Despite Recent Setbacks in the Courts, the SEC Remains Focused on Short Sales in PIPE Transactions

*By Jeffrey T. Hartlin**

Private investments in public equity offerings, or "PIPEs", have quickly become a well-accepted and common financing alternative for public companies. The number of reported PIPE transactions, which give public issuers the ability to secure capital on a confidential basis and more quickly than a traditional public offering registered with the Securities and Exchange Commission ("SEC"), has grown remarkably over the past decade. In 1998, issuers completed 428 PIPE transactions for gross proceeds totaling approximately $3 billion.[1] By comparison, in 2008 over 1,000 PIPE transactions were completed in which issuers raised more than $120 billion.[2] As a larger number of issuers have turned to PIPEs as a primary source of capital, these transactions and their participants have become a more central focus of regulatory authorities, including the SEC.

One particular focus of the SEC over the past few years has been what is perceived to be the improper use of "short sales" by investors in PIPE transactions. For decades, the SEC has fought to limit the availability and timing of these short sales through a combination of SEC regulations, Staff interpretative guidance and a number SEC enforcement and administrative actions targeted primarily against PIPE investors. In three recently adjudicated cases brought by the SEC's Division of Enforcement, the courts either outright rejected or cast substantial doubt upon some of the SEC's long-term theories governing short sales in PIPE transactions. Despite these setbacks, however, the SEC appears committed to maintaining its positions.

Background

Features of PIPE Transactions

PIPE transactions have two primary components. The first involves the original issuance of securities—that is, the private placement of securities by a public company to one or more accredited investors in reliance on the statutory private placement exemption provided by

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Section 4(2) of the Securities Act of 1933 ("Securities Act") and/or private offering exemption provided by Regulation D under the Securities Act. The securities sold in PIPEs may include common stock, straight or convertible preferred stock, straight or convertible debt or a combination of these securities, as well as warrants issued to investors as a "sweetener." These securities are privately placed to the PIPE investors, and are therefore considered "restricted securities" within the meaning of the rules under the Securities Act.[3]

Because the PIPE investors require resale liquidity, the second component involves the filing of a registration statement by the issuer to register with the SEC the reoffer and resale of the (underlying) common shares issued or issuable in the PIPE by the investors as named selling securityholders on a delayed or continuous basis in one or more transactions at varying prices (i.e., variable priced).[4] Although the PIPE can be structured so that an effective registration statement is a condition to closing the transaction (commonly referred to as a "pure" or "traditional" PIPE), most PIPEs today provide for the filing of a registration statement with the SEC within some number of days *after* the private placement is completed. Once the SEC declares the registration statement effective, the PIPE investors are then generally able to freely resell their shares in the trading market.

Short Selling

The public announcement of a PIPE transaction often causes the price of the PIPE issuer's shares to decline. This occurs for a few reasons. First, the issuance of shares in a PIPE transaction dilutes the issuer's pre-transaction shares outstanding; that is, each share outstanding prior to the PIPE represents a smaller percentage of the issuer's total equity once the transaction is completed.[5] Second, because the PIPE shares are deemed "restricted securities" within the meaning of the rules under the Securities Act, they are often sold by the issuer at a discount to the issuer's recent trading price.[6] The discount is designed in part to compensate investors for the illiquidity of these shares prior to the time the resale registration statement is declared effective by the SEC or the PIPE investors are otherwise eligible to resell their shares publicly pursuant to Rule 144 under the Securities Act. Finally, for many issuers, the completion of a PIPE transaction is interpreted by the market as an indication that the issuer was unable to raise capital through more traditional (i.e., preferable) methods that generally offer more favorable pricing terms to the issuer, including through a registered public offering. Because the public announcement of a PIPE typically causes an issuer's stock price to decline, pre-announcement knowledge of a PIPE transaction can provide PIPE investors (and others with advance knowledge of the transaction) with potentially unfair profit opportunities if left unregulated.

