

January 4, 2008

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Eva Marie Carney  
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RE: RECENT DECISIONS ON SHORT SELLING AND  
PIPEs: SECTION 5 CLAIMS DISMISSED, INSIDER  
TRADING CLAIMS SURVIVE

***RECENT DECISIONS ON SHORT SELLING AND PIPEs: SECTION 5 CLAIMS  
DISMISSED, INSIDER TRADING CLAIMS SURVIVE***

*Two district court judges recently rejected SEC claims that using shares obtained in private investment in public equity transactions (PIPEs) to cover a short position taken in the PIPE issuer violates Section 5 of the Securities Act of 1933. SEC litigators fought the dismissals, arguing strenuously that a ruling against Section 5 liability would overturn some thirty-five years of clear and consistent Commission precedent. Market participants should expect to hear more from the SEC on this subject – whether the SEC’s response is to identify friendly courts of appeal in which to argue its Section 5 analysis, or to undertake rulemaking. Both judges permitted the SEC to move forward with insider trading claims against the fund managers who put on the short positions on a misappropriation theory. In doing so, they accepted the SEC’s theory that a fund manager that agrees to keep in confidence material non-public information it obtains when being solicited to invest in a PIPE and then shorts the PIPE issuer’s stock can be sued under the antifraud provisions of the federal securities laws.*

***Sale Of Unregistered Securities Claims Dismissed***

On January 2, 2008, in SEC v. Lyon, (06-Civ.-14338) (S.D.N.Y.), Judge Sidney H. Stein of the U.S. District Court for the Southern District of New York soundly rejected the SEC’s theory that short selling in order to hedge a PIPE constitutes an unlawful sale of unregistered securities in violation of Section 5 of the Securities Act of 1933. This is a serious blow to the SEC’s attempt over the last few years to establish that such short-selling is an unlawful sale of unregistered securities and is not a ruling that we expect the SEC to accept without further effort to establish its position. Since at least 2005, the SEC has included a Section 5 theory in administrative actions against defendants that covered short positions with PIPE shares, and it has obtained settlements in some of those cases. The SEC’s litigation team in Lyon argued to the Court that the SEC’s theory in the PIPEs cases was entirely consistent with the SEC’s decades-

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long interpretation of Section 5, but the Court concluded that the precedent cited was “equivocal” and unpersuasive.

The crux of the SEC’s Section 5 claim was its integration analysis. The SEC argued that a Section 5 violation occurred because the defendants, Gryphon Partners LP and related entities, and their managing partner, Edwin Buchanan Lyon, IV, in the equivalent of a multi-step, unregistered public distribution of the restricted PIPE shares, first bought PIPE shares issued by publicly-traded companies that were restricted from being sold publicly, then sold short the restricted PIPE shares before a registration statement was effective, and in a third “ministerial” step, once the registration statement was effective, used the PIPE shares to close out the short positions. The SEC urged that, as a consequence of the defendants’ integrated transaction, the buyers of the shares that were sold short did not have the benefit of an effective registration statement for the PIPE offering, nor all of the information to which the buyers were entitled under the Securities Act.

The Court rejected outright the SEC’s integration analysis. Instead it concluded that the short sales were transactions distinct from the transactions that later “covered” the short sales with the PIPE shares. In the Court’s view, Gryphon’s delivery of once-restricted PIPE shares to close the short positions could not be deemed to convert the short sale into a sale of PIPE shares. It said: “[F]rom the Court’s perspective, a short sale of a security constitutes a sale of that security. How an investor subsequently chooses to satisfy the corresponding deficit in his trading account does not alter the nature of that sale.” As Lyon pointed out, the defendants were under no legal obligation to use their PIPE shares to cover their short positions and could have covered with various kinds of shares – publicly traded shares, shares derived from convertible bonds, or once-restricted PIPE shares.

In light of its Section 5 analysis, the Court rejected the SEC’s accompanying allegation that the defendants knowingly made misrepresentations about their investment intent in violation of Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934 – the PIPE documents required the defendants to warrant that they had no present intent to distribute the restricted shares or to otherwise violate Section 5.

