

Securities Enforcement Commentary

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SEC Increases Scrutiny of Hedge Fund "PIPE" Deals

In furtherance of its recent efforts to regulate hedge funds and their managers, the SEC is investigating hedge funds' participation in Private Investment in Public Equities transactions, or "PIPEs." PIPEs, which can represent an affordable method for publicly-traded companies to obtain financing, have now become commonplace. In the first four months of 2004, 392 companies had raised almost \$5 billion using PIPE transactions.¹ In a PIPE transaction, a public company sells newly issued securities to an investor, usually a hedge fund², pursuant to a private placement.³ The privately-placed securities usually become freely tradable within a short time frame after the closing of the transaction - a feature that makes PIPEs attractive to hedge funds because it provides the potential for a quick, profitable exit.

Typical PIPEs involve companies that cannot easily assume additional debt or obtain additional equity from via traditional means. The PIPE securities are usually offered at a predetermined discount to the market price of the company's publicly-traded securities, and frequently the investor receives an option to purchase additional

shares. PIPE participants generally agree not to engage in any sales or purchases of the underlying securities until days or weeks after the transaction is publicly announced, since non-public material information may be involved. However, some companies have agreed to allow hedge fund investors to sell their newly-acquired shares immediately after the registration statement becomes effective. This has created the opportunity for funds to utilize short selling during the PIPE offering to drive the price of the securities down and thereby increase the number of shares the fund will receive at the conversion price. If the market price of the stock falls below the preset conversion price, the conversion price may be adjusted downward. Without a price floor imposed on the hedge fund, the process may be repeated and existing company shareholders could suffer significant losses. These PIPEs are frequently called "death spirals" or "toxic PIPEs."⁴

Last year, in an apparent case of first impression, the SEC filed a settled, civil action against Rhino Advisors ("Rhino"), an unregistered advisory firm and its president, Thomas Badian (*SEC v. Rhino*

1 See Matthew Goldstein, *Looking Out for Desperation Finance in PIPE Deals*, TheStreet.com (April 9, 2004).

2 About 90% of PIPE transactions involve at least one hedge fund. Chidem Kurdas, *Hedge Funds Ride PIPE Bandwagon As It Gains Momentum*, by HedgeWorld Daily News, March 12, 2004 (internal citation omitted).

3 See Barbara A. Jones, Matthew H. Hurlock, and Pamela R. Henry, *Structuring PIPE Transactions in Key European Jurisdictions*, 37 Int'l Law. 23 (2003).

4 *Id.* at n.12.

Advisors, Inc. and Thomas Badian, Civ. Action. No. 03 civ 1310 (RO) (S.D.N.Y. 2003)), for allegedly manipulating the stock of Sedona Corporation (“Sedona”) after one of Rhino’s clients entered into a \$3 million PIPE called a “Convertible Debenture and Warrants Purchase Agreement” with Sedona. Unlike many PIPEs, the Debenture precluded Rhino’s client from selling Sedona’s stock short while the Debenture was outstanding. Despite this contractual provision, Rhino allegedly engaged in extensive short selling and pre-arranged trading on behalf of its client prior to exercising the conversion rights under the Debenture. This short selling depressed Sedona’s stock price. As a result, Rhino’s client received more shares from Sedona when it exercised its conversion rights under the Debenture than it otherwise would have received. Following the conversion, Rhino allegedly engaged in wash sales and matched orders to cover the short positions and conceal the client’s involvement in the scheme. Without admitting or denying the allegations in the SEC’s complaint, Rhino and Badian consented to the entry of an injunction for violations of the anti-fraud provisions of the federal securities laws and to pay, jointly and severally, a \$1 million civil penalty. In addition, Rhino consented to a court order requiring it to hire an independent consultant to review its compliance policies and procedures and to implement the consultant’s recommendations.

Following in the footsteps of *Rhino*, the SEC is heightening its scrutiny of PIPEs and is investigating whether hedge funds, despite written or oral promises to abstain, are shorting shares of a company (through their own trading, or by using nominee accounts or other conduits to do so) prior to finalizing a PIPE deal. In addition, the SEC may be investigating whether some hedge funds are using illicit tactics, including the sharing of material non-public information, to learn about PIPEs involving other funds and issuers. With

that information, the funds can short the company’s shares first, giving them a financial advantage if and when the company’s stock price falls during a PIPE offering.