In large part based upon the anticipated decline in the trading price of an issuer's stock following the public announcement of a PIPE, many PIPE investor groups elect to hedge their investment in the issuer's publicly-traded stock. Short sales are one of the most common forms of hedging activities by these investors. In a conventional short sale effected in connection with a PIPE, promptly after the issuer publicly announces the PIPE transaction (or in some cases, prior to its public announcement), the investor borrows the issuer's publicly-traded security from a third party, which is often a brokerage firm, and sells it through a market transaction pursuant to an exemption from registration provided under Section 4(1) of the Securities Act. The investor pays a loan or transaction fee to the lender for the borrowed shares. At some point following the sale, the investor acquires the number of shares equal to the borrowed amount through a public or private transaction and provides (i.e., returns) them to the lender. The delivery of the shares to the lender is referred to as "covering" the investor's short position. In a number of instances, PIPE investors have covered their short positions in the issuer's securities by delivering shares they purchased in the PIPE transaction after the registration statement covering the resale of those shares was declared effective by the SEC.

The SEC's Enforcement Actions

The SEC's enforcement actions targeting short sales made in connection with PIPE transactions have been premised generally on one or more of the following three theories:

1. Sale of unregistered securities in violation of Section 5 of the Securities Act ("Section 5").
2. Material misrepresentations in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") and Rule 10b-5 promulgated thereunder ("Rule 10b-5").
3. Insider trading in violation of Section 10(b), Rule 10b-5 and Section 17(a) of the Securities Act ("Section 17(a)").

Until recently, substantially all of the cases brought by the SEC's Enforcement Division in this area were settled by the parties prior to trial. Although these settlements produced a number of significant victories for the SEC against PIPE investors and their affiliates, in many cases resulting in suspensions and disbarment from the securities industry and large fines,[7] they deprived the courts of the opportunity to evaluate the merits of the SEC's theories. Recently, however, PIPE investors named as defendants in three of these cases have elected to forego the settlement process in favor of trial. In all three cases, the courts struck down some or all of the SEC's claims.

The Cases

SEC v. Mangan[8]

In December 2006, the SEC filed a complaint against John F. Mangan, Jr. in the United States District Court for the Western District of North Carolina alleging that Mangan committed unlawful insider trading in violation of Section 10(b), Rule 10b-5 and Section 17(a) by short selling securities of CompuDyne Corporation prior to the public announcement of CompuDyne's 2001 PIPE offering. At the time of the short sale, Mangan worked for a registered broker-dealer acting as the placement agent for CompuDyne's PIPE offering. After the price of the PIPE had been set, Mangan instructed his broker to sell CompuDyne's stock short through an account of Mangan's business partner, which was purchasing shares in the PIPE. Mangan's broker placed the short order before the PIPE transaction closed and was announced to the public, when CompuDyne's share price was $14.16. Shortly after the announcement, the share price rose to a high of $15.20, but subsequently fell and closed at $14.25. In addition to the insider trading claim, the SEC's complaint alleged that Mangan engaged in unregistered sales of CompuDyne's securities in violation of Sections 5(a) and 5(c) of the Securities Act by using shares purchased in the PIPE to cover the short position.

SEC v. Lyon and Gryphon Funds[9]

Also in December 2006, the SEC filed a complaint against Edward Lyon and the Gryphon Funds, a series of on-shore and off-shore hedge funds, in the U.S. District Court for the Southern District of New York in connection with at least 35 PIPE transactions completed during 2001 to 2004. The complaint alleged that the defendants perpetrated an illegal trading scheme to evade the registration requirements of the federal securities laws in violation of Sections 5(a), 5(b) and 5(c) of the Securities Act by selling the PIPE issuers' stock short and covering their short positions with shares acquired in the PIPE transactions after the resale registration statements covering the PIPE shares were declared effective by the SEC. In addition, the complaint alleged that to induce the issuers to sell them the securities in the PIPE transactions, the defendants falsely represented to the PIPE issuers—in violation of Section 10(b) and Rule 10b-5—that they would not sell, transfer or dispose of the PIPE shares other than in compliance with the registration provisions of the Securities Act. The SEC's complaint also alleged that on at least four occasions the defendants engaged in their short sales prior to the public announcement of the PIPEs, which constituted insider trading in violation of Section 10(b), Rule 10b-5 and Section 17(a).

