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Down But Not Out: The SEC Will Rise From The PIPE Ashes

By Ernest E. Badway and Vincent A. Vietti

The Securities and Exchange Commission's (SEC) recent prosecution of Securities Act of 1933 (Securities Act) Section 5 cases in PIPE (private equity investment in public equity) transactions hit a brick wall in 2007 and early 2008.

PIPE transactions – a prevalent structure used in financing for smaller public companies – generally involve investments by hedge funds and sophisticated investors in restricted securities of public companies. For many years, the SEC has been scrutinizing these transactions as they believe the structure of certain deals and the trading practices of certain investors in these deals hurt rather than help smaller public companies. The SEC has brought several enforcement cases against traders and hedge funds involved in the PIPE market, alleging violations of the anti-fraud provisions of the federal securities laws and engaging in the sale of unregistered securities in violation of Section 5 of the Securities Act.

In two recent federal district court cases, the SEC's Securities Act Section 5 claims have spiraled down in flames. In both cases, the SEC advanced a novel argument. The SEC argued that, in many PIPE transactions, investors engaged in short sales of an issuer's stock prior to the effective date of the registration statement covering the public resale of the restricted shares issued in the PIPE transaction. After the registration is declared effective, the investors cover their short positions with the newly registered shares issued in the PIPE transaction. The SEC argued that the short sales by PIPE investors were, in reality, public sales of unregistered securities in violation of Securities Act Section 5.

The first broadside against the SEC was leveled by a North Carolina federal district court judge in *SEC v. Mangan*. In *Mangan*, the court found that the SEC was advancing a "creative liability theory" and chastised the SEC for bringing these claims because, in the court's opinion, the *Mangan* investor did not cover his short sales with unregistered securities. In fact, the court stated that the shares used to cover the short sales were registered, and reasoned that, if the *Mangan* investor could not cover the short sales with securities pursuant to a registration statement, the PIPE investor would have been required to re-enter the market to cover those short positions.

Similarly, in early 2008, a New York federal district court, in *SEC v. Lyon*, granted a PIPE investor's motion to dismiss Securities Act Section 5 claims brought by the SEC. In the Lyon case, the court also offered very little support for the SEC's arguments, and claimed that the SEC position was based upon an "inherent logical implausibility." The court also questioned the SEC's approach in that it did not advance the purpose of Securities Act Section 5 regulation.

However, all is not lost for the SEC. Both the *Mangan* and *Lyon* courts were reluctant to dismiss the insider trader claims brought by the SEC against the investor-defendants, because the SEC had made plausible arguments relating to whether these PIPE investors made these short sales based upon inside information. One court noted that these claims were factual in nature, and that there were confidentiality restrictions contained in the PIPE transaction documents that may have been violated. The *Mangan*

court was, nonetheless, swayed by the defendants' arguments that, if the disclosure did not significantly affect the stock price, then the disclosure was immaterial as a matter of law. Despite this fact, the *Mangan* court denied the motion to dismiss the insider trading claims.

In sum, although the SEC was turned back on the Securities Act Section 5 claims, short sales and other trading activity by PIPE investors prior to the time such deals are announced or such shares are registered for sale to the public still pose substantial risk of insider trading liability. Further, the SEC has made public statements, after these court rulings, that it will continue to view a short sale covered by shares issued in PIPE transactions as a violation of Securities Act Section 5, and is considering rule making in this area.

SEC Adopts Amendments to Regulation D; Mandates Electronic Filing of Form D

By Vincent A. Vietti and Lauren Taylor

The September edition of this *Newsletter* summarized a proposal by the SEC to simplify and require the electronic filing of Form D – the notice filing required by companies that have sold securities in a private offering in reliance on the exemption from registration provided by Regulation D. On February 6, 2008, the SEC approved the amendments to Regulation D substantially as proposed. Although the final rule is effective on September 15, 2008, there will be a transition period from September 15, 2008, through March 15, 2009, during which time Form D filings may be made either in paper format or electronically. Effective March 16, 2009, all Form D filings must be made electronically by responding to discreet information requests on an electronic form.

The amendments are intended to ease the burdens of complying with Form D, facilitate electronic filing, improve and update Form D information requirements, and increase the public's access to Form D information. In the future, the system also may facilitate "one-stop filing" of Form D with the SEC and state securities regulators in a single electronic transaction. While one-stop filing will not be available initially, the SEC and state regulators are working to implement this capability as soon as practicable.

