker for short sellers is known as a 'short squeeze' and could be viewed as market manipulation.

The federal securities laws enforced by the SEC and the US Department of Justice contain broad provisions prohibiting manipulation of the markets. Section 9 of the Securities Exchange Act of 1934 is the primary basis for manipulation enforcement. Additionally, the SEC uses Section 10(b) of the Exchange Act to fight market manipulation. This general antifraud provision prohibits making false statements in connection with the purchase or sale of securities.

## **Risk of SEC Enforcement**

Pursuant to its authority under Section 12(k) of the Exchange Act, the SEC can also issue trading suspensions if it believes the public interest and the protection of investors so require. Indeed, the SEC has suspended trading in the securities of at least 20 companies because of questionable trading and social media activity following the recent market volatility.

If the SEC's Division of Enforcement becomes aware of potential market manipulation, it will almost certainly open an investigation. Division of Enforcement examinations can be informal in which the staff seeks voluntary cooperation. However, if there is a lack of cooperation or if necessary information can only be obtained through a subpoena, the Division of Enforcement will issue a Formal Order of Investigation, which gives the staff subpoena power. Recently, the interim chair of the SEC made it easier for the Division of Enforcement to obtain subpoena power. Thus, one should expect more formal SEC investigations.

Violations of the federal securities laws can also be enforced criminally by the DoJ. Sometimes the SEC will refer certain matters to the appropriate United States Attorney for potential criminal prosecution. In recent years there has been an increasing amount of co-operation between the SEC and the DOJ, and as a result, any parties involved in an SEC investigation should always consider the possibility of the DOJ also being involved.

The risk of enforcement may also arise during a routine exam conducted by the SEC's Division of Examination. In

the ordinary course, the Division of Examination will conduct examinations of registered investment advisors, which may involve a review of the advisor's investment activity. If there is any investment activity involving publicly traded securities, the Division of Examination will likely review the beneficial owner filings made by the advisor and the PE funds it manages and the personal trading activity of the advisor's supervised persons to see if there are any anomalies that warrant further investigation.

### **Action Items for PE Firms**

PE managers should expect increased regulatory scrutiny on certain aspects of compliance programmes. As a result, they should examine their current practices and procedures, with a particular focus on conflicts of interest, to determine whether they are effective in light of their operations and emerging compliance risks.

While Rule 206(4)-7 under the Investment Advisers Act of 1940 requires registered advisors to review the adequacy of their policies and procedures, and assess the effectiveness of their implementation, at least annually, since the occurrence of significant market events warrant an additional interim review. All PE managers that are registered advisors must maintain and implement policies and procedures reasonably designed to prevent violations of the Advisers Act, as well as a Code of Ethics that requires the advisor's supervised persons to comply with applicable federal securities laws. PE managers that are not registered, but are exempt reporting advisors, also must maintain and enforce certain policies and procedures.

PE managers should determine whether their trading policies address conflicts of interests when the GP and investors of a PE fund hold the same public company securities and may have different lock-up periods. In furtherance of managing potential conflicts of interests, PE managers should have:

- Blacklists/grey lists and policies regarding participating hedging transactions with regards to the PE funds public company holdings;
- Policies and procedures that prevent the misuse of material, non-public information in violation of the Advisers Act or the Exchange Act, or the rules or regulations thereunder;
- Pre-clearance policies and procedures for trading and investment activities of their employees;
- Procedures for verifying quarterly statements and annual statements with regards to the PE manager's compliance protocols.

PE managers should also have procedures to ensure timely reporting of public company ownership by their PE funds and the GP.

Relatively new, PE managers should have policies and procedures that limit the ability of their employees to participate in social media platforms and social news gathering platforms, such as Reddit, so as to ensure the ability of their employees to comment on trading activities or generate market activity. In addition, PE managers should have policies and procedures regarding rumours.

Developing sound policies and procedures regarding rumours can be a challenging task for PE managers so as not to chill the legitimate investment process. As fiduciaries, advisors have a duty of care to provide investment advice in the best interest of the client, including a duty to provide advice that is suitable for the client. Advisors must have a basis for their investment decisions to substantiate their duty to provide suitable advice.

Preventing inappropriate rumours is not as simple as outright prohibiting their origination or circulation. PE managers will need to consider how rumours are defined – is all unverified information rumours? Should rumours that are not reasonably expected to impact market pricing be prohibited?

These and other questions need to be considered in light of the firm's particular business risks, as well as exceptions, such as those where a legitimate business reason exists for discussing a rumour.

Clearly, not all opinions on the market should be viewed as rumours, but opinions can have an impact on the market, especially if the purpose of stating an opinion is to influence the market. The rumour policy generally should prohibit employees from knowingly circulating false rumours or information that might reasonably be expected to affect market conditions or induce trading.

PE managers should also consider how, to whom and what their employees are permitted to communicate. Compliance programmes should include policies and procedures regarding communications with third parties and electronic communications generally.

### **Adherence to Policies and Procedures**

While a PE manager's policies and procedures might be adequate, they are only effective if implemented properly. The manager's compliance group should increase its monitoring in light of the increased risk associated with the recent market events to ensure the effectiveness of its policies and procedures. The compliance department should consider the following responsive actions and document their review:

- Review watch/restricted lists frequently to ensure they are up to date, and the updated list is communicated internally in accordance with its policies and procedures.
- Spot check personal securities transaction reports to ensure the personal trading activities of access persons have been pre-approved and are otherwise in compliance with the PE manager's trading policies and procedures. This will also allow a manager to verify whether any access persons are trading in securities on its watch or restricted lists.
- Investigate any substantial disparities between the quality of performance access persons achieve for their own account and that which they achieve for clients, as well as any substantial disparities between the percentage of personal trades that are profitable versus client trades. Always be vigilant and on the lookout for outliers and patterns that might indicate market timing and other abuses. When in doubt, PE managers should check the employee's electronic communications and social media activity.
- Conduct electronic communication surveillance regularly to pick up recent market rumours or volatility (*i.e.*, names of specific issuers, social media sites, chatrooms, etc). While the SEC has published multiple risk alerts and other guidance regarding increased risks of insider trading and other matters caused by the pandemic's remote work environment, such risk may be caused by social media chatter. Therefore, PE managers should be particularly aware of employees' use of new devices and platforms for electronic communications.

The trading events of January show the powerful effect of the internet and social media on publicly traded securities. It is clear that such power (or the perceived abuse of it) is on the radar for lawmakers and regulators. At a minimum, PE managers should expect greater scrutiny of their participation, if any, in the public securities market.

PE managers should take every opportunity to mitigate the risk of an SEC investigation or enforcement action, and

the first step to mitigation is a review of its compliance policies and procedures and whether it addresses current market events and the firm's current business model.

## **Market Manipulation**

Market manipulation is when someone artificially affects the supply or demand for a security. The SEC is actively pursuing cases involving market manipulation. Stocks can be manipulated through a number of different activities. One of the more obvious examples of manipulation is where a market participant quietly purchases shares of a company and builds up a position without causing a price increase. Subsequently, the purchaser begins making larger purchases to cause a stock price increase and attract other purchasers – the combination of which then pushes the stock price up. Market observers then notice the activity, and it gets reported, causing even more interest in additional buyers and social media chatter about the company involved. The manipulator then sells its position into the strong upward market.

What is not as obvious is the so-called 'indirect' market manipulation. This is where parties may talk up a security, whether on a social media platform, message boards or spam email. These parties are not engaged in the actual trading of the public company security, but their communications may pump up a stock or devalue a stock. The chatter could then cause parties to trade on the stock based on an inflated or artificial sense of value.

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