

Federal Court Rejects Ambiguous SEC Interpretation on PIPE Transactions

Contributed by George Brunelle
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Ordinarily, the Courts presume the validity of the SEC's interpretations of its own Rules. A recent decision of the U.S. District Court in Manhattan proves that there are limits to this deference, and that it can only occur when the SEC has widely published its interpretation and has done so prior to the events in controversy. In *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. January 2008) (Stein, J.), the SEC faced a motion to dismiss its claim that the purchase of privately issued PIPE shares, followed by short sales of the corresponding public shares, all with the potential that the short sales will be covered with stock obtained upon issuance of the PIPE shares, would be regarded as a violation of Section 5 of the Securities Act. In a rare repudiation of the SEC in the interpretation of its own Rules, the Court found this theory to be unsupported by clear and widely published interpretations, and therefore unenforceable.

First, we will define terms. A "PIPE" transaction (meaning "Private Investment in Public Equities") is a private offering of new shares of an issue of which other shares have been registered and are currently outstanding. Investors in a PIPE typically acquire the shares at a discount, with the understanding that the issuer will, within a short time, register the PIPE shares with the SEC for public sale. Then the PIPE investors can resell the shares at a profit. But registration and public sale of the new shares frequently causes the price of the public shares to fall. Accordingly, upon purchasing the PIPE shares, the investors are expected, after acquiring the shares, to hedge against potential loss on the shares by selling other, publicly traded shares of the same issue, short. Later, the PIPE investors may cover their short sales with publicly traded shares. To facilitate the cover, the short seller will, at the time of the short sale, perform a "locate" -- locating publicly traded shares that they can borrow and deliver against the short sale. Sometimes, according to the SEC, the investor plans to cover the short sale only after the public registration of the PIPE shares. In *Lyon*, the SEC argued that this happened with four of the defendants' PIPE investments, and that the defendants, in effect, sold their privately acquired shares to the public at a time when the shares were not yet registered. Their so doing, alleged the SEC, violated Section 5 of the Securities Act, the statute that prohibits the public sale of stock unless the stock has been registered or either the stock or the sale is exempt from registration. In *Lyon*, the Court found that the SEC had not given unequivocal and public utterance to this theory of liability, and therefore could not enforce its interpretation as though it had the force of law. According to the Court: "The SEC also relies on a series of agency releases, proposals and requests for comment that it considers strong support for its interpretation of section 5. The Court recognizes its duty to give effect to an agency's regulation containing a reasonable interpretation of an ambiguous statute." *Christensen v. Harris County* 529 U.S. 576, 586-87 (2000), citing *Chevron USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); see also *Clearing House Ass'n, LLC v. Cuomo*, 510 F.3d 105, 117-18 (2d Cir. 2007). However, this Court has found section 5 unambiguous with respect to whether a security used to close a short position is considered "sold" under the statute at the time when the short position is first established. Even if *Chevron* deference were applicable here, none of the agency materials cited by the SEC constitutes an agency determination that the security used to close a short position is the security sold via the short sale. As is set forth below, these documents provide negligible support for the SEC's view of short sales. "To support its claim, the SEC cited a "concept release" on short selling that the SEC issued in 1972. It stated "concerns" for the propriety of transactions somewhat resembling those before the Court, but did not express a clear prohibition. A 1974 Rule Proposal Release by the SEC suffered from the same infirmity. In *Lyon*, moreover, the Court found no "preconceived plan" to distribute unregistered shares. The use of converted "distribution shares" to cover the short sale, the Court noted, had been possible, but not inevitable. Accordingly, the Court dismissed that part of the SEC's case, finding that, on the law, the SEC's case was not plausible." The SEC has been similarly constrained in other cases, notably that of *Upton v. SEC*, 75 F.3d 92-98 (2d Cir. 1996), where the Second Circuit declared that: "Due process requires that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited. Although the Commission's construction of its own regulations is entitled to "substantial deference," we cannot defer to the Commission's interpretation of its rules if doing so would penalize an individual who has not received fair notice of a regulatory violation. This principle applies, albeit less forcefully, even if the rule in question carries only civil rather than criminal penalties."

(Citations omitted.)