FEDERAL DISTRICT COURTS REJECT SEC CHARGES OF SECTION 5 VIOLATIONS FOR SHORT SELLING OF PIPE SHARES

On January 2, 2008, Judge Sidney H. Stein of the Federal District Court for the Southern District of New York granted a motion to dismiss a charge brought by the Securities and Exchange Commission (the "SEC") alleging a violation of Section 5 of the Securities Act of 1933 (the "Securities Act") and related fraud charges in connection with short sales of Public Investment in Private Equity ("PIPE") shares.[1] This is the second time in less than four months that this violation, which is often charged in SEC actions involving PIPES, has been dismissed.[2] Although these decisions are significant blows to the SEC's program in this area, it is unclear whether the SEC will challenge the decisions or refrain from bringing Section 5 charges in similar situations going forward.

Under Section 5, no security may be offered, sold, or delivered after sale in interstate commerce unless a registration statement is in effect as to the security, or an exemption from registration is available.[3] In *Lyon*, the court characterized the SEC's Section 5 theory as follows: "[D]efendants unlawfully sold PIPE shares to the public via an unregistered three-step distribution. First, defendants bought PIPE shares issued by publicly traded companies that were restricted from being sold publicly. Next, they sold short the PIPE issuers' public shares prior to the effective date of a resale registration statement for the PIPE shares. Finally, after the resale registration statements for the PIPE shares became effective, defendants 'covered' their short positions with those PIPE shares."

The court stated: "Whether a plausible section 5 claim can be based on the short sales at issue in this case depends on *what security was sold or offered for sale in those transactions.* The SEC contends that PIPE shares were sold or offered for sale by defendants when they transacted their short sales; [the defendants] maintain that publicly traded shares were offered and sold through those trades." [Emphasis added.] Under the facts as alleged by the SEC in this case, the court agreed with the defendants.

As stated by the court: "According to the SEC, the means that an investor uses to close down his short position determines what security was actually sold when the short sale was executed." The court rejected this proposition as illogical, unnecessary to achieve the objectives of Section 5, and not compelled by SEC precedent. The court stated, tautologically, that "a short sale of a security constitutes a sale of that security," and that how the short seller chooses to close out the

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1 *SEC v. Edwin Buchanan Lyon IV, et al.*, 06 Civ. 14338 (SHS) (S.D.N.Y. January 2, 2008).

2 *SEC v. John F. Mangan, Jr., et al.*, 3:06CV531 (W.D.N.C. October 24, 2007), (motion to dismiss was granted where the SEC alleged that the defendant violated Section 5 when the trader purchased shares in a PIPE transaction, sold the PIPE issuer's shares short, and subsequently covered the short position with the PIPE shares after a registration statement covering the PIPE shares became effective).

3 The Securities Act and rules thereunder provide significant exemptions from the prohibitions of Section 5, but they are not essential to the court's analysis in *Lyon*.

corresponding stock loan (*i.e.*, the obligation to ultimately deliver shares to cover the short sale) "does not alter the nature of the sale."

The court focused on the notion that when a short seller holding restricted securities effects a short sale of securities of the same class and series as such restricted securities and then borrows unrestricted securities to deliver on the short sale transaction, no violation of Section 5 occurs and the buyers get exactly what they expected. The fact that the short seller may subsequently acquire newly registered shares and use them to satisfy its obligation to return shares to the lender does not transform the short sale into a sale of the newly registered shares at a time when they were restricted. Turning to policy, the court noted that the primary purpose underlying Section 5's registration requirement is to provide material information to purchasers of securities. The SEC did not allege, however, that the buyers on the defendants' short sales lacked the information required by the Securities Act, or that the means by which a short sale is covered alters the information that must be disclosed to the buyers at the time of sale.

The court also found that prior statements by the SEC and an SEC enforcement action that involved covering short sales with newly registered shares were inapposite to the facts of the present case. The court found that the prior instances cited by the SEC involved conspiracies between issuers and broker-dealers to distribute securities in advance of the effectiveness of a registration statement, and it was clear that the parties intended to use the newly registered shares to cover their short sales.

The court also dismissed two "telephone interpretations" published by the SEC Staff.[4] Although the court acknowledged that one of the interpretations is consistent with the SEC's position in the litigation, the court noted that the interpretation was conclusory and contained no analysis.[5]

Almost all of the court's discussion deals with short sales where securities are borrowed and delivered to the buyers according to normal market practice. Although the court recognized that the SEC alleged that Section 5 violations also occurred in this case when the defendants engaged in "naked" short sales,[6] the court did not analyze the SEC's theory in that context. Where naked short sales are involved, the short seller does not borrow unrestricted securities to deliver to the buyer. Rather, the only shares that are ever used to satisfy the short seller's delivery obligation are the newly registered PIPE shares. Finding a Section 5 violation in that context would appear to be consistent with the precedents cited by the SEC.

The impact of Judge Stein's ruling (together with the decision in *Mangan*[7]) cannot be predicted. Although the rulings are binding on the SEC in these cases only, the SEC may feel compelled to

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4 The court noted that Staff views are not binding or authoritative. "Because 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.'"

5 The telephone interpretation, however, is consistent with SEC statements extending back more than 30 years. *See* Securities Exchange Act Release No. 54888 (December 6, 2006), 71 Fed. Reg. 75002, 75003 n.14.

6 The court explained that naked short selling "occurs when an investor 'sells a security without owning or borrowing it and does not deliver the security when due.'"

7 Judge Stein did not cite the *Mangan* decision, even though the judge there reached the same conclusion on the SEC's Section 5 theory.

appeal these decisions.[8] The rulings struck at the heart of the SEC's theory of Section 5,[9] and also resulted in the elimination of fraud charges in *Lyon* based upon the defendants' allegedly false representations that their PIPE investments were made in compliance with Section 5.[10] In proposing recent amendments to Rule 105 of Regulation M, the SEC asked whether that rule should be expanded to cover short sales in anticipation of a registered offering of PIPE shares.[11] The SEC took no action on this question when it adopted final amendments to Rule 105,[12] but these judicial setbacks may well cause the SEC to revisit this issue.[13]

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If you have any questions concerning this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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8 It is unclear whether the SEC could take an appeal of these interlocutory rulings at present.

9 Recently, the SEC expressed continuing support for its Section 5 theory. The SEC stated its view that in a short sale of securities, the sale of securities occurs at the time of the short sale rather than at the time that shares are delivered to close out that short position. *See* Securities Act Release No. 8869 (December 6, 2007), 72 Fed. Reg. 45094, 45096 n.90. The SEC apparently concludes from this that when a person sells short in anticipation of covering, or in fact covers, the short position related to the sale with securities after they become registered, then the person sold those shares at a time when they were restricted.

10 The *Lyon* court declined, however, to dismiss an SEC charge predicated on insider trading.

11 *See* Securities Exchange Act Release No. 54888 (December 6, 2006), 71 Fed. Reg. 75002, 75006. As subsequently adopted, Rule 105 provides that, if a person sold a security short within a defined restricted period prior to the pricing of a firm commitment offering of that security, then that person is prohibited from purchasing shares in the offering. *See* n.12 below.

12 *See* Securities Exchange Act Release No. 56206 (August 6, 2007), 72 Fed. Reg. 45094, 45096 n.41.

13 At the November 2007 meeting of the American Bar Association Committee on Federal Regulation of Securities, John White, the Director of the SEC's Division of Corporation Finance, said the Division will be recommending the issuance of a release clarifying the law in this area.