SEC v. Berlacher[10]

In September 2007, the SEC filed a complaint against Robert A. Berlacher, Lancaster Investment Partners L.P. and eight related entities, in the U.S. District Court for the Eastern District of Pennsylvania in connection with at least 10 PIPE transactions completed during 2000 to 2005. The claims against the defendants were similar to those brought against the defendants in *Lyon*. Specifically, the complaint alleged that the defendants violated Sections 5(a), 5(b) and 5(c) of the Securities Act by selling the PIPE issuers' stock short and covering their short positions with shares acquired in the PIPE transactions after the resale registration statements covering the shares were declared effective by the SEC. In addition, the complaint alleged that the defendants made materially false representations to the PIPE issuers in violation of Section 10(b) and Rule 10b-5, and on at least one occasion engaged in short sales of the issuer's stock prior to the public announcement of a PIPE transaction in violation of Section 10(b), Rule 10b-5 and Section 17(a).

The Claims

Unlawful Sale of Unregistered Securities

Absent an exemption, Section 5 prohibits the offer, sale and delivery of unregistered securities and the sale and delivery of registered securities unless accompanied or preceded by a prospectus that complies with Section 10 of the Securities Act. A "sale" includes "every contract of sale or disposition of a security or interest in a security, for value" and an "offer to sell" means "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[11]

The SEC believes it is a violation of Section 5 for a PIPE investor to take a short position in a PIPE issuer's publicly traded shares prior to the effective date of the resale registration statement covering the PIPE shares and to later cover that short position with shares acquired by the investor in the PIPE transaction.[12] Specifically, the SEC deems the shares that an investor uses to cover a short position to be the shares that were initially sold by the investor to create its short position—that is, the shares delivered to cover a short position are deemed to have been sold by the investor at the time the short sale was made (to create the short position), not when the shares are actually delivered to close the short position.[13] Accordingly, in the event a PIPE investor takes a short position prior to the effective date of the resale registration statement covering the PIPE shares and later uses the shares it acquires in the PIPE to cover, the SEC believes that the investor is effectively reselling *restricted* securities in an unregistered (i.e., illegal) public distribution, and without delivering a prospectus meeting the requirements of Section 10 under the Securities Act, in violation of Section 5. This position, which has been advanced by the SEC for decades through a number of SEC releases, Staff no-action letters and SEC enforcement actions,[14] was also set forth in the SEC's Division of Corporation Finance Manual of Publicly Available Telephone Interpretations ("Telephone Interpretations") issued in July 1997:

> 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 . . . and cover the short sale with registered shares after the effective date. The issuer was advised that the short sale could not be made before the registration statement becomes effective, because the shares underlying the short sale are deemed to be sold at the time such sale is made. There would, therefore, be a violation of Section 5 if the shares were effectively sold prior to the effective date.[15]

According to the SEC, there is a correct way for PIPE investors to hedge their investment risk using short sales. Under this approach, commonly referred to as the "double print" technique, the investor must sell the shares short in a public transaction in compliance with Section 5 of the Securities Act (e.g., pursuant to the exemption provided under Section 4(1) under the Securities Act) and later cover its short position by delivering shares it acquires in the public market *after* the public announcement of the PIPE.[16] To qualify as a valid double print transaction, the acquisition of shares in the public market to cover the short position must be independent from the investor's resale of the PIPE shares—that is, the investor cannot use the PIPE shares to engage in "wash sales," "matched orders," "closing the box" techniques or pre-arranged trades to acquire the open market shares.[17] The SEC reaffirmed its acceptance of the double print approach in *Lyon*, as well as other "short sale" cases brought by the Division of Enforcement in connection with PIPE transactions. In one such case, the SEC stated in its complaint:

> Many PIPE investors 'hedge' their investment by selling short the PIPE issuer's securities before the resale registration statement is declared effective. There is nothing per se illegal about 'hedging' a PIPE investment by selling short the issuer's securities. Such short sales do not violate the registration provisions of the Securities Act if, among other things, the investor closes out the short position with shares purchased in the open market . . .[18]

The defendants in *Lyon*, *Mangan* and *Berlacher* used the shares they acquired in PIPE transactions to cover their short positions in the PIPE issuers' stock after the resale registration statements covering the reoffer and resale of the PIPE shares were declared effective by the SEC. In each case, the SEC argued that the defendants violated Section 5 by selling and delivering unregistered securities without an exemption.

