HEDGING PIPES

NO NEED TO CALL THE PLUMBER, MARTHA. THAT'S A DERIVATIVE EMBEDDED IN THE PIPE.

WE CREATED THE PIPE structure in 1984-1985. We had no idea it would give rise to its own brave new world. But we did know that the methodology would evolve as the needs of issuers and investors evolved. Some of this change has been extremely positive. Other parts, less so. PIPE transactions have become important hybrid financing alternatives for companies that need to raise capital in difficult market environments or that need to raise capital quickly, or both.

When we first created PIPEs, the most active PIPE investors were institutional or "sector" investors that wished to make a long-term investment in a particular company or sector. Market dynamics changed as the number of hedge funds multiplied and as they have become an increasingly significant force in the financial markets. Hedge funds participate actively in hybrid financings. Some hedge funds purchasing in these transactions are "financial buyers" that view the transactions simply as part of an arbitrage strategy, or that would like to mitigate the risk associated with their ownership interest. For us, this has been a profoundly important development.

PIPE investors contract to purchase an issuer's securities at a fixed price in a private placement and receive restricted securities. Investors purchasing in the PIPE represent that they are purchasing the securities with investment intent. The issuer undertakes to file with the SEC a registration statement covering the resale from time to time by the investors of those restricted securities. The timing of registration is negotiated between the issuer and investors. The issuer may commit to file and have declared effective a resale registration statement immediately prior to, or promptly following, the closing of the private placement. The resale registration statement is kept effective until investors may sell the securities pursuant to Rule 144(k). The resale registration statement is intended to provide PIPE investors with enhanced liquidity in connection with future resales of the restricted securities. Investors in a PIPE bear price risk from their execution of the purchase agreement. Consequently, some may wish to hedge the risk associated with their investment once the occurrence of the PIPE transaction has been publicly disclosed.

A number of interesting, almost existential, questions arise in connection with any hedging activity. First, how much risk is enough risk? This is a tough one. Surely, there must be some degree of risk that would be deemed sufficient risk. The SEC has answered that without risk there may not be investment intent. Also, the Staff has considered the length of time during which the holder bears risk. How much time is enough time to be at risk? All this might suggest that you have a busted PIPE—meaning not a good private placement. Or, that there is a possible Section 5 concern. If there was no investment intent, was the PIPE investor really an underwriter? Assuming one were to get beyond these questions, other interesting ones arise. If an investor purchases securities in a PIPE and engages in short sales of the issuer's common stock, how would the investor properly cover its short? Does it require a "double print"? Should the investor sell the PIPE securities pursuant to the resale registration statement and use the proceeds to purchase unrestricted shares in the open market to cover any shorting activity? Any way you look at it, the PIPEs world and the derivatives world have become inextricably linked. Inevitably, the future holds more, and more varied, combined structures, and, perhaps, more regulation. That's to be expected in any brave new world.