

## **The Rise of the PIPE Market**

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### **ABOUT THE AUTHOR**

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### **INTRODUCTION**

The private investment in public equity (PIPE) market has been growing rapidly over the last decade. As shown in Table 1, the number of PIPE deals has grown from 306 in 1996 to 1,249 in 2007. The total amount of capital raised via PIPEs has increased from \$4 billion dollars in 1996 to \$56 billion in 2007. In comparison, in 2007, the number of Seasoned Equity Offerings (SEOs) is 377 and the total amount of capital raised in the SEO market is \$75 billion. These numbers suggest that the PIPE market has grown to an important alternative equity selling mechanism for U.S. public companies.

[Insert Figure 1 here.]

[Insert Table 1 here.]

With the rapid growth of this market segment, the PIPE market has drawn attention from more and more investors, small- and medium-size public corporations which are barred from traditional financing venues such as public debt market and SEOs, and the regulators. Many issues and concerns have emerged. For instance, potential issuers are concerned why and when they should choose PIPEs rather than SEOs, how expensive PIPEs are, how the firm's stock performance will be impacted by the offering; investors have questions such as what is the return and risk profile of PIPE transactions, how to protect investors' benefits using various contract provisions; and regulators are concerned whether and to what extent that existing shareholders' benefits will be impacted by the PIPE offering, whether there are illegal insider trading and market manipulation by PIPE investors, and how to fix these problems. The research in this field, however, is rare. The purpose of this chapter is to provide a detailed review about the structure and development of this market, the problems associated with this market, and the existing research on PIPEs.

The chapter starts with an introduction of the PIPE market, including the definition of PIPE, security structure, and commonly used contract terms. Next, the chapter reviews the cost of PIPEs to issuers, returns of PIPEs to investors, and the role of placement agents in the offering. Then I discuss the recent SEC enforcement on hedge funds who involved in some PIPE transactions. Finally, I analyze how the current financial crisis has impacted the PIPE market and where this market is going down the road.

## WHAT IS A PIPE?

In U.S., PIPEs are private placements by public companies to accredited investors made in reliance on Section 4(2) and/or Regulation D. Section 5 of the Securities Act of 1933 requires that a registration statement must be in effect and a prospectus must be delivered prior to sale. Section 4 (2) or Regulation D provide exemption to issuers from Section 5 registration requirement when the offering involves the following elements:

- The offer is made to a limited number of financially sophisticated investors or accredited investors.<sup>1</sup>
- The offering does not involve any general advertising or general solicitation;
- Investors are given information relevant to their investments.

Following the closing of a PIPE transaction, the issuer prepares and files with the SEC a resale registration statement. In contrast to a traditional private placement, the closing does not depend upon the SEC review process. This feature makes PIPE a time-efficient mechanism for issuers to raise capital. However, investors cannot resell or short securities purchased until the SEC declares the effectiveness of the registration statement. To compensate investors

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<sup>1</sup> Regulation D Rule (501) defines investors from the following categories as accredited investors: banks, broker or dealer, insurance company, registered investment company or business development company, Small Business Investment Company, pension funds, director, executive officer, or general partner of the issuer, corporation, limited liability company, trust or partnership with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered, any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds \$1 million, or income or joint income exceeds \$200,000 or \$300,000, respectively, in each of the two most recent years, and any entity in which all equity owners are accredited investors.

for this temporary illiquidity, PIPE issuers often offer the securities at a discount to market price.

The security structure is very complex in the PIPE market. The option generally includes: plain vanilla common stock issuance, common stock reset issuance, common stock shelf sale, company installment convertible issuance, fixed price convertibles, floating price convertibles, convertible reset issuances, and structured equity lines. Typically, plain vanilla common stock issuance and fixed-price convertibles issuance are categorized as “traditional PIPEs” and others are called “structured PIPEs”.

As shown in Table 2, plain vanilla common stock and fixed convertibles are the top two security types used in the PIPE market based on the number of transactions and the amount of capital raised. For instance, during the period from 1996 to 2007, plain vanilla common stock PIPEs account for 45% (46%) of the market, while fixed convertible PIPEs account for 25% (31%) of the market, based on the number of transactions (amount of capital raised). While there is a fairly large number of floating convertible PIPEs, nevertheless, the amount of capital raised through this security type accounts for only 11% of the total market. Furthermore, as shown in fig. 2, it seems that the number of floating convertible PIPEs has been declining since 2001. In comparison to the peak of 237 floating convertible PIPEs in 1997, there were only 48 such PIPEs in 2001. The number of transactions further declined to 18 in 2003. Hillion and Vermaelen (2004) demonstrate that firms issuing floating convertible bonds tend to perform poorly in the long run. They suggest that such floating convertibles encourage short

selling by convertible holders and that the resulting dilution triggers a permanent decline in the share price. One of the reasons for the declining popularity of floating convertible PIPEs is SEC's investigations on potential unlawful behaviors of investors (insider trading, market manipulation, etc.) involved in this category.<sup>2</sup>

[Insert Figure 2 about here.]

[Insert Table 2 about here.]

PIPEs seem to be most popular in the following four sectors, healthcare, communications, technology, and industrial. About 72% of the PIPE transactions are conducted by firms in the above-mentioned sectors.

[Insert Figure 3 about here.]

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PIPEs are also becoming more popular over years in Canada, Europe and Asia. The definitions of PIPEs could be slightly different across countries due to the different securities regulation frameworks. For instance, in Canada, before November 2001, the restricted period when that PIPE purchasers are prohibited from reselling their PIPE shares to the public market ranged from 6 to 18 months, and is reduced 4 months thereafter.<sup>3</sup> In U.S., the restricted period is dependent on when the PIPE issuing firm files the registration statement and how long it takes the SEC to declare it effective. Thus, it varies across deals. On average, it is about 120 days, comparable to the existing length of restricted period in Canada.

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<sup>2</sup> The SEC has filed complaints against some PIPE investors alleging insider trading and registration violations. Specifically, the allegations involve short selling prior to both the initial public announcement and to the effective date of the resale registration statement.

<sup>3</sup> Maynes and Pandes, 2008.

## **CONTRACT TERMS IN PIPE OFFERINGS**

In this section, I describe the contracts between the PIPE investors and issuers in great detail. In particular, I focus on contract terms that are designed to protect benefits of both new shareholders (PIPE investors) and the company.