The courts ruled against the SEC in all three cases. Specifically, each court held that the SEC had no basis to allege that the delivery of PIPE shares to close a short position effectively converted the underlying short sale into an unregistered resale of the PIPE shares at the time of the short sale. In rejecting the SEC's position, the court in *Lyon* advanced two main points. First, it stated that when the defendants created their short positions, they did not transfer an interest in the PIPE shares. Instead, the court noted that by effecting a short sale the PIPE investor's account incurred a deficit—an obligation to later deliver securities to cover its short position—and that the manner in which the investor chose to satisfy that deficit (e.g., through the delivery of pre-owned shares or shares acquired in the PIPE or in open market transactions) did not "alter the nature" of the short sale.[19] According to the court, a "short sale of a security constitutes a sale of that security," not the security used to cover the short position.[20] Second, the *Lyon* court found that the SEC's position did not advance the primary purpose of Section 5 of the Securities Act, which is to protect investors by making material information concerning public offerings of securities available to them. The court determined that the purchasers of the shorted shares received all of the information regarding the PIPE issuers' securities to which they were entitled.

Perhaps more significant than its decision to dismiss the SEC's Section 5 claims, in its opinion the *Lyon* court called into question both the significance and authority of SEC releases and regulatory proposals, as well as Staff Telephone Interpretations. The court stated that these sources provided "negligible support for the SEC's view of short sales" and that "[b]ecause telephone interpretations are expressly not rules, regulations, or even approved statements of the SEC, they are not entitled to any deference beyond their 'power to persuade.' "[21] In particular, the *Lyon* court noted that Telephone Interpretation A.65 is "simply a conclusory statement" made by the Staff without any underlying support.[22]

Calling the SEC's Section 5 theory "creative,"[23] the *Mangan* court noted that the defendant would have needed to cover his short position with shares purchased in the open market if the PIPE transaction had failed to close to contradict the SEC's theory that the shares used to cover a short position are effectively sold at the time the short position is created. In addition, as in *Lyon*, the *Mangan* court noted that the shares received by the buyers in the short sales were freely tradable by the buyers, as opposed to restricted securities. Accordingly, the court determined that "no sale of unregistered securities occurred as a matter of law."[24] Without issuing a written opinion, the *Berlacher* court expressly adopted the reasoning of the *Lyon* court to dismiss the SEC's Section 5 claims.

Material Misrepresentations

In order to offer and sell securities in a PIPE transaction (as a valid private placement), the issuer typically relies on the exemption from registration provided under Section 4(2) of the Securities Act and/or the private offering exemption provided by Regulation D under the Securities Act. To qualify for either exemption, the investors must purchase the PIPE securities for investment purposes and without a present intent to distribute them. Otherwise, the investors may be deemed "underwriters" of the PIPE issuer's securities under federal securities laws, which would require that the sale of the PIPE securities by the issuer be registered under the Securities Act. To substantiate their exemption from registration, PIPE issuers typically require that investors pledge their investment intent in the PIPE purchase agreement, and further agree not to sell, transfer or dispose of their PIPE shares other than in compliance with the registration provisions of the Securities Act. In CompuDyne's PIPE purchase agreement, for example, the investors represented and warranted to CompuDyne that they were acquiring the PIPE shares "for investment only and with no present intention of distributing any . . . shares" and that they would not "dispose of . . . any of the shares except in compliance with the Securities Act."[25]

Because the investors' investment intent is one of the requirements for a valid private placement, the SEC believes that these investor representations are materially false and violate Section 10(b) and Rule 10b-5 if at the time they are made, the PIPE investor plans to sell the issuer's shares short (or in fact already has sold the issuer's shares short) and cover the short position with shares acquired in the PIPE transaction after they are registered for resale.[26] Section 10(b) makes it illegal to use "any manipulative or deceptive" practice "in connection with the purchase or sale of any security." Under Rule 10b-5, it is unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading . . . in connection with the purchase or sale of any security." According to the SEC, when an investor purchases PIPE shares with the intent of using them to cover the investor's pre-effective short position, the investor is effectively planning to engage in a distribution of the PIPE shares in violation of Section 5.[27]

