REGULATORS CONTINUE TO FOCUS ON PIPE TRANSACTIONS: SEC FILES ENFORCEMENT ACTION AGAINST HEDGE FUND MANAGER AND THREE HEDGE FUNDS FOR ENGAGING IN ILLEGAL TRADING IN PRIVATE INVESTMENT IN PUBLIC EQUITY (PIPES)

On March 14, 2006, the Securities and Exchange Commission (the "SEC") filed charges against three New York based hedge funds, Langley Partners, North Olmsted Partners and Quantico Partners (collectively, "Langley Partners"), and their portfolio manager, Jeffrey Thorp ("Thorp"). The SEC alleges that Langley Partners and Thorp perpetrated an illegal scheme to evade the registration requirements of the Securities Act of 1933 (the "Securities Act") in connection with 23 unregistered securities offerings, which are commonly referred to as "PIPEs" (Private Investment in Public Equity), and engaged in insider trading. Without admitting or denying wrongdoing, Langley Partners and Thorp, agreed to settle the charges.[1] As part of the settlement, Langley Partners will disgorge $8.8 million in ill-gotten gains and pre-judgment interest, and Langley Partners and Thorp will pay civil penalties totaling $7 million.

Companies often use PIPE transactions when conventional means of financing are unavailable. In a PIPE transaction, a company sells unregistered shares that are generally locked up for two to four months until the company files a resale registration statement under the Securities Act. The PIPE investors cannot freely trade their shares until the SEC declares the resale registration statement effective. PIPE shares are customarily offered to investors at a discount to attract investors and compensate them for the temporary illiquidity during the lock-up period.

The complaint alleges that from 2000 to 2002, Thorp implemented an unlawful trading scheme in which Langley Partners agreed to invest in PIPE offerings and then quickly sold short the issuer's stock, frequently using pre-effective date "naked" short sales executed in Canada.[2] Langley Partners and Thorp would then close out the short positions using the shares acquired in the PIPE offering. This scheme allowed Thorp and Langley Partners to invest in PIPE transactions without incurring any market risk.

During the relevant period, "naked" short selling was permissible in Canada, so without either owning or borrowing unrestricted shares, Langley Partners established its "naked" short positions through a Canadian broker-dealer. In addition, Langley Partners also engaged in short-selling in the United States through domestic broker-dealers or through electronic communications networks.

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[1] SEC v. Langley Partners, L.P., North Olmsted Partners, L.P., Quantico Partners, L.P., and Jeffrey Thorp, Civil Action No. 1:06CV00467 (D.D.C.) (March 14, 2006); SEC Litigation Release No. 19607 (March 14, 2006), available at http://www.sec.gov/litigation/litreleases/lr19607.htm.

[2] A "naked" short occurs when someone sells a security but does not own or intend to deliver the security, in order to cover the trade.

At the time Thorp executed the short sales of the PIPE issuer's stock, there was no resale registration statement in effect with respect to the PIPE shares. To avoid detection and regulatory scrutiny, Thorp employed a variety of deceptive trading techniques, including wash sales and matched orders. To close out Canadian short positions, Langley Partners directly transferred its PIPE shares to its Canadian account or instructed its Canadian broker to sell its PIPE shares on a particular exchange and buy the same number of shares at the same time and price on the same exchange. These orders were matched and executed against each other. In other instances, Langley Partners simply journaled its PIPE shares from its cash account at its prime broker to its short account with instructions to close out its short position. In some cases, cooperating market makers purchased the PIPE shares from Langley Partners and then sold the shares back to Langley Partners, and the "washed" shares were used to close out the short position.

The complaint alleged that Thorp violated Section 5 of the Securities Act when he covered the pre-effective date short positions with shares he received in the PIPE transaction. The complaint states that "[t]his is because shares used to cover a short sale are deemed to have been sold when the short sale was made." The complaint also implies, but does not expressly state, that a legal way to hedge a purchase of PIPE shares is to borrow freely tradeable shares of the PIPE issuer and sell them before the resale registration statement is declared effective. The scope and implications of this suggestion are not clear. For example, does it represent a change of SEC view regarding the application of Section 5 to the hedging of restricted securities positions?[3]

In connection with each transaction, the complaint alleged that Thorp made materially false representations to the PIPE issuers to induce them to sell securities to Langley Partners. As a precondition of participation in a PIPE offering, Langley Partners had to represent that it would not sell, transfer or dispose of the PIPE shares except in compliance with the registration provisions of the Securities Act. The SEC alleged that this representation was material to the PIPE issuers, who, as the stock purchase agreements made clear, relied on the investors' representations in connection with qualifying for an exemption from the registration requirements for their private offering. According to the SEC, "Thorp signed these securities purchase agreements despite knowing that Langley Partners was (i) not purchasing the PIPE securities for its own account, and (ii) had a present intention to distribute the PIPE securities through its short selling and to cover with the PIPE shares in violation of Section 5."[4]

The SEC further alleged that, in connection with seven PIPE offerings, Thorp engaged in insider trading by selling the PIPE issuers' securities short on the basis of material nonpublic information gleaned from offering documents he had received before the announcement of the PIPE offering. Thorp engaged in this conduct, notwithstanding express language in the offering documents requiring Thorp to maintain the information in confidence and/or refrain from trading on the information.

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[3] *See*, *e.g.*, Securities Act Release No. 7391 (Feb. 20, 1997), 62 FR 9248 (proposing revision of Rules 144 and 145 and Form 144).

[4] *See supra* note 1.

The SEC and the NASD continue to examine PIPE offerings and the involvement of hedge funds in these financings. The Langley Partners case is very similar to the enforcement actions brought by the SEC and NASD in May 2005 against Hilary L. Shane, a former hedge fund portfolio manager, for short selling securities of CompuDyne Corporation based on material nonpublic information she possessed about CompuDyne Corporation's impending PIPE offering and before the effective date of the resale registration statement for the PIPE shares.[5] Ms. Shane received the information when she was invited to participate in the PIPE issuance on the condition she treat the information as confidential.

The continuing focus on this area by the SEC and NASD suggests that more cases may be forthcoming.

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[5] *See* SEC v. Hilary L. Shane, Civil Action No. 05 4772 (S.D.N.Y.) (May 18, 2005); SEC Litigation Release No. 19227 (May 19, 2005), available at http://www.sec.gov/litigation/litreleases/lr19227.htm; NASD News Release (May 18, 2005).