New York Law Journal
Corporate Update
VOLUME 235—NO. 3
THURSDAY, JANUARY 5, 2006
ALM

INSIDER TRADING

PIPE Offerings Contain Potential for Illegal Trading

BY CHARLES A. ROSS AND CHRISTOPHER L. PADURANO

Certainly to the initiated, a PIPE[1] is not something challenging to surf. Rather it is a recognized and legitimate method of funding for a public company. However, some recent examples illuminate the risk of illegal insider trading in the context of PIPE offerings. Indeed, "insider trading" is a term these days often associated with illegal, criminal conduct. However, the term includes both legal and illegal conduct. Legal insider trading happens every day and occurs when corporate insiders, such as officers, directors, or employees, buy and sell stock in their own companies. The corporate insiders must then report their trades to the Securities and Exchange Commission ("SEC").[2]

On the other hand, some would argue that illegal insider trading also occurs on a daily basis.[3] Illegal insider trading, both criminal and regulatory, is generally the buying and selling of a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.[4] Other insider trading violations may include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

One of the more recent developments in the area of securities enforcement is the prosecution of those alleged to have used inside information obtained as a result of his or her involvement in a PIPE transaction and, in violation of his or her fiduciary duty, short sell securities.[5]

Charles A. Ross *is a partner and* **Christopher L. Padurano** *is an associate at Herrick, Feinstein.*

Charles A. Ross

Christopher L. Padurano

This article is designed to provide a brief overview of what a PIPE transaction is, how the potential for criminal insider trading exists, and the body of law regulators and prosecutors will utilize to investigate and charge both individuals and companies with violations of securities laws. Additionally, we provide several examples of civil enforcement and criminal prosecution proceedings involving the short selling of securities pursuant to the announcement of a PIPE offering. Finally, we provide counsel with suggestions on how best to represent clients involved in trading occurring in connection with PIPE offerings.

What Is a PIPE?

In a PIPE offering, investors commit to purchase a certain number of restricted shares[6] from a company at a specified price. A PIPE is a means, albeit often a means of final resort, for a company to raise capital, generally via Section 4(2) of the Securities Act and/or the SEC's Regulation D safe harbor. Generally, investors will agree to purchase the restricted shares in a private placement and the company agrees, in turn, to file a resale registration statement immediately after the closing of the private placement so that the investors can resell the shares to the public. To the extent that they increase the supply of a company's stock in the market, PIPE offerings can potentially dilute the value of existing shares. PIPE transactions can offer a company the speed and predictability of a private placement, while providing investors with a nearly liquid security at a discount from the current trading price.

Potential for Abuse

Because a PIPE allows for more shares of an issuing company's stock to be released into the marketplace, the PIPE itself can devalue, at least temporarily, the share price of a company's stock. Indeed, as a general rule, the announcement of a PIPE offering is often followed by a drop in the share price of the issuer company's stock. In turn, this predicable drop in price allows for those who know of an impending PIPE to short sell[7] the stock and make a profit.

An investor in units of a PIPE private placement may even short sell the stock and cover the sale with shares purchased as part of the PIPE, often purchased at a deep discount to the market. In addition, anyone with knowledge of the imminent announcement of a PIPE can short sell the issuer's stock and simply cover the sale by purchasing the needed shares in the market following the drop in price upon the announcement of the PIPE offering. Both regulators and prosecutors have taken the position that this type of transaction is unlawful insider trading.

Relevant Securities Laws

The statutory authority employed by the SEC and the Department of Justice ("DOJ") to bring civil enforcement insider trading actions or criminal prosecutions in connection with short selling PIPE offerings are generally Section 17(a) of the Securities Act,[8] Section 10(b) of the Exchange Act[9] and

Rule 10b-5 thereunder. Sections 5(a) and 5(c) of the Securities Act[10] have also been advanced as possible theories of prosecution. The DOJ, in an insider trading criminal prosecution, will more often than not attempt to add additional ancillary criminal offenses to an indictment, such as mail and wire fraud, conspiracy, and even obstruction of justice.