### **Anti-Dilution Protection**

PIPE offerings frequently include anti-dilution protection that protects the PIPE investors against future financing at a lower valuation than the valuation of the current (protected) offering. In the extreme case, the company is not allowed to issue or sell any equity securities or securities convertible into equity during certain period after closing, for example, from closing date until 90 trading days following the effectiveness of the Registration Statement or not allowed to issue or sell any equity securities or securities convertible into equity at a price below the current offer price or a benchmark price while the security remains outstanding. In other cases, PIPE investors are protected from the above-mentioned events by being able to reduce the current offer price or conversion price to the lowest price paid for such security in future financing, or having the right to receive cash or additional common shares without additional consideration.

### **Redemption rights**

Investor optional redemption is commonly used to strengthen the liquidation rights of the PIPE investors' investment. This provision gives the PIPE investors the right to demand that the firm redeems the investors' claim upon a

change of control, typically at face value or a certain percentage of face value (often higher than 100%, occasionally, higher than 200%) plus accrued and unpaid interest. In some cases, the interest rate will also increase by some basis points per annum. Many PIPE offerings also have company optional redemption provision, which gives the company the right to force the PIPE investors to exercise the redemption right after certain date or upon certain events.

### **Investor Registration Rights**

The key feature of PIPE offerings is that firms can close the offering before filing any registration statements with the SEC, which makes the PIPE offering time-efficient. Nevertheless, PIPE investors assume the risk of illiquidity before the effectiveness of Registration Statement simply because they are not allowed to resell the stocks obtained through PIPEs. Most PIPE contracts specifically request the company to file a Registration Statement covering the resale of common stocks (underlying the issued securities) no later than certain days after the closing and to make it effective within certain time window. In some cases, investors place a cap on the amount of capital that the company can draw down before the effectiveness of the Registration Statement.

### **Investor Board Representation**

The board of directors is generally responsible for (1) hiring, evaluating, and firing top management; and (2) advising and ratifying general corporate strategies and decisions. In a relatively small percentage of cases, PIPE

investors have the right to nominate certain number of directors to the company's board after the PIPE (in some cases, investors have to keep certain percentage of the company's shares or purchased shares in offering to keep this right) . Sometimes the designation is contingent upon certain events, for instance, in the event that the company fails to redeem the investors' claim upon a change of control.

### **Trading/Hedging Restrictions**

Many PIPE offerings have provisions restricting investors' trading/hedging behavior during certain time period. Typically, such provisions ask investors not to engage in any short transactions or hedging of the company's common stock or in excess of the amount of shares owned (an offsetting long position) prior to the effectiveness of the Registration Statement, which otherwise will result in insider trading according to the SEC regulation. Sometimes investors are asked not to short or hedge in a longer period than the SEC's requirement or as long as the purchased security remains outstanding. If the company is planning a public offering shortly subsequent to the PIPE, it will ask investors not to affect any sales to the public of shares of the company for a period of certain days following the effectiveness of the Registration Statement in order to avoid the price pressure from investors' resale of their shares to the public.

An additional provision related to restrictions on investors' trading behaviors is the so-called lock-up period. Basically, with this provision investors may not sell any shares of the company's common stocks purchased or received



through the exercise of warrants for the duration of a few months following the closing.

### **Company Forced Conversion**

Securities in PIPE offerings often include company forced conversion provisions in which the security held by the PIPE investors will automatically convert or are forced to convert into common stock under certain conditions. These conditions often relate to the stock performance of the company, for instance, the stock price or the weighted average stock price during a period exceeds certain benchmark or the daily trading volume exceeds certain level for some consecutive trading days. In some extreme cases such as the company taking a 10,000-to-1 reverse stock split, the security will also automatically convert into common stocks.

The effect of the company forced conversion provisions is to require the PIPE investors to give up their superior rights if the company attains a desired level of performance. Upon such performance, the PIPE investors retain only those rights associated with their ownership of common stock. If the company does not deliver that performance, the investors retain their superior rights.

### **Investor Call Option, Investor Right of First Refusal and Company Put Option**

Investor call option and investor right of first refusal give investors the right to purchase additional shares of the company's security during a certain period in

the future, while company put option gives the company the right to request PIPE investors to purchase additional amount of securities at specified price in the future. As for Structured Equity Lines, the company has the option to obtain as much as the agreed amount of capital from the PIPE investors over the term of Equity Line by delivery of Draw Down Notice specifying the amount to be drawn. These provisions give investors/companies the rights for future investment/financing opportunities with a lower transaction cost.

[Insert Figure 4 about here.]

Some of the above-mentioned provisions are widely used in all types of PIPEs. For example, over 95% of PIPEs have the investor registration right. Investor right of first refusal is also commonly (on average 39%) included in all types of PIPE contracts. On the other hand, some provisions are more often used in certain types of PIPEs, but not in other types of PIPEs. For instance, price floors (hard floor and green floor) are more often to be seen in the term sheets of convertible PIPEs. About 52% of convertible PIPEs include anti-dilution provisions, while less than 5% of the common stock PIPEs include this provision. Trading and hedging restrictions are also more likely to be included in convertible PIPEs but less often in common stock PIPEs. Investor board representation is more commonly seen in plain vanilla common stock PIPEs and fixed-convertible PIPEs but less often in floating convertible PIPEs or security equity line or company installment convertible PIPEs.

Chaplinsky and Haushalter (2008) examine when investors are more likely to include price protection terms in the purchase agreements of PIPEs. They find

that all else equal, there is a higher probability of price protection the greater the degree of uncertainty regarding the issuer's future performance and the more difficult it is for investors to protect against downside risk such as high trading costs that make shorting costly.

