

CAPITAL MARKETS BULLETIN

January 2008

UNITED STATES FEDERAL COURT DEALS BLOW TO SEC THEORY ON SECURITIES ACT VIOLATION WHEN COVERING SHORT SALES OF PIPE SECURITIES

On January 2, 2008, Judge Stein of the United States District Court for the Southern District of New York (the "Court") issued an opinion dismissing a claim brought by the Securities and Exchange Commission (the "SEC") against investment manager Edwin Buchanan Lyon IV and his related companies and managed funds (collectively, the "Gryphon Entities").¹ The claim was based on the SEC's long-stated theory that covering short sales with securities purchased in a PIPE transaction that were restricted at the time of the short sale violates Section 5 of the Securities Act of 1933 (the "Securities Act") even if those securities were subsequently registered prior to the time the short sale was covered.

An unregistered security generally cannot be sold publicly until a registration statement is filed by the issuer and is declared effective by the SEC or an exemption from registration is available. In PIPE transactions, the issuer typically agrees to register the securities for future resale.

During the period between the acquisition of a security in a PIPE transaction and the effective date of the resale registration statement, PIPE investors often "hedge" their investments by selling short the PIPE issuer's publicly traded securities. Lyon and the Gryphon Entities hedged all but one of their PIPE investments by executing short sales that fully hedged, or hedged as much as possible, their PIPE positions. When the defendants shorted the PIPE issuers' publicly traded stock, no resale registration statement was in effect for the corresponding PIPE

shares and no registration exemption was available. To "cover" their short positions, Lyon and the Gryphon Entities waited until the SEC declared a PIPE resale registration statement effective and then used their formerly restricted PIPE shares to close out their short positions.

The SEC alleged that Lyon and the Gryphon Entities violated Section 5 of the Securities Act by taking short positions in PIPE shares before the PIPE resale registration statement was in effect and then closing the short positions with PIPE shares after the effective date of the resale registration statement. The short sales were effected in the open market.

The Court dismissed the SEC claim, stating that, "[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."

The Court further elaborated that the SEC's categorization of a short sale did not advance the purpose of Section 5's registration requirement. The Court cited the United States Supreme Court's observation that "[t]he primary purpose of the Securities Act is to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning public offerings of securities in interstate commerce,"² and further noted that the SEC did not allege that the buyers in the short sales lacked adequate public information when making their decision to buy.

Judge Stein's decision mirrors that of Judge Graham C. Mullen of the United States District Court for the Western District of North Carolina in SEC v. Mangan,³

¹ SEC v. Lyon, 2008 U.S. Dist. LEXIS 9 (D.N.Y.. 2008).

² Pinter v. Dahl, 486 U.S. 622, 638, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988).

³ Civil Action No. 3: 06-CV-531 (W.D.N.C. Filed December 28, 2006).

which also ruled against the SEC. Just as in Lyon, the SEC brought a Section 5 violation claim as a result of the short selling of a PIPE issuer's publicly traded securities later covered by PIPE shares that were not registered at the time of the short sale. Judge Mullen stated, "[t]he government's allegation of a Section 5 violation is certainly creative. And while there seems little doubt that the defendant sold short anticipating the receipt of PIPE shares to cover the short, it's also true that in any case he would have had to cover with the shares purchased in the open market should the PIPE fail to close or been withdrawn or otherwise not be available to produce those shares. And what we have here, it seems to me, is a *post hoc ergo propter hoc* argument by the government that because the PIPE in fact was not registered and because the PIPE shares were later in fact used, he in effect sold the PIPE. Well, maybe, but I don't think he did anything illegal. In short, no sale of unregistered securities occurred as a matter of law."

The SEC's view, rejected by these two decisions, has been that restricted shares sold short can only be covered by securities purchased on the open market and not in what it calls "sham" transactions.

We will continue to monitor any appeals and report further developments in a future *Capital Markets Bulletin*.

ATTORNEY ADVERTISING. PRIOR RESULTS DO NOT GUARANTEE A SIMILAR OUTCOME. THE INFORMATION CONTAINED IN THIS NEWSLETTER IS FOR INFORMATIONAL PURPOSES ONLY AND IS NOT INTENDED AND SHOULD NOT BE CONSIDERED TO BE LEGAL ADVICE ON ANY SUBJECT MATTER. AS SUCH, RECIPIENTS OF THIS NEWSLETTER, WHETHER CLIENTS OR OTHERWISE, SHOULD NOT ACT OR REFRAIN FROM ACTING ON THE BASIS OF ANY INFORMATION INCLUDED IN THIS NEWSLETTER WITHOUT SEEKING APPROPRIATE LEGAL OR OTHER PROFESSIONAL ADVICE. THIS INFORMATION IS PRESENTED WITHOUT ANY WARRANTY OR REPRESENTATION AS TO ITS ACCURACY OR COMPLETENESS, OR WHETHER IT REFLECTS THE MOST CURRENT LEGAL DEVELOPMENTS.

This edition of the newsletter may be found on the web at www.sewkis.com under Publications and Speeches.

SEWARD & KISSEL LLP

IF YOU HAVE ANY QUESTIONS OR COMMENTS ABOUT THIS NEWSLETTER, PLEASE FEEL FREE TO CONTACT GARY J. WOLFE (212-574-1223) OR ROBERT E. LUSTRIN (212-574-1420), OR EMAIL BY TYPING IN THE ATTORNEY'S LAST NAME FOLLOWED BY @SEWKIS.COM

SEWARD & KISSEL LLP

One Battery Park Plaza, New York, New York 10004
Telephone: (212) 574-1200 **Fax:** (212) 480 8421
Email: sknyc@sewkis.com
www.sewkis.com