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Secrets in the Pipeline

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Listen. Do you want to know a secret?

Do you promise not to tell?

Closer. Let me whisper in your ear.

Say the words you long to hear.

— The Beatles

WALL STREET, where information is transformed into cold, hard cash, is also a place where secrets have their own special currency. And while trading on inside information, to most people, means buying a stock ahead of news that sends it soaring, whispers about events that might depress a company's stock — such as an imminent securities offering that will dilute existing holders' stakes — can also produce stellar profits for those in on the chatter.

More often than not, according to recent regulatory actions and lawsuits, those in the know have been hedge fund managers. Over the last 18 months, the Securities and Exchange Commission has filed four lawsuits against individuals and hedge funds that the commission said had profited on nonpublic information about stock offerings.

Hedge fund managers are not the only ones drawing scrutiny, however. Brokerage firms that underwrite stock offerings and thereby have access to potentially market-moving information are being examined by regulators concerned about whether the firms are tipping off clients to deals.

The hot tips at issue in these cases involve an increasingly popular type of security called a "private investment in public equity." These securities — PIPE's for short — are not registered with the S.E.C.; companies that need cash quickly (sometimes because they are in financial trouble) sell PIPE's privately to institutional investors, with brokerage firms getting a fee for acting as intermediaries on the transactions.

Because PIPE's dilute existing shareholders' stakes and are sold to buyers at a discount to the issuer's prevailing stock price, news that such a deal is in the PIPEline can depress a company's shares. Companies that issue shares this way are typically small enough that raising capital can have a more magnified impact on their existing shares than might be the case with a larger concern — making advance knowledge of a PIPE even more attractive to traders looking for stocks poised to head south.

A recent deal that has attracted regulatory interest is a $32 million PIPE that Javelin Pharmaceuticals, a small drug company in Cambridge, Mass., issued last November. Two small brokerage firms, Rodman & Renshaw in New York and Riverbank Capital Securities in Cary, N.C., placed Javelin's offering, of 14.2 million shares.

Regulators want to know whether anyone got wind of the Javelin deal and traded in advance of it, according to people briefed on the inquiries. Given that the stock sale would have increased the pool of Javelin's outstanding shares by about 35 percent, news of the PIPE was sure to push its stock down. Only an in-depth analysis of trading in Javelin's shares can answer whether those in the know profited by shorting the company's shares — borrowing them and selling, then profiting by buying them back after the PIPE had driven down the stock price.

To be sure, not every PIPE causes a company's stock to drop. Measured Markets, a Toronto research firm that looks for anomalies in stock trading, examined PIPE's valued from $100 million to $250 million that companies on the Nasdaq or the American Stock Exchange issued in the first half of this year. Only half — 9 of 18 — had their shares drop in the 30 days leading up to the deals. (One of the company's stocks stayed flat and the other eight rose.) Of those that fell, the average decline was 8.6 percent. Of those that rose, the average increase was 20 percent.

Measured Markets also identified unusual activity in one-third of the deals that lost value in the 30 days leading up to the PIPE. The firm's analysis showed abnormal trading volume in the stocks, an unusual number of trades executed on certain days, or odd movements in stock prices — sometimes all three. The unusual trading occurred on days when no news or other public announcements occurred that might have affected the stocks.

"Looking at our data on the PIPE's examples felt like being in an episode of 'The X-Files,' " said Christopher K. Thomas, founder of Measured Markets. "We could identify strange behavior, but had no explanation for it at the time or shortly thereafter."

REGULATORS also say that the close and profitable ties between hedge funds, famous for seeking outsize returns on behalf of their investors, and brokerage firms eager for the unusually rich commissions the funds pay them, are rife with potential conflicts.

For this reason, securities lawyers say brokerage firms underwriting PIPE's in a legitimate fashion are obligated to walk a fine regulatory line. They must assess investor interest in a future offering without tipping off traders who may say no to the deal and then try to profit on the information by shorting the company's shares.

“You have to share information with people at a time when the market is unaware of the information, to sell the deal,” said Larry E. Bergmann, special counsel at Willkie Farr & Gallagher in Washington and a former senior official in market regulation at the S.E.C. Mr. Bergmann added that brokerage firms “should have a process by which they make clear that they are providing it on a confidential basis and that it is nonpublic and that it has to be treated as nonpublic.”