The SEC brought this claim against the defendants in *Lyon* and *Berlacher* and lost in both cases. Based on its prior determination that covering a pre-effective short sale with shares acquired in a PIPE did not constitute a "distribution" of the PIPE shares for purposes of Section 5, the *Lyon* court held that the investors' representations were not false.[28] The *Berlacher* court again adopted the reasoning set forth in *Lyon* to reach the same conclusion.

Insider Trading

If timed properly, short sales can be a legal and effective way for PIPE investors to hedge their investment risk. However, according to the SEC, an improperly timed short sale may constitute insider trading in violation of Section 10(b), Rule 10b-5 and Section 17(a). Over the last decade, the SEC has brought a number of enforcement actions against PIPE investors who sold an issuer's publicly-traded shares after learning about the issuer's proposed PIPE transaction, but prior to its public announcement.[29] The SEC believes that these short sales are being completed by PIPE investors on the basis of material, non-public information in violation of federal securities laws.[30]

In order to establish an illegal insider trading claim, it must be shown that the information at issue is both material and non-public, and that the recipient of the information either had a fiduciary (i.e., insider)[31] relationship with the issuer (the "classical" theory of insider trading) or misappropriated confidential information in breach of a duty of trust or confidence owed to the issuer (the "misappropriation" theory of insider trading).[32] The SEC considers the fact that an issuer is planning to engage in a PIPE transaction is, by itself, material information about the issuer.[33] According to the SEC, this is supported by the fact that in many instances the PIPE issuer's stock price declines immediately after the PIPE is publicly announced.[34] In addition, the SEC believes that by accepting information about an issuer's proposed PIPE transaction, the recipient becomes bound by a duty to the PIPE issuer to keep the information confidential.[35] As a result, the confidential information is misappropriated by the PIPE investor in breach of this duty when the investor engages in a short sale of the issuer's stock (or effects any other market transaction in the issuer's securities) prior to the public announcement of the PIPE.

To minimize the risk that potential investors will trade in the issuer's securities after learning about a proposed PIPE transaction, a placement agent or other party responsible for contacting the prospective PIPE investors typically will require that the potential investors covenant not to disclose the proposed PIPE or engage in any transaction in the issuer's securities (other than purchasing the securities in the PIPE) until the transaction is publicly announced by the issuer. Often these covenants are also set forth in the preliminary offering materials distributed to the prospective investors. Regardless of whether these covenants are made, however, the SEC believes that insider trading rules prohibit any party who receives notice of a proposed PIPE from trading in an issuer's securities at least until the time the transaction is publicly disclosed.

To date, the SEC has had limited success enforcing this theory in the courts. In *Mangan*, after dismissing the SEC's Section 5 claim regarding unlawful sales of unregistered securities, the court initially permitted the SEC to proceed with its insider trading claims against the defendant. The court stated that the insider trading claims depended on whether the information regarding the proposed PIPE was material, and noted that it was "a very close call" since the public announcement of the PIPE appeared to have had little impact on the issuer's stock price.[36] However, after further hearings, the court issued its final Order in August 2008 and dismissed the SEC's insider trading claims entirely.[37] The court placed particular emphasis on the nexus between the public disclosure of the PIPE and changes in the issuer's stock price, stating that "price movement is determinative of materiality under this factual record." Because CompuDyne's stock price *increased* immediately after the PIPE was publicly announced and later closed above the trading price of CompuDyne at the time the defendant shorted his stock, the court determined that the information regarding the PIPE could not have had a material, negative impact on the share price and was therefore "immaterial as a matter of law."[38]

With some glimmer of hope for the SEC, the courts in both *Lyon* and *Berlacher* have permitted the SEC's insider trading claims against the defendants to proceed. Unlike in *Mangan*, the defendants in *Lyon* did not argue that the information regarding the proposed PIPE transactions was not material. Instead, the defendants challenged the second prong of the SEC's insider trading allegations and claimed that they were not bound by a duty of confidentiality to the issuers when they executed their short sales. In its decision, the *Lyon* court noted that the SEC had "alleged facts with the requisite specificity that plausibly support its claim that a confidential relationship arose between defendants and those four PIPE issuers" based primarily on the confidentiality requirements set forth in certain PIPE offering materials provided to the defendants.[39] The insider trading claims in both cases are still pending.

