Over the worst of it

The US courts have reached the wrong conclusions in recent Pipe cases. The SEC has been unable to help them

A North Carolina court has made high-school Latin relevant again. In a Pipe (Private Investment in Private Equity) case, *SEC v Mangan*, the judge dismissed the SEC's (Securities and Exchange Commission's) charge that defendants had engaged in the unregistered sale of securities. The judge accused the SEC of a logical causal fallacy, in a *post hoc ergo propter hoc* edict ("after this, therefore because of this"). This decision was the first in a series of well-publicised, and therefore embarrassing defeats for the SEC in its Pipes enforcement initiative.

The *Mangan* case also raised several questions about short selling, which the SEC has promised to resolve by providing guidance on naked shorting. In response to SEC requests about whether additional regulatory guidance on hedging would help, commentators in the past have universally agreed that less is more. Practitioners have long understood the SEC's views and its guidance on Section 5 of the Securities Act and hedging restricted securities. The consensus, though, was that the market was far better served by not having more specific guidelines relating to risk mitigation techniques.

More attractive

This comes at an interesting time for the Pipes market. Pipes have become an increasingly important hybrid-financing alternative. In 2006 and 2007 Pipes raised about $36 billion and $50 billion respectively. The term Pipe generically refers to any private placement of a public company's securities. Several capital-raising techniques involving private financing by an already public company are referred to as Pipe transactions. But the traditional Pipe is a specific form of private placement made to selected accredited or institutional investors. Investors commit to purchase a specified number of securities (usually common stock) from an issuer at a fixed price not subject to market price adjustments or fluctuating ratios. The issuer undertakes to file a registration statement with the SEC covering the investors' resale of the restricted securities sold in the Pipe. A Pipe may involve newly issued issuer (primary) shares, shares held by selling stockholders (secondary shares), or a combination of the two. In the case of primary (issuer) shares, the issuer relies on Section 4.2 and/or Regulation D exemptions from the Section 5 registration requirements. Disclosure of the Pipe occurs only after the issuer receives definitive purchase commitments, reducing the market impact of the financing and the risk of deal failure.

The credit crisis and resulting market volatility have made Pipe transactions an even more attractive financing option for issuers of all sizes. Issuers appreciate the targeted marketing of a Pipe, which allows them to test the waters without committing publicly to a financing transaction. Fully marketed follow-on offerings frequently subject an issuer's stock to short selling. Of course, in a Pipe an issuer sells its securities for less than the market price of the issuer's securities, given that the issuer is selling restricted securities. This discount compensates investors for the illiquidity associated with holding restricted securities. Recent SEC changes shortening the Rule 144 holding period for restricted securities have reduced this liquidity discount, thus improving Pipe pricing for issuers. Institutional or sector buyers eager to acquire a stake in companies that are already public have historically been active Pipe investors, although many are subject to limits on their restricted stock holdings. Now, given the abbreviated Rule 144 holding period, many show renewed interest in Pipes.

On balance, SEC scrutiny of the trading activities of hedge fund investors in Pipes has limited abusive practices. The SEC has prosecuted many Pipe cases, in which defendants traded on inside information or engaged in manipulative trading practices. The information that these cases provide is straightforward. It underscores the need for issuers, financial intermediaries acting as Pipe placement agents and investors to take care in connection with Pipes and other hybrid financings. Throughout these cases, the SEC reiterated its support for traditional Pipes. All of this should bode well for the Pipe market. In fact, given their troubled past, Pipes may never have had as bright a future. It may be the case that *Mangan*, similar court decisions on Section 5 issues and the SEC's response, will lead to an increase in the use of Pipes.

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A brief history

Pipes have largely overcome their troubled past. Many of the issues that surfaced in recent enforcement actions are not new. A brief review of the SEC's guidance may give helpful context to these events. They are consistent, but for the confusion generated by the courts' views on potential Section 5 violations arising from shorting activities.

In the mid-nineties, the SEC focused on the private placement aspect of the Pipe – was there a *bona fide* private placement? Many Pipes were completed at substantial discounts to the trading price of the issuer's common stock; many Pipe investors flipped their Pipe shares immediately after the Pipe closing. The SEC questioned whether the investment representations made by Pipe investors in the purchase agreements were accurate and made in good faith. In 1999, during the ascendancy of death-spiral and convertible Pipe transactions, the SEC focused on whether Pipe investors bore market risk for the restricted securities purchased. The SEC objected to many of the adjustment features in these deals. Specifically, the SEC viewed variable-price provisions as a mitigation of market risk, which challenged the availability of the original private-placement exemption in the Pipes. Guidance in the form of SEC staff telephone interpretations addressed these concerns.

The SEC raised similar issues in connection with equity-line transactions structured as private placements. The put/call features of equity lines mitigated the market risk for equity-line investors. Eventually in 2001 the

SEC required that disclosure be included in the registration statements to identify potential violations of Section 5 regarding the private-placement portion of these transactions. The SEC concluded that equity lines were indirect primary offerings. As a result the SEC required that equity line investors be identified as underwriters.