## **FIRMS ISSUING PIPES**

### **Why Firms Choose PIPES?**

Most PIPE issuers are small, young, and risky (see Brophy, Ouimet, and Sialm (2008), Dai (2007), and Chaplinsky and Haushalter (2008)). Many of these issuers have difficulty to obtain capital through more traditional means of financing, such as SEOs. Chen, Dai, and Schatzberg (2008) examine how firms choose between traditional SEOs and PIPES. They find that PIPE firms possess high levels of information asymmetry and poor operating performance. More than 50% of the PIPE issuers are not covered by any financial analyst, the stock bid-ask spread of the PIPE issuers are much greater than that of SEO issuers, and majority of the PIPE firms are not profitable at the time of PIPES. Jointly, these represent characteristics which are unattractive to the traditional SEO process. Chen, Dai, and Schatzberg (2008) further find that following unsuccessful SEOs (withdrawn SEOs), firms which subsequently switch to the PIPE market have characteristics suggesting greater information asymmetry and worse operating performance than firms that are successful with second attempt SEOs. Overall, these findings suggest that PIPE issuances may represent the last resort for

these firms with high information asymmetry or poor operating performance to obtain additional equity capital. Because most PIPE transactions are highly risky for investors, investors often ask for a large discount as compensation, which is on average 5-6 times the discount of SEO offerings.<sup>4</sup> Thus, the emergence and rapid growth of the PIPE market fills the capital need of at least some firms that are rejected by the traditional SEO market; and in doing so, this market also compensates investors willing to bear such risks by offering large risk premia in the form of attractive discounts. Hence, the PIPE market may act as a supplement to the traditional SEO market.

In addition to solving the capital needs of firms with high levels of information asymmetry, PIPEs also provide an enhanced market environment for the issued securities. Dai, Jo, and Schatzberg (2008) show that both the information environment and the stock liquidity of issuing firms after the PIPE offering are significantly improved. Issuing firms, in general, are followed by more analysts, have smaller bid-ask spreads, higher turnover, and smaller price volatilities after PIPEs.

### **Cost of PIPEs**

Due to the high-risk nature of PIPE issuers, the cost of PIPE is found higher than that of traditional SEO. Dai and Chen (2008) calculate both the direct cost and the indirect cost of PIPE transactions and compare those with SEOs. The direct cost is measured as agent fees in PIPEs or gross spread in SEOs.

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<sup>4</sup> According to Dai, Chen and Schatzberg (2008) the mean and median discount of PIPEs is 21.1% (13.6%), while 3.6% (2.7%) for SEOs during the period of 1996-2003.

Agent fees/gross spreads are the commissions paid to investment bankers when securities are issued, expressed as a percentage of gross proceeds. The indirect cost is measured as discount, which is computed as the percentage change from the offer price to the closing price on the day prior to the offering. Discounts are the money left on the table by issuers. According to Dai and Chen (2008), the mean (median) agent fee of common stock PIPEs is 6.8% (6.6%), 230 (160) basis points higher than the mean (median) gross spread of SEOs, which is 4.5% (5.0%). The discounts of PIPE offerings are also much higher than SEO discounts. The mean (median) discounts are 31.5% (18.4%), more than eight times the SEO discounts, which have a mean of 4.1% and a median of 3.0%. As mentioned earlier, firms issuing PIPEs are often small, young and risky. Both investment banks and PIPE investors are taking substantial risk, which could potentially explain both the high agent fees and large discounts. Furthermore, PIPE investors take the risk of illiquidity since they are not allowed to resell the PIPE shares to the public market before the registration statement becomes effective. Dai and Chen (2008) also find that there exist economies of scale in the PIPE market in that agent fees and discounts decline as issue size increases.

### **Stock Performance at Closing and in the Long-Run**

The short run market reaction around the announcement of a PIPE is on average positive (see Dai (2007), Brophy, Ouimet, and Sialm (2008), etc). Nevertheless, PIPE issuers typically have negative post-issuance long-run performance. It is not yet fully understood why market reacts to the PIPE

issuance positively in the short run and negatively in the long run. Scholars have provided several potential explanations for the puzzle.

Dai (2007) examines whether the identity of PIPE investors can explain the short-run market reactions. She finds that VC-led PIPEs on average have a CAR (0, 3) of 5.6%, while hedge fund invested PIPEs on average have negative CAR (0, 3). Furthermore, VC-led PIPEs have a significantly positive abnormal alpha which implies one-year abnormal return of about 39%. In contrast, hedge funds invested PIPEs have an alpha not different from 0. Brophy, Ouimet, and Sialm (2008) find similar results. They show PIPEs invested hedge funds have less positive short run market reaction but more negative long-run post-PIPE stock performance than PIPEs invested by other investors. They further show security type also matters for the short-run market reaction. For instance, traditional PIPEs have more positive short-run market reaction and less negative long-run stock performance than structured PIPEs.

Dai (2007) further explores why investor identity matters for the market reaction to PIPEs. She examines the changes in ownership structure and board structure before and after PIPE to determine whether PIPE investors are active or passive investors. She finds that VCs often purchase a substantial stake of the firm via PIPEs and request board seats after the PIPE. Furthermore, VCs usually keep their stake for a long period, with 71% of VC investors hold their stake for more than one year, and 47% hold for more than two years. These findings indicate that VC investors have the control power to affect the management after the PIPE. In contrast, hedge funds rarely sit on the board of the firm and often

exit from their investment shortly after the PIPE even though they also obtain a block stake through the PIPE, suggesting hedge funds are more likely targeting the quick profits from trading and are more likely passive investors. Dai (2007) shows that the difference in ownership stake acquired through PIPEs and the length that investors keep their stake could partially explain the short-run and long-run stock performance of firms issuing PIPEs. Specifically, larger ownership by VCs increases CAR (0, 3) and the length that investors keep their stake after PIPEs increases buy-and-hold abnormal return (BHAR) during one year following the PIPE.

## **INVESTORS IN THE PIPE MARKET**

As we mentioned earlier, Regulation D requires that PIPEs must be offered to accredited investors. Regulation D Rule (501) defines investors from the following categories as accredited investors: banks, broker or dealer, insurance company, registered investment company or business development company, Small Business Investment Company, pension funds, director, executive officer, or general partner of the issuer, corporation, limited liability company, trust or partnership with total assets in excess of \$5 million not formed for the specific purpose of acquiring the securities offered, any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds \$1 million, or income or joint income exceeds

\$200, 000 or \$300,000, respectively, in each of the two most recent years, and any entity in which all equity owners are accredited investors.

According to the amount of capital invested in the PIPE market, the major investors in the PIPE market are the following: hedge funds, pension/government funds, corporation, mutual fund/institutional advisors, buyout firm/private equity, venture capital firm, broker/dealer, bank, insurance company, charitable/educational/family trust, and various individual investors.

[Insert Figure 5 about here.]

[Insert Table 4 about here.]

