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COURTS THWART SEC PIPES ENFOREMENT

Recent rulings likely to have dramatic impact on future investigations

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The Securities and Exchange Commission has expressed its clear intent to target insider trading and trading related to private investments in public equity (PIPEs) as part

of its campaign to regulate the hedge fund industry.

Testifying before the Senate Judiciary Committee in 2006, SEC Division of Enforcement Director Linda Thomsen stated, "Insider trading by hedge funds remains a substantial concern to the Division, and represents a significant focus of our current enforcement efforts." Discussing the settlement of a PIPEs-related enforcement action, Scott Friestand of the SEC explained, "This case is an example of our ongoing effort to stamp out fraud and other trading abuses by investors in the PIPEs market . . . . We have devoted substantial resources to these investigations and will continue to do so."

The SEC's enforcement focus on PIPEs has ensnared numerous individuals and firms. Through its enforcement actions, the SEC has racked up settlements totaling nearly $23 million in fines and disgorged profits. The SEC's PIPE-related enforcement actions typically allege the improper sale of unregistered securities in violation of Section 5 of the Securities Act, and insider trading and securities fraud in violation of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act.

The Section 5 claims in these enforcement actions have been based on the following premise: If an investor in a PIPE shorts the issuer's stock prior to the registration of the shares acquired in the PIPE transaction and intends to cover the short position with stock received through the PIPE offering, such a trade—in the SEC's view—is a sale of unregistered securities in violation of Section 5.

Until recently, no PIPEs enforcement matter had been litigated, and the SEC's application of the securities laws to PIPEs transactions had not been subject to judicial scrutiny. Three recent decisions by federal district courts have changed all that. And, in all three of those decisions, the courts took a dim view of certain of the SEC's claims and theories.

Judge Graham C. Mullen of the Western District of North Carolina delivered the first blow to the SEC's PIPEs enforcement program. During a hearing last October in *SEC v. John F. Mangan Jr.*, et al., Mullen granted Mangan's motion to dismiss the SEC's sale of unregistered securities claim brought pursuant to Section 5 of the Securities Act. While that hearing has gained some notoriety for Mullen's admonition to an SEC attorney to "[s]it down" and "shut up," it may have more lasting substantive significance.

At oral argument on Mangan's motion to dismiss, the SEC argued that by shorting an issuer's stock prior to registration of the PIPE shares, which were purchased at a discount to the market, Mangan locked in a profit by "effectively" selling the PIPE shares prior to registration.

Mangan argued that when he entered the short sale transactions, he was not selling the PIPE shares and he was in no way committed to using the PIPE shares to cover his short positions. He could have held the shares acquired in the PIPE and purchased shares in the market to cover. In fact, Mangan posited that he risked suffering a loss if the PIPE shares were not registered timely.

Judge Mullen agreed with Mangan, stat-

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ing that "no sale of unregistered securities occurred as a matter of law."

Ruling from the bench, Mullen dismissed the Section 5 claim and chided the SEC for pursuing that claim in light of a 2006 Federal Register notice, in which the SEC essentially conceded that there is no law or regulation prohibiting the short selling activity complained of in Mangan.

On Jan. 2, Judge Sydney Stein of the Southern District of New York delivered the second blow to the SEC in the PIPEs arena. In *SEC v. Edwin Buchanan Lyon IV*, et al., Stein granted the defendants' motion to dismiss the SEC's Section 5 claims and securities fraud claims based on the alleged violations of Section 5. Without citation or reference to the Mangan decision, Stein ruled that the SEC's position that defendants had engaged in the sale of unregistered securities lacked any legal basis.

Finding that the SEC's argument had "no support in the text or purpose" of Section 5, Stein wrote that "delivery of once-restricted PIPE shares to close a short position does not convert the underlying short sale into a sale of PIPE shares."

Noting the "inherent logical implausibility" of the SEC's Section 5 position, Stein equated the post-registration PIPE shares to common stock obtained through the conversion of convertible bonds. Stein posited a situation where an investor shorted a stock, possessed convertible bonds at the time of a short-sale and subsequently used stock obtained through the conversion of those bonds to close out the short position.

Judge Stein observed that "the buyer on the other side of that hypothetical short sale received common stock, not convertible bonds." Therefore, how an investor ultimately chooses to cover a short position "does not alter the nature of the [short] sale."

The third strike against the SEC's PIPEs program came from Judge Eduardo C. Robreno of the Eastern District of Pennsylvania. On Jan. 23, in *SEC v. Robert A. Berlacher, et al.*, Robreno granted defendants' motion to dismiss the SEC's PIPE-related Section 5 and related fraud claims. The SEC claimed that Berlacher and the funds he managed engaged in PIPE-related trading that resulted in more than $1.7 million in ill-gotten gains.

Robreno expressly adopted and applied the reasoning in Lyon and also cited Third Circuit precedent regarding the treatment of short sales and the subsequent close of the short position as two distinct transactions. Robreno noted that "ultimately whether the SEC's theory will rise or fall as it moves through the appellate process . . . really depends on the strength of the arguments that are captured in the Lyon case," and he dismissed the Section 5 claims and the fraud claims that were "bootstrapped" to the alleged Section 5 violations.

While the Section 5 and related fraud claims have been dismissed in *Mangan, Lyon* and *Berlacher*, the SEC's securities fraud and insider trading claims, which are based primarily on short sales made prior to the public announcement of PIPE offerings, have survived the defendants' motions to dismiss. Whether the SEC's surviving claims hold up in response to summary judgment motions or at trial remains to be seen.

The decisions in *Mangan, Lyon* and *Berlacher* are likely to have a dramatic impact on PIPEs-related enforcement actions and investigations. How the SEC and other enforcement agencies respond to the obstacles identified by the courts in cases that are currently pending and in ongoing investigations is still an open question.

Given its public pronouncements about hedge funds, insider trading and PIPEs, it is not likely that the SEC will abandon altogether the pursuit of what it considers trading abuses linked to PIPEs. Whatever the response, those representing individuals and entities ensnared in PIPEs enforcement matters have new-found weapons in the form of the first three judicial opinions arising from the SEC's enforcement focus on PIPEs. ■