The SEC's insider trading enforcement efforts in the PIPE arena recently received more press when in November 2008, the Enforcement Division filed an insider trading case against Mark Cuban, owner of the Dallas Mavericks, HDNet and Landmark Theaters, in connection with his sale of 600,000 shares of common stock of Mamma.com (now known as Copernic Inc.) in June 2004.[40] The sales took place after Mr. Cuban learned, on a confidential basis, about Mamma.com's proposed PIPE and prior to the time the PIPE was publicly disclosed. Although Mr. Cuban did not short sell Mamma.com's stock, the SEC's complaint alleged that his sales were made in violation of Section 10(b), Rule 10b-5 and Section 17(a) because Mamma.com's proposed PIPE, as well as the terms of the PIPE, constituted material, non-public information that was misappropriated by Mr. Cuban when he sold his 600,000 shares. The day after Mamma.com publicly announced its PIPE transaction, its stock price opened down 9.3% from the previous day's closing price. This case is still pending.

Advice to PIPE Issuers and Investors

Despite these defeats, the SEC appears undeterred in its goal to curb perceived short sale abuses in PIPE transactions. On November 26, 2008, well after the *Lyon*, *Mangan* and *Berlacher* courts dismissed the SEC's Section 5 claims, the SEC effectively reissued Telephone Interpretation A.65 as Compliance and Disclosure Interpretation 239.10.[41] In addition, in 2007, the SEC's Division of Corporation Finance began requiring through the comment letter process that certain issuers disclose in their PIPE resale registration statements whether any PIPE investor (listed as selling security holder) holds a short position in the issuer's stock and, if so, the date on which the investor entered into the short position—specifically, whether it was before or after the public announcement of the PIPE and also whether it was before or after the filing of the registration statement.[42] The reissuance of this interpretation and the SEC's request for short position disclosure can be understood to mean that notwithstanding these three decisions, the SEC likely will continue to advance and seek to enforce its position that it is unlawful to cover a pre-effective date short position with shares purchased in the PIPE. Therefore, PIPE investors who elect to cover their short positions in this manner may continue to find themselves at risk of an SEC action.

The SEC may also remain firm in its position that an investor's knowledge of a pending PIPE transaction constitutes material, non-public information for which the investor has a duty not to misappropriate. *Mangan* suggests that whether knowledge about a proposed PIPE transaction constitutes material information perhaps can only be assessed with the benefit of hindsight based on the price patterns of the issuer's stock after the PIPE is publicly announced. In addition, *Lyon* suggests that an investor may be subject to a duty not to misappropriate information relating to the PIPE even where the investor has not expressly agreed to assume this obligation. *Accordingly, the safest course for investors who wish to hedge their position in a PIPE issuer's stock is to wait at least until the PIPE is publicly disclosed by the issuer.*