More recently, in 2006, the SEC took the position that for small-cap issuers a resale registration statement might not be available in connection with the registration of securities originally sold to investors in Pipe deals. Small-cap issuers were not eligible to use short-form registration statements on a primary basis before the amendments to the short-form (Form S-3) registration statement. The SEC commented that a resale registration statement might not be available if the issuer had sold a disproportionately large number of securities in a Pipe (relative to the issuer's pre-transaction total shares outstanding). It asked whether the purported secondary offering could be a primary offering. As a guide, the SEC indicated that it would subject to closer scrutiny Pipe transactions resulting in the issuance of shares of more than 33% of the issuer's pre-transaction outstanding shares.

The SEC also published its proposal for Rule 144 amendments. The proposal suggested tolling the holding period for restricted securities for up to six months if a security holder had entered into a risk mitigating transaction for restricted securities during that period (if the holder had a short position or had entered into a put-equivalent position). The proposed reintroduction of tolling was withdrawn from the final Rule 144 amendments. But it again signalled the SEC's concern about risk mitigation-transactions regarding restricted securities.

Insider trading

During the SEC's 2005 and 2006 review of hedge fund activities, hedge fund trading in close proximity to Pipes caught its attention. In 2007, the Enforcement Division set up a special unit to focus on insider trading by hedge funds. The SEC found many hedge funds traded before news of a Pipe was made public or while in possession of non-public information relating to Pipe issuers. The SEC brought successful actions charging hedge funds and investment bankers with insider trading and manipulative trading practices. These included actions against Guillaume Pollet, Hilary Shane, Galleon Management, Langley Partners, and Deephaven Capital Management. In recent cases, the SEC has successfully pursued allegations relating to insider trading violations.

An issuer contemplating a Pipe will not disclose the potential financing publicly. To avoid bringing about a premature disclosure, the placement agent must implement procedures to ensure that potential investors are aware of the confidential nature of the financing discussions. Such investors do not normally receive material non-public information about the issuer or its business. Marketing materials are limited to an issuer's Exchange Act or other public filings. But the fact that the issuer is considering a financing may itself be material non-public information. Investors contacted by a placement agent about a Pipe will have received news of a potential financing. They will be asked to keep this material non-public information confidential.

The SEC found that many hedge fund investors that were Pipe offerees or Pipe investors traded in the securities of the Pipe issuer before the transaction was announced. Trading based on this non-public information, including entering into hedging transactions in the issuer's securities, violates the securities laws. Interestingly, defendants in *Mangan* questioned whether news of the financing was itself "material." Once a Pipe has been announced, either through a press release or in a Form 8-K, investors no longer have any material non-public information, assuming they have no other special knowledge.

Confidential

To prevent premature disclosure of a Pipe and for a Pipe issuer to comply with Regulation FD, an issuer must ensure that before the placement agent shares the issuer's name or other details with potential investors, the investor promises that it will keep such information confidential and refrain from effecting transactions in the issuer's stock. Under Regulation FD, an issuer is owed a duty of confidence from its agents (such as placement agents), and from other participants in the Pipe process from whom it has obtained a confidentiality undertaking.

Placement agents often enter into transaction-specific confidentiality or omnibus confidentiality agreements. These agreements require potential investors to confirm that they will treat as confidential the information they receive relating to possible Pipe financings; they must confirm that they understand the federal securities law obligations about the need to keep such information confidential and to refrain from trading in the issuer's stock until that information becomes public. Other placement agents rely on scripts to pre-qualify potential investors and receive oral undertakings that are later confirmed in writing.

This raises questions about Pipe offerees that ultimately do not participate in the Pipe and do not reaffirm their confidentiality undertaking in a purchase agreement. In *SEC v Lyon*, relating to the Gryphon funds, many questions were raised about how the placement agent had informed the funds of the confidential nature of the information they were receiving. For example, the defendants received an email from a placement agent containing the assertion that acceptance of the appended documents constituted an acknowledgement that they were receiving restricted non-public information. The defendants alleged that this sort of communication did not create a duty of confidence. The case is as a reminder for placement agents of the importance of appropriate compliance procedures. They must obtain express confidentiality undertakings in connection with Pipes.

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Tensions

Pipe investors make representations and warranties for the issuer's benefit. These include proof that investor is an accredited investor, confirmation that the issuer delivered the materials connected with the offering, a confidentiality undertaking (discussed above), and an investment representation. Pipe investors give each investor an opportunity to conduct its own investigation regarding the issuer and its business. The investment representation states that the investor is purchasing the securities without a view to distribution. It is essential to a good private placement.

Recent Pipe cases have shown tensions in connection with the investment intent representation. The divide between straight private placements and public offerings has narrowed because of the proliferation of hybrid transactions such as Pipes. Investment representations must be reconciled with the almost immediate availability of a resale registration statement.

The SEC has explained that investors in a private placement transaction completed in

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reliance on the Section 4.2 exemption or Rule 152 must bear the risk of holding the restricted securities they committed to purchase before the resale registration statement was filed. In a traditional Pipe, investors commit to purchase a specified number of securities at a fixed price, bearing price risk as soon as they enter into a definitive purchase agreement. The purchase price cannot be contingent on the market price of the securities at the time of effectiveness of the registration statement.