Several studies have examined how investor identity impacts the funded firms' performance.<sup>5</sup> For example, Brophy, Ouimet, and Sialm (2008) report that hedge funds tend to invest in firms with poor fundamentals and pronounced informational asymmetries. Hedge funds require substantial discounts, repricing rights and enter short position of the underlying stocks of funded firms. Authors also find that firms obtaining funding from hedge funds substantially underperform those obtaining funding from other types of PIPE investors during the following two years.

Dai (2007) examines the PIPEs invested by venture capital funds and compares the investment behavior of VCs and hedge funds in the PIPE market. She finds that the stock performance of VC-invested firms is significantly better than hedge fund invested firms both in the short run and in the long run. She further reports that VCs gain substantial ownership, request board seats, and

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<sup>5</sup> Also see discussions on how investor identities impact the short-run and long-run stock performance of PIPE firms in Section 3.3.



often keep their stake after the PIPEs. In contrast, hedge funds rarely join the board of directors and typically cash out their positions shortly after the PIPE.

## **THE ROLE OF PLACEMENT AGENTS**

An issuer undertaking a PIPE generally engages the services of an investment bank to serve as its agent. Unlike the straight (traditional) private placement, whereby a lead investor or a group of lead investors dominates and shapes the process, the PIPE process is led by the placement agent. The major obligations of placement agents include assisting with preparation of the private placement memorandum, assisting with preparation of a road show or investor presentation, and introducing the issuer to potential investors. These duties are typically outlined in an engagement letter with the issuer. The engagement letter also sets forth the agency fees and the terms and conditions for payment. A placement agent often negotiates for itself a “tail” affording it the right to receive a fee in respect of future financings, especially other PIPEs during some set period. A placement agent may also negotiate with the issuer a right of first offer or a right of first refusal to participate in future financings or to serve in an advisory capacity. Different from most of the U.S. IPO/SEO underwriting business, the placement agent has no commitment to purchase any of the securities, suggesting the best efforts contract rather than the firm commitment contract. In PIPEs, placement agents conduct their own due diligence and many

take the view that they may be regarded as “underwriters” under the securities laws.

While the underwriters of IPO and SEOs supposedly take the third-party “gatekeeping role” between issuers and investors, PIPE placement agents could be exposed to additional risk of alleging violations of both stock registration and investor misrepresentation. Because PIPE investors are aware of the possibility that an issuer’s stock can decline after the PIPE announcement, they have a strong incentive to short-sell the number of shares they purchase in the PIPE and cover the sale by purchasing the needed shares in the market following the price drop upon the announcement of the PIPE offering. Both regulators and prosecutors have taken the position that this type of transaction is unlawful insider trading. In addition, because the nature of the relationships between issuers and investors can be difficult to discern in PIPE offerings, PIPE offerings often raise the question whether there was an affirmative misrepresentation regarding investment intent.

According to Dai, Jo, and Schatzberg (2008), some of the placement agents are well-known names in the IPO and SEO underwriting business, such as Citigroup, UBS, Lehman Brothers, etc. Others, such as Coastline Capital Partners, Halpern Capital, ThinkEquity Partners, are less well-known and are specialized players in this market. Dai, Jo, and Schatzberg (2008) also relate PIPE agents to the Carter and Manaster (C&M thereafter) ranking, which is commonly used to represent the participation and reputation of IPO/SEO underwriters. Among the 215 PIPE placement agents in their sample (1996-

2005), a total of 121 agents have C&M ranking with a mean (median) ranking of 5.4 (5.1). A total of 20 placement agents have a C&M ranking of at least 8.1. In very rare cases, PIPE placement agents are the issuers' IPO underwriters or previous SEO underwriters (only 1.5%).

Dai, Jo, and Schatzberg (2008) examine how placement agents select PIPE firms and how their reputation impacts the PIPE transactions' discounts, agent fees charged, and information environment of the firm before and after the PIPE offering. They find that there exists a positive assortative matching in the PIPE market, where reputable placement agents are associated with larger offers and firms with less risks. More reputable agents offer higher quality services in that their deals are priced at lower discounts and improved information environment. Nevertheless, more reputable agents do not seem to charge a price premium. Rather than fees per se, the quality of the issuing firm and the reputation concern of the placement agent are the key factors that drive the equilibrium in the PIPE market. Authors also find evidence that lower discounts and not necessarily higher agent fees charged in the prior PIPE transactions increase the agent's market share in the future.

Huang, Shangguan, and Zhang (2008) investigate the networking function of placement agents in the PIPE market. They find that placement agents with stronger networking abilities help issuers attract more investors. Similarly, investors are more likely to participate in an issue if they have an existing relationship with the placement agent.

## ISSUES IN THE PIPE MARKET AND SEC REGULATIONS

Some problems emerge while the PIPE market has been picking up its steam over the last a few years. Recently, the SEC has filed complaints against several PIPE investors.<sup>6</sup> The common charges include a) false representation, b) illegal insider trading, and c) sale of unregistered securities. During the PIPE offering, the placement agent will distribute non-public information about the issuer to the potential PIPE investors and the latter are requested to sign an agreement to keep the information confidential and not to trade or direct others to trade on the issuers' securities. Many PIPE investors "hedge" their investment by selling short the PIPE issuer's securities before the resale registration statement is declared effective or even before the public announcement of the PIPE offering. There is nothing per se illegal about "hedging" a PIPE investment by selling short the issuer's securities. Such short sales do not violate the registration provisions of the Securities Act if, among other things, the investor closes out the short position with shares purchased in the open market. An investor violates Section 5 of the Securities Act, however, when it covers its pre-effective date short position with the actual shares received in the PIPE. This is because shares used to cover a short sale are deemed to have been sold when the short sale was made.

For instance, in the case of Hilary L. Shane in connection with a PIPE offering of stock by CompuDyne Corporation, the SEC alleges that Shane had sold short CompuDyne's stocks before the company publicly announced the

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<sup>6</sup> See [www.sec.gov](http://www.sec.gov).