Before participating in a PIPE, hedge funds should consider, at a minimum, whether the issuing company is fiscally sound or contemplating bankruptcy, and whether the privately-placed securities will become freely tradable within a relatively short time frame. Timing is crucial given the recent unpredictability of public securities markets. Furthermore, if the fund intends to utilize short selling of the company’s securities as a hedge, the fund should disclose its intention to do so upfront, ensure that the privilege exists in writing, and confirm that the company’s shares are not too illiquid to short sell. Hedge funds should also be aware that participation in PIPEs involves the review and execution of several legal documents and agreements, unlike trading in the secondary market where the relevant securities are already registered.

Conversely, a company contemplating a PIPE transaction needs to carefully assess the terms and risks of the securities being offered, including the potential impact on its reputation and its public investors. As the SEC noted in *Rhino*, certain PIPEs, particularly those having conversion or issuance mechanisms tied to a company’s stock price, pose risks to the company and its public investors, including the risk of significant dilution of shares. When financially practicable, a company should consider imposing pre-conversion trading restrictions on a hedge fund to ensure that the company’s stock price remains stable during and after the PIPE transaction.

DEREK M. MEISNER

dmeisner@kl.com

617.261.3114

MARK P. GOSHKO

mgosbko@kl.com

617.261.3163

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BOSTON

Aimee Bierman	617.261.3166	abierman@kl.com
Andrew C. Glass	617.261.3107	aglass@kl.com
Mark P. Goshko	617.261.3163	mgoshko@kl.com
D. Lloyd Macdonald	617.261.3117	dmacdonald@kl.com
Wm. Shaw McDermott	617.261.3120	smcdermott@kl.com
Derek M. Meisner	617.261.3114	dmeisner@kl.com

LOS ANGELES

Michael J. Quinn	310.552.5046	mquinn@kl.com
Ronald W. Stevens	310.552.5521	rstevens@kl.com

NEW YORK

Sean E. Kreiger	212.536.4091	skreiger@kl.com
Eugene R. Licker	212.536.3916	elicker@kl.com
Richard D. Marshall	212.536.3941	rmarshall@kl.com
Keith W. Miller	212.536.4045	kmiller@kl.com
William O. Purcell	212.536.3922	wpurcell@kl.com
Steven A. Yadegari	212.536.4889	syadegari@kl.com

PITTSBURGH

David A. Brownlee	412.355.6446	dbrownlee@kl.com
Mark A. Rush	412.355.8333	mrush@kl.com

SAN FRANCISCO

Eileen M. Clavere	415.249.1047	eclavere@kl.com
Sandra L. Geiger	415.249.1018	sgeiger@kl.com
David Mishel	415.249.1015	dmishel@kl.com
Richard M. Phillips	415.249.1010	rphillips@kl.com

WASHINGTON

Nicole A. Baker	202.778.9018	nbaker@kl.com
Alan J. Berkeley	202.778.9050	aberkeley@kl.com
Christopher E. Dominguez	202.778.9404	cdominguez@kl.com
Andrew J. Dubill	202.778.9176	adubill@kl.com
Charles L. Eisen	202.778.9077	ceisen@kl.com
Andrew H. Feller	202.778.9228	afeller@kl.com
Paul Gonson	202.778.9434	pgonson@kl.com
Stephen W. Grafman	202.778.9057	sgrafman@kl.com
Michael J. King	202.778.9214	mking@kl.com
Rebecca L. Kline	202.778.9064	rkline@kl.com
Erin Ardale Koeppel	202.778.9420	ekoepfel@kl.com
Stavroula E. Lambrakopoulos	202.778.9248	slambrakopoulos@kl.com
Jeffrey B. Maletta	202.778.9062	jmaletta@kl.com
Charles R. Mills	202.778.9096	cmills@kl.com
Michael J. Missal	202.778.9302	mmissal@kl.com
Brian A. Ochs	202.778.9466	bochs@kl.com
Glenn R. Reichardt	202.778.9065	greichardt@kl.com
Eric C. Rusnak	202.778.9212	erusnak@kl.com
Kathryn A. Sellig	202.778.9083	ksellig@kl.com
Jon A. Stanley	202.778.9410	jstanley@kl.com
Nicholas G. Terris	202.778.9408	nterris@kl.com
Stephen G. Topetzes	202.778.9328	stopetzes@kl.com



Kirkpatrick & Lockhart LLP

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