Javelin’s shares certainly took a roller-coaster ride in the weeks just before and after the company did its PIPE deal last fall. In early September, the shares traded at $2.85. By midmonth, they had risen to $3.45. In October, however, Javelin’s stock began a decline that took it to $2.06 a share on Nov. 2, the day before the PIPE was announced. Over the 17 previous trading days, Javelin’s shares had fallen 36 percent.

Anyone shorting Javelin’s shares would have profited handsomely by covering the bet just before the PIPE was announced. Conversely, the volatility in the shares hurt others, including the company. Had its stock not declined so precipitously, Javelin would have raised significantly more money from the offering. Also on the losing end were shareholders who sold during October when the stock fell, only to watch it rebound in November.

Investors buying the Javelin PIPE included NGN Capital, a venture capital firm in New York, and Wexford Capital, a hedge fund and private equity firm in Greenwich. They paid $2.25 a share for their stakes, according to corporate filings; one week later, Javelin’s shares had popped back up to $3.30 each. Last Friday, the company’s shares closed up 2 cents, to $3.82.

Officials at NGN did not return a call for comment. A Wexford spokesman said he knew of no problems with the deal and that his firm still owned Javelin shares. Officials at Riverbank Capital did not respond to an e-mail message and could not be reached by phone; Rodman & Renshaw declined to comment.

A Javelin spokesman, Rick Pierce, said the company had not been contacted by regulators about the deal. “If there were any negative forces at play that affected our share price at the time of the deal, we would want to know about them and see justice prevail,’’ Mr. Pierce said.

PIPE deals tend to happen quickly — within weeks — which is one reason cash-stretched companies like them. After the deals close, a company issuing the securities typically files a registration statement with the S.E.C. that will, when approved, let buyers resell their shares in the open market — a process that usually takes about 60 days.

Companies in the health care, energy and financial fields are the biggest issuers of PIPE’s. The deals give small companies in these capital-intensive arenas access to money that the more traditional financial markets do not provide.

If you are raising less than $75 million to $100 million of equity, “the old-fashioned registered underwriting doesn’t exist,” said William W. Sprague, head of investment banking at the Sanders Morris Harris Group, a brokerage firm that is prominent in PIPE’s. “Something has to emerge in their place. The hedge funds have emerged. The hedge funds have become for these kinds of companies the dominant capital providers, and they want to do PIPE’s.”

Interest is rising in these deals, recent figures show, even among larger, more established companies. According to ***Sagient Research Systems*** in San Diego, 2006 is on the way to becoming the biggest year for PIPE’s. As of this month, almost 800 deals worth $18 billion have come to market; in 2005, a total of 1,301 deals worth $20 billion were done. The biggest year was 2000, when 1,106 deals worth $24.3 billion changed hands.

During the first half of this year, Sagient said, the biggest firm placing PIPE deals was Rodman & Renshaw, with 22 transactions worth almost $317 million. Roth Capital Partners, another boutique firm, ranked second after placing 20 deals worth $266 million.

Ranked by dollar amount of transactions, the biggest brokerage firms involved in PIPE’s during the first half were Cowen & Company, with $744 million in deals; Deutsche Bank Securities, $602 million; and J. P. Morgan Chase, $511 million.

As Mr. Sprague noted, hedge funds are the biggest buyers of PIPE’s. In the first half of 2006, Cornell Capital Partners, a private equity firm in Jersey City, bought 38 deals worth $191 million, Sagient said. Magnetar Capital, a $3 billion hedge fund in Evanston, Ill., bought 24 deals worth $98 million and Lehman Brothers bought 12 deals valued at $92 million.

To some degree, these figures reflect a trend among companies toward private securities issuance as a way to avoid laborious, costly public deals. When done properly, PIPE deals can please everyone involved. The issuer gets quick and relatively easy access to capital, investors get a discounted stake in a company, and brokerage firms get fees.

But as recent regulatory actions indicate, some PIPE deals can also lead to problems — when traders with an ear to the PIPEline profit by shorting an issuer’s shares.

Bruce Lieberman, a fund manager at Deephaven Capital Management, a $1.5 billion hedge fund based in Minnetonka, Minn., essentially did this from 2001 to 2004, according to an S.E.C. lawsuit filed in May. Mr. Lieberman sold short ahead of 19 PIPE deals, generating $2.7 million in profits, the commission said.

According to the S.E.C., Mr. Lieberman traded on the pending PIPE deals even though he had signed confidentiality agreements with the brokerage firms placing the deals and had promised not to sell short shares before the offerings. He closed out his short positions with shares issued to him in the PIPE.