PIPE offering using material non-public information about the company disclosed by the placement agent to Shane.<sup>7</sup> At the time of her short selling, she did not borrow, or deliver to the purchaser, the shares of CompuDyne that she sold short. She ultimately used the shares that she obtained from the PIPE offering to cover her short position. Thus, Shane breached her duty of trust and confidence because her transactions violated her agreement with the company and placement agent not to trade on the non-public information and was engaged in insider trading. Furthermore, when she executed her short sales of CompuDyne securities, there was no resale registration statement in effect for the PIPE shares and no exemption from registration applied to the sales of those shares. By short selling CompuDyne securities before the effective date of the resale registration statement for the CompuDyne PIPE shares and covering her short sales with the PIPE shares after the resale registration statement became effective, Shane effectively sold the shares prior to their registration, thus violated Section 5 of the Securities Act.

According to the SEC documentations, to avoid detection and regulatory scrutiny, some PIPE investors employed a variety of deceptive trading techniques, including wash sales and matched orders, to make it appear that they were covering their short positions with legal, open market stock purchase when in fact the covering transactions were not open market transactions. For example, in the case of Langley Partners in connection with the PIPE offering by the MGI Pharma, Inc., Langley Partners invested \$1,100,000 in the

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<sup>7</sup> For more details of the case, see <http://www.sec.gov/litigation/complaints/comp19227.pdf>.

offering, receiving 100,000 restricted MGI Pharma shares at \$11 per share, which represents a discount of approximately 15% from MGI Pharma's then-market price of approximately \$13 per share.<sup>8</sup> Langley Partners quickly short sold all 100,000 of its restricted shares (50,000 at \$13.15 and 50,000 at \$13.56), garnering proceeds of \$1,335,500. Thus, Langley Partners had purchased 100,000 shares in the PIPE and shorted 100,000 shares before the resale registration statement was effective.

Using its Canadian broker-dealer, Langley Partners executed "naked" short sales by, among other things, selling short without either owning unrestricted shares or borrowing unrestricted shares to deliver.<sup>9</sup> In addition to its "naked" Canadian short selling, Langley Partners also engaged in short selling in the United States through domestic broker-dealers or by executing short sale orders itself through electronic communications networks. Once Langley Partners had established its short position, it waited until the SEC declared effective the resale registration statement and then began to use its PIPE shares to cover (or "unwind") the short positions.

To close out Canadian short positions, Langley Partners engaged in pre-arranged matched orders with its Canadian broker-dealer. To execute the matched orders, Langley Partners called the Canadian broker to inform him that Langley Partners intended to sell a certain number of its PIPE shares from its domestic prime brokerage account at a particular time and price using a particular exchange. At the same time, Langley Partners asked the broker to

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<sup>8</sup> For more details of the case, see <http://www.sec.gov/litigation/complaints/comp19607.pdf>.

<sup>9</sup> "Naked" short selling was permissible in Canada during the relevant period.

enter a buy order for Langley Partners' Canadian account for the same number of shares at the same time and price and on the same exchange. Thus, the buy and sell orders would meet on the specified exchange, and the Canadian broker-dealer would use the PIPE shares that he had just purchased from Langley Partners' domestic account to close out Langley Partners' short positions.

To close out its short position in its US domestic prime brokerage account, Langley Partners used wash sales. Langley Partners asked broker-dealers to register as market makers in particular PIPE securities to assist Langley Partners in washing its PIPE shares. With the help of these broker-dealers, Langley Partners sold its PIPE shares to the brokers, which then sold the exact same shares back to Langley Partners. Once Langley Partners had received its PIPE shares back from the broker-dealers, Langley Partners used those PIPE shares to close out its short positions.

Through the deceptive methods described above, Langley Partners used the shares obtained from the PIPE offering to close out its short position established before the SEC declares the effectiveness of the security registration statement. Langley Partners' profit was therefore locked in at the moment its short sales were executed: the \$1,335,500 short sale proceeds minus the \$1,100,000 investment, for a net profit of \$235,500. Thus, Langley Partners violated Section 5 of the Securities Act.

In addition to the above mentioned issues (false representation, insider trading, and sales of unregistered securities), another primary concern of the

SEC involves the structured PIPEs where floating convertibles, which are often called “Death Spiral” convertibles or “Toxic” convertibles, are issued.

Any PIPE that involves issuance of a security at a discount from its current market value can expose a company’s existing shareholders to the risk of significant dilution. In particular, in a structured PIPE, the amount of securities issuable upon conversion is indeterminate and variable. Typically, to protect the investors, the conversion price or ratio reset downward if the market price of the common stocks decline. As the company is required to issue more stocks upon a lower conversion price, its stock price drops further, thus causing the stock to enter a death spiral. Unless the securities have a cap or floor that limits such adjustments, the extent of potential dilution could be substantial. Hillion and Vermaelen (2004) demonstrate that firms issuing floating convertible bonds tend to perform poorly in the long run. Furthermore, they suggest that such floating convertibles encourage short selling by convertible holders and that the resulting dilution triggers a permanent decline in the share price.

A sample case on the manipulative trading is SEC vs. Rhino Advisers in connection to the PIPE offering by Sedona Corporation.<sup>10</sup> Sedona issued convertible debentures to one of Rhino’s clients. The Debenture granted the investor the right to convert all or any portion of the Debenture into Sedona common stock at a price equal to 85% of “the volume weighted average price of the Common Stock on the Nasdaq Small Cap Market during the five trading days immediately prior to the Closing Date or Conversion Date”. The Debenture does

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<sup>10</sup> For more details on this case, see <http://www.sec.gov/litigation/complaints/comp18003.htm>.



include a provision that prohibit investors from selling Sedona's stock short while the issued debentures remain issued and outstanding. Despite this contractual provision, Rhino engaged in extensive short selling prior to exercising the conversion rights. The extensive short selling substantially depressed Senona's stock price. As a result, Sedona had to issue more shares when Rhino exercised its conversion rights.

While the SEC has made the above arguments with respect to PIPE investors, as far as we know, the courts have not yet validated the SEC's positions. Despite this unsettled state of the law, various hedge funds and their advisers have agreed to multi-million dollar settlements as well as suspensions or bars when faced with SEC enforcement actions. When asked whether the SEC plans any rulemaking to attack this problem at the 27<sup>th</sup> SEC Government-Business Forum on Small Business Capital Formation Program, Brian Breheny, the deputy director of the division of corporation finance of the SEC, replied, "I don't know what we'll see in the future. It is something that we're certainly looking about and it is something that we're looking for..."