In order to meet its burden of proof to sustain a charge of insider trading, the government must demonstrate first, that in connection with the purchase or sale of a security, the defendant engaged in any one or more of the following: (a) employed a device, scheme or artifice to defraud, or (b) made an untrue statement of a material fact or omitted to state a material fact which made what was said, under the circumstances, misleading, or (c) engaged in an act, practice or course of business that operated, or would operate, as a fraud or deceit upon a seller or purchaser of the security. Next, the government must show that the defendant acted willfully, knowingly and with the intent to defraud. Finally, the government needs to prove that the defendant knowingly used, or caused to be used, any means or instruments of transportation or communication in interstate commerce or the use of the mail in furtherance of the fraudulent conduct.[11]

The court will then inform the jury that the "device, scheme or artifice" the government alleges the defendant utilized is known as insider trading. Additionally, the court will elaborate on who qualifies as an "insider," namely, corporate officers, directors, and controlling shareholders. The court will also specify that

> [a]n insider is one who comes into possession of material, confidential, non-public about a stock by virtue of a business relationship which involves trust or confidence. When a person has such "inside information" and his position of trust or confidence prevents him from disclosing that information, the law forbids him from buying or selling the securities in question …the mere possession of non-public or "inside" information does not impose any duty on the defendant to disclose before trading. [The jury] must find that there existed some special relationship … that created the duty. It is the breach of that duty that provides the basis for the government's charge that the defendant unlawfully engaged in a device, scheme or artifice to defraud by trading on material non-public information.[12]

Recent Enforcement

In *Securities and Exchange Commission v. Hilary L. Shane*, 05 Civil 4772 (S.D.N.Y. May 18, 2005), the SEC alleged Ms. Shane[13] was asked to participate in a PIPE offering by CompuDyne Corporation ("CompuDyne"). The SEC charged Ms. Shane with committing insider trading and violating registration requirements by short selling securities of CompuDyne prior to the public announcement of a PIPE offering and prior to the effective date of the resale registration statement for the PIPE shares. According to the SEC, the PIPE offering was going to have a significant dilutive effect on the value of existing CompuDyne shares because the PIPE shares would increase the supply of stock in the market by more than 200 percent. Sure enough, the stock dropped between $3 and $5 per share after the announcement of the PIPE offering and after the first trading day after the resale registration statement for the PIPE shares became effective.

While PIPEs may not always be a company's first choice to raise funds, they are becoming a more and more popular method for doing so… Criminal defense counsel for individuals in securities fraud cases will do well to know that a PIPE is not just something surfed on a big wave day at Waikiki.

The Complaint also alleged Ms. Shane agreed to purchase shares in the PIPE offering for her personal account and for one of the hedge fund accounts she managed. Although Ms. Shane agreed both orally and in writing to keep information about the PIPE offering confidential, the morning just before the public announcement of the PIPE offering, Ms. Shane began short selling CompuDyne securities in both her personal and the hedge fund's account. She continued short selling shares until she had sold the same number of shares she had been allocated in the PIPE offering. In essence, she covered all of her short sales with the shares she obtained in the PIPE offering making substantial profits for both accounts.

Ms. Shane subsequently submitted an Offer of Settlement which the SEC accepted. Ms. Shane consented to the entry of a final judgment in which she agreed to disgorge $652,938 in profits, to pay prejudgment interest of $125,292, and to pay a $296,785 civil penalty. She also consented to a bar from the broker-dealer industry and a suspension from the investment advisory industry.

On the other hand, Guillaume Pollet, was criminally prosecuted for trading on the basis on material nonpublic information he obtained as a result of his involvement in PIPE transactions.[14] The United States Attorney's Office for the Eastern District of New York, in conjunction with the SEC, filed a criminal complaint against Mr. Pollet, the former managing director of SG Cowen Securities Corporation ("SG Cowen"). SG Cowen was a broker-dealer of securities registered with the SEC and the National Association of Securities Dealers ("NASD"). SG Cowen was also a wholly-owned subsidiary of Société Générale Group, an international bank headquartered in France.

The Complaint alleged that Mr. Pollet, whose responsibilities included trading on the SG Cowen Regulation D desk, conspired to engage in criminal insider trading by causing accounts that he managed at SG Cowen to "short sell" over $4.6 million in publicly-traded securities of several companies while he was in possession of material, non-public information. It charged Mr. Pollet with engaging in this scheme from December 2000 through November 2001 while he was employed as a managing director in SG Cowen's New York office.