The Court’s analysis would apply whether the short sale is “conventional,” meaning that the seller borrows shares to cover the short sale at the time of the hedge and then eventually replaces the borrowed shares with shares acquired in the PIPE, or “naked,” meaning that no shares are used to cover the short sale until the PIPE shares become available – both types of short sales were alleged in Lyon.

The decision in Lyon follows on an earlier federal court rejection of the SEC’s theory that short-selling in connection with a PIPE violates Section 5. In October 2007, Judge Mullen of the Western District of North Carolina issued a ruling from the bench against the SEC, in which he dismissed a claim that an investment manager sold unregistered securities in violation of Section 5 when he hedged a PIPE investment by selling short an equal number of the issuer’s shares. SEC v. Mangan, Civil Action No. 3: 06-CV-531 (W.D.N.C., filed December 28, 2006). Judge Mullen did not, however, issue a written decision explaining his reasoning.

### *Insider Trading Claims Survive*

Although both the Lyon and Mangan decisions represent significant defeats for the SEC with respect to its theory under Section 5, the SEC successfully withstood motions to dismiss its insider trading fraud claims that also were part of both complaints.

In Lyon, Judge Stein refused to dismiss claims that the Gryphon defendants violated Section 10(b) and Rule 10b-5 under the misappropriation theory of insider trading liability. The Court observed that advance knowledge of a PIPE offering gives an investor a clear market advantage over other investors without such knowledge, and noted that, as a result, PIPE issuers combat the risk that prospective PIPE investors will trade on such information before it becomes public by taking steps to guard the confidentiality of their planned offerings and imposing duties on prospective investors to refrain from trading on that information until it becomes public. The SEC's complaint in Lyon alleged that the defendants shorted the publicly-traded stock of four PIPE issuers while they had material non-public information that the PIPE offerings were in process, in violation of Gryphon's pledge to keep that information confidential and not use it in securities trading. The SEC claimed that the defendants were subject to duties of confidentiality imposed, in one instance, by a purchase agreement provision explicitly specifying that information about the PIPE was to be kept in confidence and to be used for the sole purpose of evaluating a possible investment in the PIPE shares. In the other transactions, according to the SEC, the offering materials or an e-mail transmitting the offering materials included similar provisions imposing confidentiality duties. The defendants urged dismissal, contending that the fact they received documents with confidentiality clauses in connection with the PIPE offerings did not establish that the defendants in fact were bound by confidentiality duties.

The Court held that the SEC had sufficiently pleaded a "plausible" claim for relief, as required under the Federal Rules of Civil Procedure to survive a motion to dismiss. And the Court mused that, as the litigation progressed, it could be that discovery would uncover communications showing that the Gryphon defendants expressly accepted the relevant confidentiality conditions or that the customary practice among participants in the private-placement market is to be bound, and to abide by, the confidentiality provisions stated in the offering materials.

In the Mangan matter, the Court likewise ruled that similar SEC insider trading claims could proceed, though Court observers reported that the Court remarked from the bench that the claim presented a close case and that the ultimate resolution would turn on the particular facts and circumstances.

In light of these rulings, it seems clear that the SEC will continue to press insider trading allegations under the misappropriation theory in circumstances where a PIPE investor subject to express or implied confidentiality duties to a PIPE issuer takes short positions in the PIPE issuer's publicly-traded stock before that PIPE is public knowledge. Certainly a short put on after disclosure of the PIPE would not subject the PIPE investor to insider trading claims, so it may prove useful for PIPE investors to obtain from issuers their agreements to disclose PIPES as soon as practicable. Unlike the SEC's Section 5 theory, the SEC's theory that the PIPE investor that possesses non-public PIPE-related information at the time the PIPE investor shorts the PIPE

issuer's stock is liable under the misappropriation theory of insider trading where it can be established that such use violates a duty to the PIPE issuer, has yet to be called into serious question.