## **THE PIPE MARKET DOWN THE ROAD**

The U.S. PIPE market totaled \$121 billion raised through 1,035 transactions in 2008.<sup>11</sup> While 2008 was a record year for total dollars raised in the PIPE market, we wonder given the current equity market turmoil, how the PIPE market has been impacted and where the market is heading for. I analyze

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<sup>11</sup> [www.placementracker.com](http://www.placementracker.com)

the trends from four perspectives, investor profile, issuer profile, placement agents, and the internationalization of this market.<sup>12</sup>

The statistics provided by Sagient Research show that the PIPE investor profile has changed in 2008. For instance, hedge funds used to be the predominant investor in the PIPE market. Investments by hedge funds often account for 40-50% of the total deals. Nevertheless, in 2008, hedge fund activities in the PIPE market dropped dramatically to about 10% of the market. On the other hand, VC/PE investors and corporate investors, who are often regarded as strategic investors, have been picking up the slack. Each group counts for more than 20% of the market in 2008. The trend makes economic sense. Given that many public firms' stocks are undervalued and have the high risk of keeping declining in the near future, it is becoming more difficult for hedge funds, who are typically targeting for the short-term financial profits, to earn quick buck out of the PIPE deals. As for VC/PE investors and corporate investors, who typically are long-term value investors, it is a great opportunity to invest in companies with solid fundamentals but short of cash due to the market condition at a more attractive price.

While the revenue sources from IPO/SEO underwriting and M&A advisory services have been drying for investment banks, many investment banks will consider cultivating the business opportunities in the PIPE segment. The potentially more competition will improve the efficiency of the offering process and make the deal less costly in terms of lower agent fees. The average agent

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<sup>12</sup> I would like to thank Brian Overstreet, CEO of the Sagient Research Systems, and Mike Kotecki, also from Sagient Research Systems, for providing data on this regard.

fee rate has decreased to 3.3% in 2008 from 6.0% in earlier years and could be declining further more.

PIPEs used to be the last-resort type of financing for small- and medium-sized public firms who are barred from more traditional financing approaches. The credit crunch and the miserable stock market have made debt financing and public equity financing highly expensive, or inaccessible even for large firms. PIPE could be an alternative financing technique for those large firms. In 2008, firms with market capitalization exceeding \$1 billion have raised about \$80 billion from the PIPE market, accounting for more than 70% of the total dollar amount raised from this market. We will observe more mega-size PIPE offerings in the future. Furthermore, distressed firms will be less likely to obtain funding from PIPE investors, while fundamentally solid firms with promising growth potential will be more likely to get capital infusion from strategic investors such as VC/PE and corporate investors.

So far, U.S. and Canada have been the most active PIPE markets. This type of financing is still rare in other parts of the world. However, we do see some development of the PIPE market outside U.S. and Canada in 2008. For instance, there were 83 PIPE transactions totaling \$2.9 billion conducted in Hong Kong, 324 transactions totaling \$10.5 billion completed in Australia, 204 transactions totaling \$8.9 billion closed in U.K.<sup>13</sup> This trend will continue. We shall see more PIPE transactions in developing economies as well, such as China and India, in the future as investors and investment banks look for alternative investment opportunities.

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<sup>13</sup> Overstreet, 2008.

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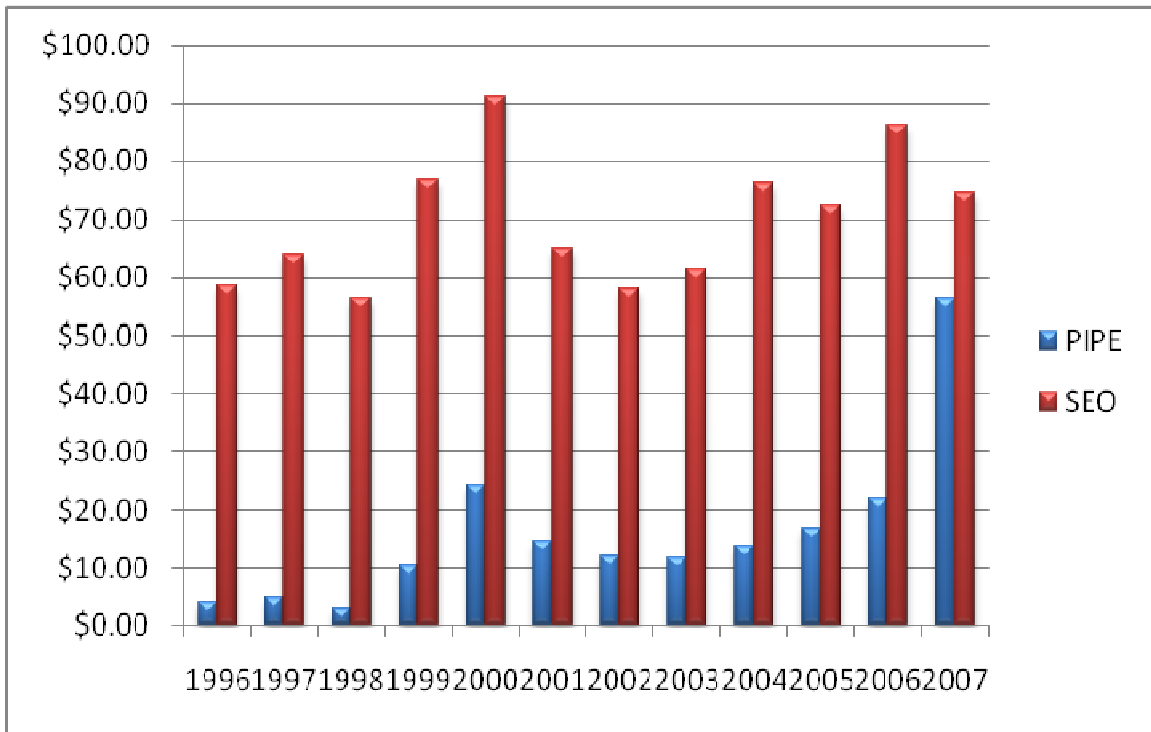