Although *Mangan*, *Lyon* and *Berlacher* only included claims against PIPE investors, these cases have broad implications for PIPE issuers. First, issuers may incur negative publicity when their names and their financings are the subject of (often) well-publicized SEC enforcement actions, particularly those involving insider trading claims. This can result in a management distraction while an enforcement action is pending and may impair the issuer's ability to raise financing in the future if prospective investors question the integrity of the issuer's stock price. Second, as noted above, in order for issuers to complete a valid PIPE transaction, they must qualify for an exemption from the registration requirements of Section 5. In light of the SEC's view that covering a pre-effective short sale with shares acquired in a PIPE transaction constitutes an unregistered distribution of the PIPE shares by the investor *for which no exemption is available*, the SEC is effectively alleging that the investor is acting as an underwriter of the issuer's securities. An underwritten offering must be registered with the SEC. Therefore, covering a short position in this manner effectively places the validity of *the issuer's* private placement in jeopardy. The SEC could begin questioning the issuer's compliance with Section 5 as a logical extension of its claims against the PIPE investors. Finally, the SEC may begin to require that PIPE issuers themselves "enforce" the positions that were struck down by the courts in *Mangan*, *Lyon* and *Berlacher*. One approach the Division of Corporation Finance may use to achieve this result is to deny issuers the ability to register for resale shares acquired by a PIPE investor that has sold short the issuer's stock prior to the public announcement of the PIPE, or after the public announcement of the PIPE if the issuer has failed to obtain a written covenant from the investor that it would not cover its pre-effective short position with shares acquired in the PIPE. Issuers often incur cash and other penalties in favor of PIPE investors for failing to register the PIPE shares for resale. The Division's solicitation of PIPE investors' short positions in connection with an issuer's resale registration statement may be viewed as a precursor to imposing these limitations.

In light of these concerns, issuers may wish to take steps to mitigate their exposure in connection with future PIPE transactions. One clear mechanism is for issuers (and their placement agents) to seek standstill agreements from prospective investors before they are provided information regarding a proposed transaction. Under the agreement (which may be made orally or in writing), each prospective investor would covenant not to engage in any transactions in the issuer's securities, including short sales, at least until the PIPE had been disclosed publicly by the issuer. Each investor's compliance with this covenant could be confirmed (and reaffirmed) in the PIPE purchase agreement. Issuers also may wish to require that investors covenant in the PIPE purchase agreement that they will not cover any pre-effective short position in the issuer's stock with securities acquired in the PIPE transaction. In the event a potential investor is unable or unwilling to agree to each of these terms, the issuer may wish to exclude the party from participating in the PIPE.

NOTES:

[1] http://www.sagientresearch.com/pt/.

[2] http://www.sagientresearch.com/pt/.

[3]*See* Rule 144 promulgated under the Securities Act.

[4]The resale offers and sales are registered on a Form S-1 registration statement or Form S-3 registration statement (depending on the issuer's eligibility) pursuant to Rule 415 promulgated under the Securities Act.

[5]*See SEC v. Mangan, Civil Action No. 3:06-CV-531 (W.D.N.C. Dec. 28, 2006)*; *SEC v. Lyon, Civil Action No. 06-CV14338 (S.D.N.Y. Dec. 12, 2006)*; and *SEC v. Berlacher, Civil Action No.07-cv-3800 (E.D. Pa. Sept. 13, 2007)*.

[6]*See SEC v. Mangan, Civil Action No. 3:06-CV-531 (W.D.N.C. Dec. 28, 2006)*; *SEC v. Lyon, Civil Action No. 06-CV14338 (S.D.N.Y. Dec. 12, 2006)*; and *SEC v. Berlacher, Civil Action No.07-cv-3800 (E.D. Pa. Sept. 13, 2007)*.

[7]*See, e.g., SEC v. Hilary L. Shane, No. 05-4772 (S.D.N.Y. May 18, 2005)*, in which the defendant agreed to disgorgement and civil penalties of $1 million, disbarment from the broker-dealer industry and a 12-month suspension from the investment management industry, and *SEC v. Langley Partners et al, No. 1:06CV00467 (D.D.C. Mar. 14, 2006)*, in which the defendants agreed to disgorge almost $9 million in profits and pay civil penalties of $7 million.

[8]*SEC v. Mangan, Civil Action No. 3:06-CV-531 (W.D.N.C. Dec. 28, 2006)*.

[9]*SEC v. Lyon, Civil Action No. 06-CV14338 (S.D.N.Y. Dec. 12, 2006)*.

[10]*SEC v. Berlacher, Civil Action No.07-cv-3800 (E.D. Pa. Sept. 13, 2007)*.

[11]Section 2(a)(3) under the Securities Act.

[12]*See, e.g.,* the SEC Complaints in *SEC v. Mangan*, *SEC v. Lyon* and *SEC v. Berlacher*.