Under the new amendments, the information requirements of Form D will be reorganized into 16 numbered categories. The material changes to the Form D information requirements include:

- reporting the date of the first sale in the offering (which may aid the SEC in identifying late filings and thereby increase compliance)
- replacing the description of business with identification of industry group from a pre-established list of industries
- deleting the requirement to identify beneficial owners of 10 percent or more of an issuer's equity securities
- requiring all issuers to disclose revenue range information
- replacing the current federal and state signature requirements with a combined single signature requirement that will also include a Form U-2
- eliminating the appendix that currently provides offering information on a state-by-state basis

Regulation D has been amended to clarify that a previously filed Form D need only be amended in the following instances:

- if a material mistake of fact is made in the prior Form D submission
- to reflect a change in certain of the previously submitted information
- annually, if the offering is ongoing

In proposing the amendment, the SEC and certain commentators raised concerns that the public availability of Form D filings on the SEC Web site could be used for marketing purposes and thereby run afoul of the prohibition against "general solicitation" and "general advertising" in Regulation D offerings. Regulation D has been amended to provide that information included in a Form D in good faith to comply with the Form's requirements will not constitute a general solicitation or general advertising for purposes of the prohibition.

SEC Amends Proxy Rules to Provide Safe Harbor for Electronic Shareholder Forums

By Vincent A. Vietti and Lauren Taylor

Federal securities laws prohibit any person from soliciting a proxy without first filing and delivering a proxy statement. The SEC recently adopted amendments to the proxy rules to permit broader use of electronic shareholder forums without violating federal proxy rules. The amendments are designed to facilitate greater online interaction among shareholders by removing two major obstacles to the use of electronic shareholder forms: first, the risk that a statement made by a participant in an electronic shareholder forum could be deemed a solicitation of a proxy; and second, the risk that one who establishes, maintains, or operates an electronic shareholder forum could be liable for statements made by participants in the forum.

In response to the first concern, the SEC adopted Rule 14a-2(b)(6), which provides that most of the proxy rules will not apply to solicitations made in an electronic shareholder forum if the following conditions are satisfied:

- the solicitation is made more than 60 days prior to the date announced by the issuer for its annual or special shareholder meeting; and
- if the issuer announces the meeting less than 60 days prior to the meeting, the solicitation does not occur more than two days following the issuer's announcement of the meeting

Rule 14a-6(g) (the filing of solicitation materials with the SEC), Rule 14a-7 (related to an issuer's obligation to provide a list of security holders or to mail soliciting material to security holders), and Rule 14a-9 (related to false or misleading statements in soliciting materials) will continue to apply to activities in an electronic shareholder forum. Any communications made within an electronic shareholder forum that fall outside the conditions described above will continue to require compliance with the proxy rules.

Once a person makes a solicitation in an electronic shareholder forum in reliance on the new exemption, that person remains eligible to later request proxy authority. Shareholders are, therefore, permitted to "test the waters" prior to a solicitation; this was prohibited under existing rules.

Persons relying on the exemption need to assess whether compliance with other SEC rules and regulations is required. For instance, communications among shareholders in an electronic shareholder forum for the purpose of acquiring, holding, voting, or disposing of the equity securities of a public company might result in the formation of a group for purposes of Regulation 13D. Solicitation activities also may impact the eligibility to file a Schedule 13G, which is not available to persons seeking to influence management of an issuer.

To address concerns regarding liability for statements made by participants in the forum, the SEC adopted a new Rule 14a-17. Under the new rule, one who establishes, maintains or operates an electronic shareholder forum will not be liable for statements made by other forum participants provided that the forum is operated in compliance with securities laws and the issuer's charter and bylaws. However, the person providing information to or making statements on an electronic shareholder forum will still be liable for the content of such communications under the anti-fraud provisions of the federal securities laws. The prohibitions in the anti-fraud provisions against primary or secondary participation in fraud, deception, or manipulation will also continue to apply to those supplying information to the site, and claims will not face any additional obstacles because of the new rule.

By reducing potential liability, the new rules should increase the level of online shareholder interaction, which is now commonplace for many public companies. Shareholders might use such forums as a polling mechanism to elicit the sentiments of the issuer's managers or other shareholders on various potential actions. These forums also may make it easier for investors to mobilize against issuers. Issuers can participate in or establish forums to gauge shareholder interest on a variety of topics. Issuers should, however, carefully weigh the risks of participating in or establishing these forums, including:

- an inadvertent release of material non-public information in violation of Regulation FD

- communications made during the exemption period may later be construed as solicitations requiring compliance with the proxy rules. The SEC indicated that postings made during the exemption period that remain in the forum after expiration of the exemption period may later be construed as a solicitation that would require compliance with the proxy rules, unless such communications fall within another exemption. The SEC suggests providing participants with the opportunity to delete postings or simply having the forum "go dark" during this period.

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