After the public announcement of a Pipe, an investor may mitigate its market risk by entering into hedging transactions. Once a Pipe is announced, the issuer's stock price often trades down. By shorting the stock, Pipe purchasers try to lock in the differential between the Pipe purchase price and the later stock price.

Lack of integrity

These hedging transactions raise concerns about the integrity of the investors' investment representations. Is it possible to reconcile short sales in connection with a Pipe with an investment intent representation? In *SEC v Lyon*, the SEC alleged that the defendants committed fraud based on affirmative misrepresentations about their investment representations. The defendants falsely represented their investment intent to the Pipe issuers, when they planned to sell short (effecting a "distribution") and cover with Pipe shares.

Little or no SEC guidance exists regarding which transactions are appropriate and which are not. Issuers have tried to address these concerns by bolstering investment representations taking a number of different approaches: prohibiting any hedging activities; obtaining evidence that the investors do not have a net-short position in the issuer's securities when the purchase agreement is executed; proscribing certain hedging transactions before conversion periods; or prohibiting investors from trading in the issuer's securities during particular periods.

Investors that violate the investment representation by disposing of the securities prematurely may be deemed statutory underwriters. As a result, they may be unable to rely on the Section 4.1 resale exemption. Put another way, investors that engage in short sales of publicly traded shares while purchasing Pipe shares are acting as underwriters in the contemplated public distribution of the issuer's stock, not as *bona fide* investors in a private placement.

Violations

In several recent cases, including *Mangan*, *Lyon* and *SEC v Berlacher*, the SEC has alleged that the defendants engaged in unregistered sales of securities in violation of Section 5. In each case the defendants purchased securities in a Pipe and shorted the securities before the declaration of effectiveness of the resale registration statement. After the resale registration statement was declared effective, the defendants covered their short positions with the Pipe shares.

The SEC argued that through the initial shorting, the defendants had sold securities, violating Section 5. It further argued that the shares ultimately used to cover the short sale were sold when the underlying short sale was made – which occurred before the resale registration statement was declared effective. In these cases, the defendants could have used a double-print approach, which the SEC has agreed is permissible. They could have covered their short positions with securities purchased in the open market, provided that the initial sale and the open market purchase(s) are not linked.

The courts dismissed the Section 5 claims. They struggled with the metaphysics of the SEC's shorting analysis and concluded that there was no statutory support for the SEC's view. Effectively, the courts concluded that a short sale is a sale of the security, the short sale is not related to the short-covering transaction, and, barring manipulative trading practices, when and how the investor covers the short sale is irrelevant. In rejecting the SEC's arguments, the courts were dismissive. In fact, the SEC has long taken the view that a hedging transaction relating to a restricted stock position may constitute a Section 5 violation.

If a short sale is made before the effective date of a registration statement of securities of the same class as those sold short and those short sales are covered with shares obtained in the registered offering, the SEC regards the initial short sale as a Section 5 violation. The SEC has expressed its views in several releases, and in the staff's telephone interpretations. In one of its telephone interpretations, the SEC staff considered the following:

An issuer filed a Form S-3 registration statement for a secondary offering of common stock, which is not yet effective. One of the selling shareholders wanted to do a short sale of common stock "against the box" and cover the short sale with registered shares after the effective date.

The SEC concluded that the short sale could not be made before the registration statement becomes effective because shares that are the subject of the short sale are deemed to be sold at the time the sale is made. Sale of the shares before the effective date of the registration statement would violate Section 5.

A logical fallacy

The courts seemed to ignore the fact that when defendants shorted shares, they introduced issuer shares into the market. At the time that they shorted – the first leg of the new transaction – the defendants held an economic interest only in restricted securities. The courts did not consider the character of the short sale. Was the short sale exempt from registration? Was the short sale an indirect sale of the restricted security? On the second leg of the transaction (the short-covering), the defendants used the shares received in connection with the Pipe transaction. The courts did not consider the fact that the registration statement in a Pipe was a resale registration; it covered resales by the Pipe investor of the restricted securities purchased in the Pipe. Resale registration covers a particular transaction or offering, not particular securities. By using the Pipe shares for the short covering, the defendants created a link back to the initial short sale. An incipient Section 5 violation became an actual Section 5 violation.

A thorough review of the judicial decisions and associated pleadings suggests that the courts lacked context relating to the dynamics of shorting and the surrounding issues. It also suggests that the SEC litigation effort was ineffective in providing the context and in explaining the issues. The defendants and their counsel see these decisions as a victory. We view the *Mangan* and similar verdicts as resulting in their own *post hoc ergo propter hoc* logical fallacy. The SEC has announced that it will provide regulatory guidance on shorting to address the confusion on the scope of permissible activities. To practitioners, it was always clear.

The US capital markets participants await the SEC guidance anxiously. They appreciate how difficult it may prove to create regulation that is intelligent, principled, and unlikely to do unintended harm. In the post-Sarbanes-Oxley world, these are reasonable concerns.

By Anna T Pinedo and James R Tanenbaum of Morrison & Foerster