Both Mr. Lieberman and Deephaven, a subsidiary of the Knight Capital Group, a big securities trading concern in Jersey City, settled with regulators, agreeing to pay $5.8 million without admitting or denying wrongdoing. Mr. Lieberman was barred from associating with an investment adviser for three years. He could not be reached for comment.

Although the S.E.C. issued new guidance in 2004 to discourage sham transactions — short sellers trying to mask how they cover their shorts — regulators say potential problems remain.

Last year, the S.E.C. and NASD charged Hilary L. Shane, a hedge fund manager, with insider trading and fraud, accusing her of illegally shorting the stock of the CompuDyne Corporation after she had been informed about its PIPE deal. According to the regulators' complaints, Ms. Shane used shares she obtained in the PIPE to close out her short position. She paid $1.45 million and, without admitting or denying the charges, agreed to be barred from associating with any NASD-registered firm. She did not return calls seeking comment.

"As our CompuDyne investigation showed, there are opportunities for abuse, and we are very interested in making sure that the players in these transactions are complying with applicable laws," said Cameron K. Funkhouser, an NASD official. Because brokerage firms not only buy and sell securities for their own accounts but also offer money management services to clients, regulators say the potential for self-dealing in these varied businesses, especially if PIPE's are in play, is substantial.

A case that the S.E.C. brought in April 2005 against Guillaume Pollet, a managing director of S. G. Cowen & Company, as Cowen was then known, illustrates the problems. Mr. Pollet was in charge of investing S. G. Cowen's funds in PIPE transactions and shorted the stocks of 10 companies that were planning to issue PIPE's. In several instances, S. G. Cowen also advised the PIPE issuer as its investment banker, the S.E.C.'s complaint noted. Mr. Pollet helped S. G. Cowen lock in $4 million in trading profits related to the PIPE's.

Mark E. Kaplan, general counsel at Cowen & Company, said that after the firm uncovered Mr. Pollet's activities and suspended him, it shut down the proprietary business he had been in and set up policies to ensure that such an incident would not recur. Mr. Pollet pleaded guilty to securities fraud.

MORE recently, the New York Stock Exchange censured Citigroup Global Markets and fined it $250,000 in late June for not having safeguards to prevent the abuse of inside information involving PIPE's. According to the exchange, Citigroup did not have procedures prohibiting traders from using newly registered shares to cover a short position established within five days of a PIPE. Citigroup consented to the exchange's finding without admitting or denying wrongdoing.

Many participants in the PIPE market contend that abuses have been cleaned up in recent years as a result of regulatory action.

Others, however, say the potential for problems remains. Alexander G. Montano, a managing director at C. K. Cooper & Company, a boutique investment bank, said that a falling stock price ahead of a deal is, of course, troubling and may signal potential leaks about PIPE deals.

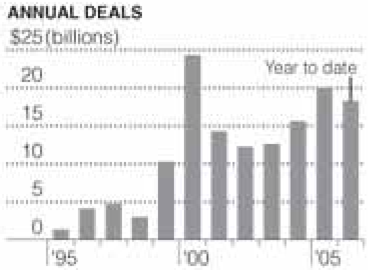
"If we see it we are suspicious," Mr. Montano said, noting that shares sometimes drop before a PIPE. "Are they receiving improper information and using it?"

Money in the PIPE

Securities calles PIPE's, for "private investment in public equity," have taken off as a way to finance smaller companies. Traders sometimes sell the stocks of issuers short, suggesting that they know that the deal will dilute existing shareholders' stakes.

U.S. PIPE Deals*

ANNUAL DEALS



TOP 5 AGENTS BY NUMBER OF DEALS
(2006 YTD)

Agent	No. of Deals	Amount (millions)
Rodman & Renshaw	**22**	$316.8
Roth Capital Partners	**20**	266.4
Cowen & Company	**17**	743.6
Midtown Partners & Co.	**12**	34.6
C.E. Unterberg, Towbin	**11**	126.7

TOP 5 INVESTORS BY NUMBER OF DEALS
(2006 YTD)

Agent	No. of Deals	Amount (millions)
Nite Capital Management	**76**	$31.3
Iroquois Capital	**70**	70.0
Highbridge International	**45**	103.4
Cornell Capital Partners	**38**	191.4
Downsview Capital	**38**	30.7

*Excluding Structured Equity Lines

Source: Sagient Research Systems Inc.

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