During that time, Mr. Pollet was reportedly responsible for investing the firm's proprietary funds through PIPE transactions. Because of this, Mr. Pollet was in a position, when he ordered the short sales, to know that the contemplated PIPE transactions would likely cause the market prices of the securities to decrease significantly.

The Complaint also alleged Mr. Pollet actively solicited material non-public information concerning the anticipated PIPEs and that he used this information to effectuate his scheme. During this time, SG Cowen acted as the placement agent for the companies contemplating the PIPEs. Mr. Pollet presumably covered his short positions by either purchasing discounted stock through an investment in the PIPEs or by purchasing the PIPE issuers' publicly-traded securities at the deflated post-announcement market prices. Mr. Pollet ultimately pleaded guilty, pursuant to a plea agreement, to, inter alia, insider trading. The agreement indicates the agreed-upon sentencing range for Mr. Pollet is between 18 and 24 months' imprisonment.

How Best to Advise a Client?

Counsel who represent an issuer of securities in a PIPE transaction should closely examine the relationships between the company seeking to raise funds, the placement agent, and the investors. When a placement agent and investor are asked to sign a confidentiality agreement agreeing not to disclose information about the PIPE offering prior to its announcement, does the agreement specifically restrict the types of trading permitted in the PIPE offering? Moreover, does the agreement specifically disallow short selling in the security? If so, for how long after the announcement must an investor refrain from short selling the security? If the agreement disallows short selling within a particular period, post-announcement, what recourse does an issuer have in the event short selling within the proscribed period occurs?

Counsel for an issuer should take care to draft strict non-disclosure provisions for investors and specifically limit any short selling of the issuer's stock until long after the announcement of the PIPE. Indeed, PIPE investors should be screened for the express purpose of a raise of capital and not for the quick buck of the hedged short sale.

Representing an investor of securities issued as part of a PIPE transaction raises serious concerns as well. For example, an investor investing in a PIPE offering may wish to hedge his or her investment and guard against a drop in the issuer's stock. Counsel for the investor should strongly advise their client that any short selling of a PIPE offering stock will subject them to regulatory action and criminal prosecution. There is also a need for counsel to examine the confidentiality agreement to determine what it exactly says about such conduct.

Finally, defense counsel who represents an individual target of a regulatory action or criminal prosecution must explore every defense possible. For example, if the target owed no fiduciary duty to the company, there may be a defense. Perhaps an impending PIPE deal was predictable, even inevitable given the track record of the issuer and an "investor's hunch" defense may be available, especially if you are representing a speculative trader. Perhaps the best criminal defense is to settle the regulatory inquiry early and avoid criminal prosecution altogether.

Conclusion

PIPE offerings are not new; in fact, companies have been raising funds in such a manner since the late 1990's. While PIPEs may not always be a company's first choice to raise funds, they are becoming a more and more popular method for doing so.[15] As a consequence of the increase in popularity of PIPEs, the investigation and subsequent prosecution of those who purportedly trade on the basis of inside information obtained as a result of his or her involvement with a PIPE offering is on the rise. Companies, investors, and placement agents need to reevaluate the manner in which confidential information is protected and used, especially in regard to the short selling of securities purchased prior to the public announcement of the PIPE. Moreover, with the advent of increased scrutiny and concomitant regulation of hedge funds, investors should heed the tales of Hilary Shane and Guillaume Pollet. Finally, criminal defense counsel for individuals in securities fraud cases will do well to know that a PIPE is not just something surfed on a big wave day at Waikiki.

1. PIPE stands for the "private investment in public equities."

2. See Section 16 of the Securities Exchange Act of 1934 ("Exchange Act").

3. See, e.g., *Securities and Exchange Commission v. Sonja Anticevic*, 05 Civ. 06991 (S.D.N.Y. Aug. 5, 2005); *United States v. Roger D. Blackwell*, 04 Cr. 00134 (S.D.Ohio Aug. 26, 2004); *United States v. Alfred S. Teo, Sr.*, 04 Cr. 00583 (D.N.J. Aug. 18, 2004); *United States v. Jeffrey K. Skilling*, 04 Cr. 00025 (S.D.Tx. Jan. 21, 2004); *Securities and Exchange Commission v. Martha Stewart*, 03 Civ. 04070 (S.D.N.Y. June 4, 2003); and *United States v. Samuel Waksal*, 02 Cr. 01041 (Aug. 7, 2002); see also Jenny Anderson, Today's Insider Trading Suspect May Wear a Lab Coat, N.Y. Times, Aug. 9, 2005, at C1 (discussing how the Samuel Waksal prosecution caused the SEC to more closely examine potential insider trading involving the approval of drugs).