[13]*See, e.g.,* the SEC Complaints in *SEC v. Mangan*, *SEC v. Lyon* and *SEC v. Berlacher*.

[14]*See, e.g., SEC v. Hilary L. Shane, No. 05-4772 (S.D.N.Y. May 18, 2005)*; *SEC v. Langley Partners et al, No. 1:06CV00467 (D.D.C. Mar. 14, 2006)*; *SEC v. Badian, No. 06 Civ. 2621 (S.D.N.Y. Apr. 4, 2006)*; Exchange Act Release No. 10636, 1974 SEC LEXIS 3486 (Feb. 11, 1974); Goldman Sachs & Co., SEC No-Action Letter (Dec. 20, 1999) and Goldman Sachs & Co., SEC No-Action Letter (Oct. 9, 2003).

[15]Telephone Interpretation A.65.

[16]*See, e.g.,* Complaint of SEC in *SEC v. Langley Partners, L.P., (D.C. Cir., Case No. 1:06CV00467) (Mar. 14, 2006)*, Complaint of SEC in *SEC v. Lyon* and In the Matter of Spinner Asset Management, LLC, Securities Act Release No. 8763 (Dec. 20, 2006).

[17]See, e.g., Complaint of SEC in *SEC v. Lyon*.

[18]*In the Matter of Spinner Asset Management, LLC*.

[19]Opinion and Order, dated January 2, 2008 at 17.

[20]Opinion and Order, dated January 2, 2008 at 17.

[21]Opinion and Order, dated January 2, 2008 at 24.

[22]Opinion and Order, dated January 2, 2008 at 25.

[23]Transcript of Proceedings before the Honorable Graham C. Mullen United States District Court Judge, October 24, 2007 at 43.

[24]Transcript of Proceedings before the Honorable Graham C. Mullen United States District Court Judge, October 24, 2007 at 44.

[25] Http://www.sec.gov/Archives/edgar/data/22912/000091565601500030/ex1.txt.

[26]*See, e.g.,* the SEC Complaints in *SEC v. Lyon* and *SEC v. Berlacher*.

[27]*See, e.g.,* the SEC Complaints in *SEC v. Mangan*, *SEC v. Lyon* and *SEC v. Berlacher*.

[28]Opinion and Order, dated January 2, 2008 at 9.

[29]*See, e.g., SEC v. Hilary L. Shane, No. 05-4772 (S.D.N.Y. May 18, 2005)*, *SEC v. Langley Partners et al, No. 1:06CV00467 (D.D.C. Mar. 14, 2006)* and *SEC v. Guillaume Pollet, No. 05-CV-1937 (E.D.N.Y. Apr. 21, 2005)*.

[30]*See, e.g.,* the SEC Complaints in *SEC v. Lyon* and *SEC v. Berlacher*.

[31]Insiders generally include directors, executive officers, other employees with access to material, non-public information about the issuer and significant stockholders.

[32]*United States v. O'Hagan*, 521 U.S. 642, 655 (1997). Rule 10b5-2 promulgated under the Securities Exchange Act of 1934, as amended, "provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading under Section 10(b) of the Act and Rule 10b-5."

[33]*See, e.g.,* the SEC Complaints in *SEC v. Lyon* and *SEC v. Berlacher*.

[34]*See, e.g.,* the SEC Complaints in *SEC v. Lyon* and *SEC v. Berlacher*.

[35]*See, e.g.,* the SEC Complaints in *SEC v. Lyon* and *SEC v. Berlacher*.

[36]Transcript of Proceedings before the Honorable Graham C. Mullen United States District Court Judge, October 24, 2007 at 46.

[37]Order, dated August 20, 2008.

[38]Order, dated August 20, 2008, at 10.

[39]Opinion and Order, dated January 2, 2008 at 13.

[40]*SEC v. Cuban, Civil Action No. 3-08-CV-2050 (N.D. TX Nov. 17, 2008)*.

[41]Issued on November 26, 2008.

[42]*See, e.g.*, Staff Comment Letter, dated May 16, 2007, issued to Carbiz, Inc. and Staff Comment Letter, dated October 15, 2007, issued to Open Energy Corp.