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# Litigation

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## Federal Court Dismisses SEC's Section 5 Claim In PIPE Case Against Hedge Fund

By **Joshua R. Pater**

On October 24, 2007, a federal judge in the Western District of North Carolina granted a motion to dismiss a claim brought by the SEC under Section 5 of the Securities Act of 1933 against a trader who bought shares in a Private Investment in Public Equity ("PIPE") offering while simultaneously short-selling stock of the same company. *SEC v. Mangan*, 06 CV 531 (W.D.N.C. Oct. 24, 2007). This ruling is a setback for the SEC as it continues its push to clean up what it sees as violations of the registration and insider trading rules in the world of PIPEs financing.

*Mangan* involved information acquired by a former registered representative at Friedman, Billings, Ramsey & Co., Inc. ("FBR") in the course of FBR's underwriting of a PIPE offering for CompuDyne Corporation. The defendant, John Mangan, learned that CompuDyne planned to make a PIPE offering of 2.45 million shares at \$12 — which represented a sizeable jump in its public float — and

that a significant portion of the funds raised would be used to cash out an institutional shareholder. Public announcements of PIPE offerings typically depress a company's share price. Mangan accordingly arranged for his trading partner to purchase 80,000 shares in the PIPE offering, while selling short the same amount of shares in three separate transactions — one just before the announcement, and two in the hours and days following it.

CompuDyne announced its PIPE offering at 11:44 a.m. on October 9, 2001. Mangan's first short sale preceded the announcement, but news of the PIPE had already leaked by the opening of trading on that day. CompuDyne's stock price dropped from \$17.38 at the end of trading on October 8 to \$16.40 when the market opened on October 9, and then further dropped to \$14.89 in the first 5 minutes of trading. The price was approximately \$14.50 when the deal was announced, but it actually rose to \$15.20 in the next 20 minutes, and was still over \$15

an hour after the announcement. The stock closed the day at \$14.25.

Over the next three weeks, the price dropped as low as \$12.41, until the SEC declared the resale registration statement for CompuDyne's PIPE effective on October 29. Mangan thereafter used the newly registered shares from the PIPE (which he had purchased at \$12) to cover his earlier short sales. This strategy netted Mangan and his partner a profit of \$178,870.

Mangan's trading activity also attracted the attention of the SEC. The SEC had been investigating the CompuDyne PIPE for some time. Its first insider trading case involving a PIPE — settled with trader Hilary Shane in 2005 for \$1.45 million — also arose out of the CompuDyne offering. The SEC filed a complaint against Mangan in December 2006, charging him with violations of Sections 5 and 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5. The Section 5 claim was for the alleged sale of unregistered securities, whereas the other three claims alleged

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unlawful insider trading. The complaint came just one week after the SEC settled similar charges against FBR and two executives based on trades FBR made for its own account before CompuDyne's registration statement was effective.

The Section 5 claim that Mangan had sold unregistered securities relied on what the court later called a "creative" theory of liability. *See Mangan*, Tr. of Oct. 24 Hr'g, at 43. The SEC alleged that, by short selling CompuDyne stock before the PIPE resale registration statement was effective, and then covering the short sales with the shares purchased in the offering after the resale registration statement was effective, Mangan had effectively sold the unregistered PIPE shares in violation of Section 5. On the insider trading counts, the SEC alleged that Mangan effected the short sales while he possessed material nonpublic information — namely, that CompuDyne was planning a significant PIPE offering — and made misrepresentations in connection with his purchase or sale of CompuDyne securities.

Mangan moved to dismiss the charges. On the Section 5 claim for sale of unregistered securities, he disputed what he called the SEC's unprecedented and unfounded theory of liability. The flaws in the SEC's theory, Mangan argued, were that (1) the only shares he transferred actually were registered when they were transferred to cover the short sale, and (2) he always faced the risk that the SEC would not declare CompuDyne's

resale registration statement effective. This would have forced Mangan to cover the short sale with securities purchased on the open market, and the fact that this was always a possibility means the short sale cannot have been an "effective" sale of the securities purchased in the PIPE offering. Moreover, Mangan pointed out, just two weeks before the SEC filed its complaint it published a request for comment in the Federal Register that conceded that Section 5 did not proscribe the conduct in question. On December 13, 2006, the SEC had posed certain questions to the public relating to a proposed amendment to Rule 105 of Regulation M, which prohibits certain activities in connection with short sales effected prior to public offerings. One question was whether the amended Rule should address "short sales effected during the period following . . . a PIPE transaction and before a registration statement for resale of the restricted securities acquired in the PIPE transaction is declared effective . . . ." *See Short Selling in Connection With a Public Offering*, 71 Fed. Reg. 75002, 75006 (Dec. 13, 2006).

The SEC responded to Mangan's Section 5 arguments by pointing to statements through the years in which it "warned the public" that actions such as Mangan's "could violate Section 5." Pl.'s Response, at 8. But the court was unconvinced. Judge Graham Mullen noted that, while Mangan very likely sold short "anticipating the receipt of PIPE shares to

cover the short," in any event he would have covered with shares purchased on the open market. Tr., at 43. "[W]hat we have here," the court said, "is a post hoc ergo propter hoc argument by the government that because the PIPE in fact was not registered and because the PIPE shares were later in fact used, he in effect sold the PIPE. . . . [But] I'm holding as a matter of law there was no alleged Section 5 violation . . . ." Tr., at 44.

Mangan also moved to dismiss the insider trading charges, arguing that the SEC could not properly allege materiality on the facts of the case. Mangan cited decisions holding that, where a company's disclosure does not significantly affect its stock price, the disclosure was immaterial as a matter of law. He urged the court to adopt this approach, and argued that CompuDyne's trading history contradicts the SEC's claim that the announcement of its PIPE offering had an appreciable effect on the market. The SEC argued that the relevant stock price was \$17.38 — the price at the close of the day before the announcement — but Mangan pointed out that the price already had dropped to \$14.50 by the time of the announcement. The court declined to dismiss the insider trading claims, but stated that it was a "very close call" and that it would re-examine the issue in the future. Tr., at 46.

A question often arises in PIPE cases whether a trader ever undertook to keep information about the transaction

confidential — a prerequisite for liability under insider trading principles. Here, the SEC alleged that Mangan owed a duty of confidence to CompuDyne because, among other things, he was a representative of FBR, which was acting as placement agent for CompuDyne. Other litigants without such employment-based duties may be in a better position to challenge the SEC on the question of confidentiality. Another frequent key question is whether there is an affirmative misrepresentation regarding investment intent. PIPE agreements generally require a representation of investment intent in order to meet the Section 4(1) exemption to registration under the Securities Act. Mangan, for example, represented that he had "no present intention of distributing" the PIPE shares. Compl., at 8.

The decision in *Mangan* is a significant development for the growing number of traders caught up in the SEC's investigations of PIPE offerings as it is the first significant setback for the SEC in this enforcement area. The dismissal of the Section 5 charge is a rejection of the SEC's position that using shares obtained through PIPE offerings to cover earlier short sales violates the registration rules. And the court's "close call" on materiality should cause future litigants to examine carefully the SEC's evidence regarding the effect of a PIPE announcement on the market.

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