4. See e.g., *Chiarella v. United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed. 348 (1980); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); and *Securities and Exchange Commission v. Materia*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); see also Leonard B. Sand et al., Modern Federal Jury Instructions,¶¶57-21, 24 (2003).

5. See, e.g., *United States v. Guillaume Pollet*, 05 Cr. 287 (E.D.N.Y. April 26, 2005).

6. See e.g., Rule 144 of the Securities Act of 1933 ("Securities Act").

7. A short sale is generally a sale of a security by an investor who does not actually own the stock. To deliver the security to the purchaser, the short seller will borrow the security. The short seller later closes out the position by returning the security to the lender, typically by purchasing securities on the open market. In general, short selling is utilized to profit from an expected downward price movement, to provide liquidity in response to buyer demand, or to hedge the risk of a long position in the same or a related security. See U.S. Securities and Exchange Commission Questions—Get Fast Answers, http://sec.gov/answers/shortrestrict.htm (last visited Aug. 17, 2005); see also 69 FR 48008 (Aug. 6, 2004) (the SEC adopted provisions of this new short sale regulation, designated Regulation SHO, which contains Rule 200 (Definition of "Short Sale" and Marking Requirements)).

8. See 15 U.S.C. §77q(a).

9. See 15 U.S.C. §78j(b).

10. See 15 U.S.C. §§77e.

11. Leonard B. Sand et al., Modern Federal Jury Instructions, ¶57-21 (2003).

12. Id. at ¶57-24.

13. Ms. Shane was a registered representative with a broker-dealer registered with the SEC and was also a portfolio manager and acted as an investment advisor to several hedge funds.

14. See supra n.5.

15. According to Sagient Research Systems, Inc., a publicly traded publisher of independent research for the financial services and institutional investment communities, companies raised over $15 billion in 2004 by way of PIPE deals. See Sagient Research Systems Resources—Market Stats, http://www.sagientresearch. com/pt/GStats.cfm?Type=6 (last visited Aug. 17, 2005).

HERRICK

WHITE COLLAR CRIMINAL DEFENSE PRACTICE

Herrick, Feinstein's full service litigation practice is complemented by a dynamic team of defense attorneys with expertise in representing institutions and individuals in the areas of white collar criminal and regulatory defense. Today's federal and state law enforcement efforts focus directly on businesses and corporations. Grand jury investigations involving companies are convened regularly. It is critical for targets, subjects and witnesses in grand jury investigations to be represented by counsel experienced in the broad range of issues that may arise. Our prominent team of lawyers have the experience, judgment and legal acumen necessary to provide this sensitive representation.

When trial is necessary we are skilled and tenacious advocates. We regularly appear as trial defense counsel in complex white collar cases in federal and state courts. Moreover, we are accomplished appellate attorneys. In addition, we appear before other agencies and investigative bodies to vigorously defend our clients against parallel proceedings. The criminal matters Herrick handles require extraordinary sensitivity. Our group of attorneys operate on a “need to know” basis only and matters are not generally discussed outside our close-knit team. This extremely discrete approach combined with our zealous advocacy have often yielded favorable outcomes which have never become matters of public knowledge. Even those that have gained public attention remain sensitive for our clients. For that reason, we do not publish the names of our clients.

Please do not hesitate to call **Charles A. Ross** in connection with questions or problems regarding any of these important and sensitive matters. He can be reached at 212.592.1420 or email at cross@herrick.com.

2 Park Avenue
New York, NY 10016
Ph: 212.592.1400
Fax: 212.592.1500

2 Penn Plaza
Newark, NJ 07105
Ph: 973.274.2000
Fax: 973.274.2500

210 Carnegie Center
Princeton, NJ 08540
Ph: 609.452.3800
Fax: 609.520.9095