Figure 1 Total Dollar Amount Raised by PIPEs vs. SEOs, 1996-2007

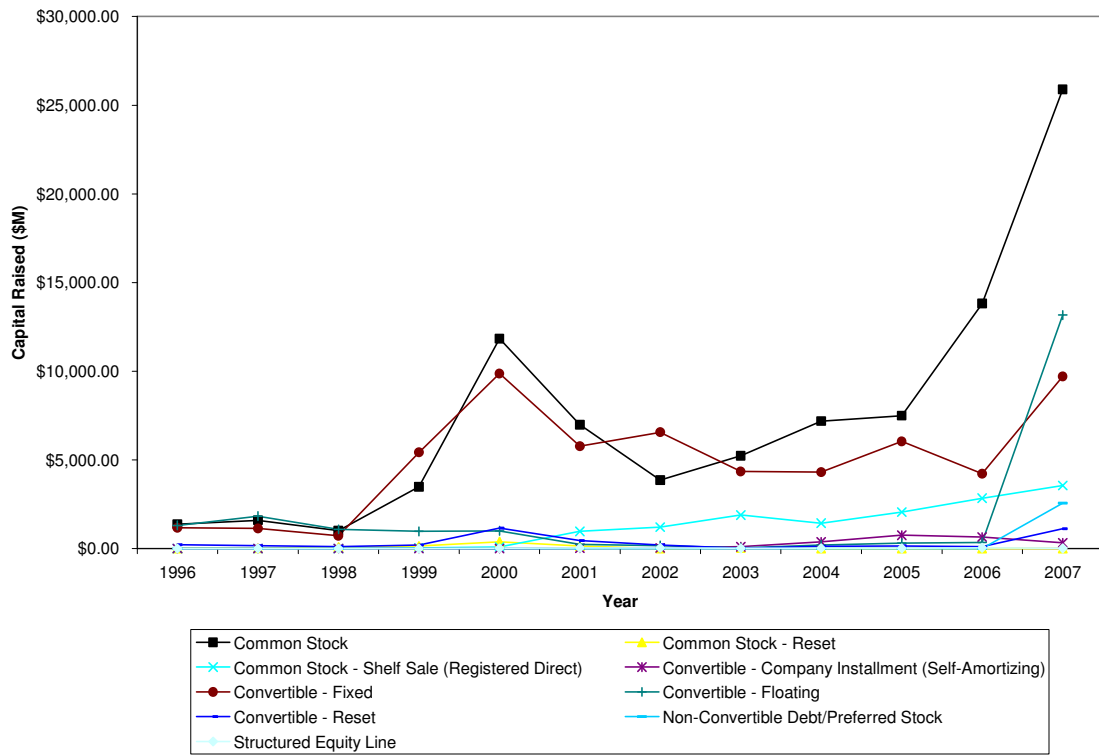


Figure 2 Amount of Capital Raised by Security Type, 1996-2007

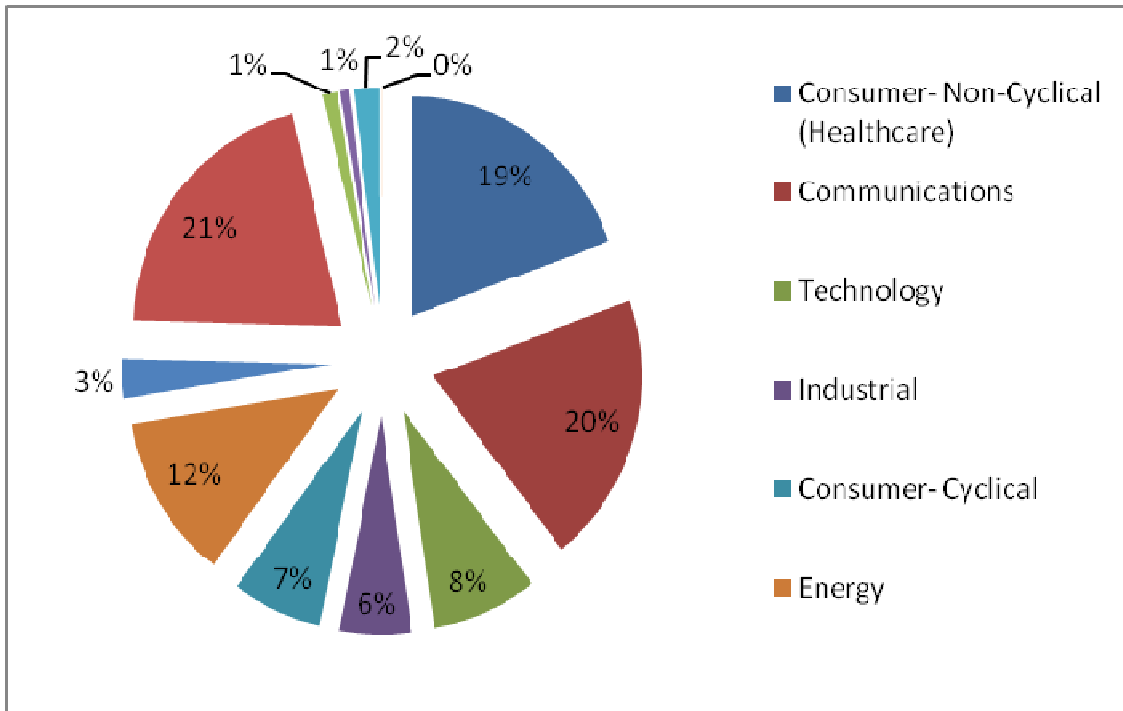


Figure 3 Distributions of PIPEs by Industries, 1996-2007

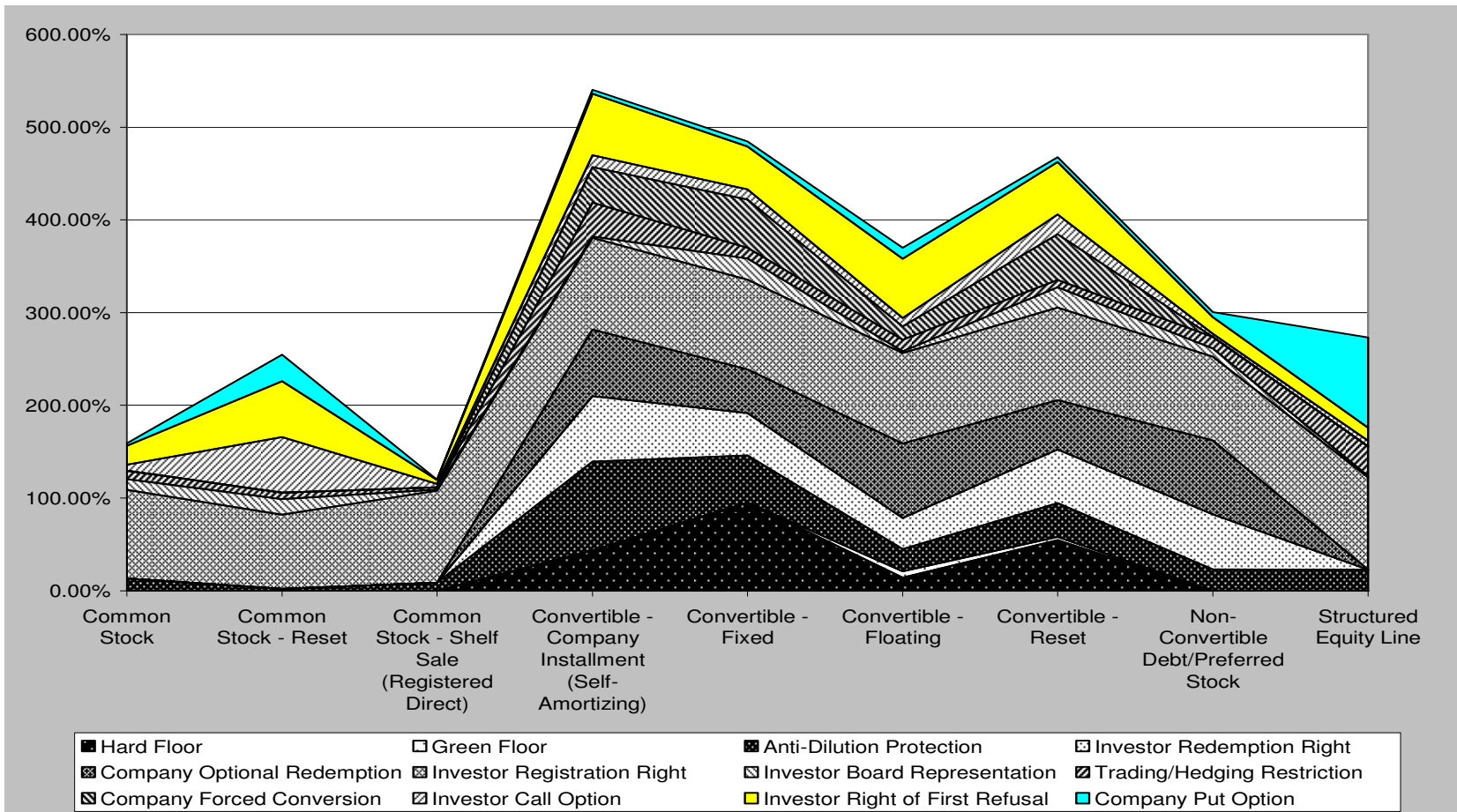


Figure 4 Contract Terms Included by Security Type



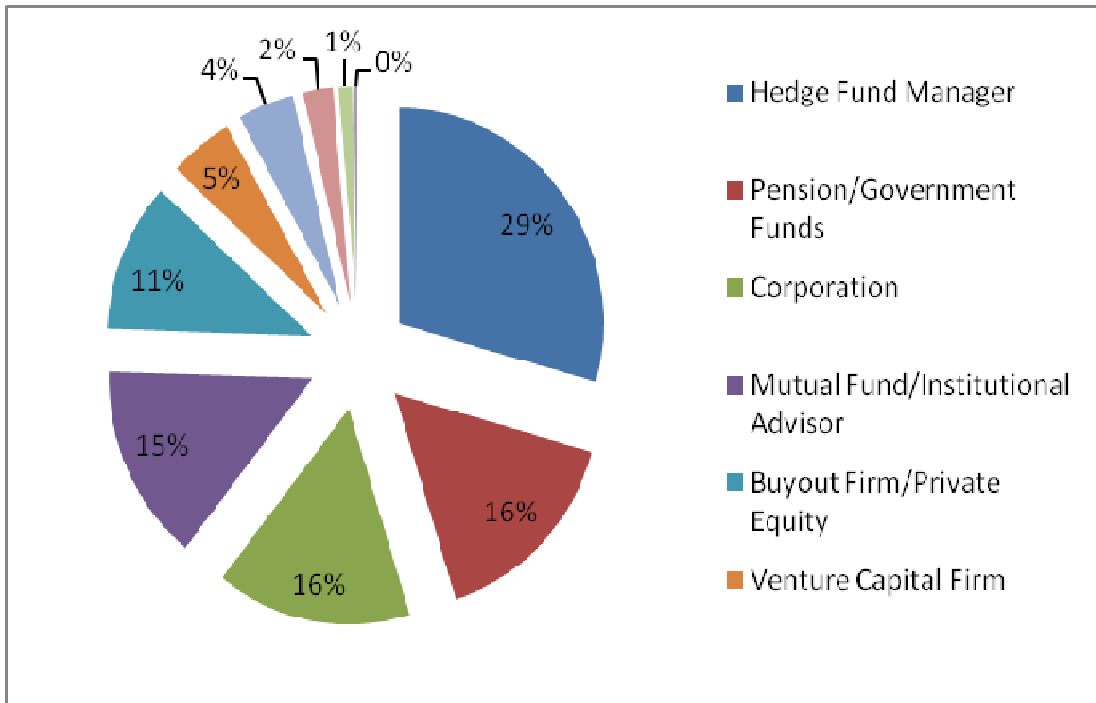


Figure 5 Market Share by PIPE Investor Type, 1996-2007

Table 1 Overview of the PIPE Market, 1996-2007

Year	PIPE		SEO	
	N	Capital Raised (\$Billion)	N	Capital Raised (\$Billion)
1996	306	\$4.1	714	\$58.5
1997	456	\$4.7	677	\$63.8
1998	440	\$3.0	542	\$56.2
1999	691	\$10.3	412	\$76.9
2000	1,254	\$24.4	373	\$91.1
2001	1,036	\$14.6	384	\$64.9
2002	757	\$12.0	377	\$58.0
2003	889	\$11.7	466	\$61.3
2004	1,285	\$13.7	533	\$76.3
2005	1,317	\$16.8	420	\$72.6
2006	1,260	\$22.0	450	\$86.2
2007	1,249	\$56.3	377	\$74.8
1996-2007	10,940	\$193.59	5,725	\$840.7

Table 2 Security Structure of PIPE Offerings

Security Type	N	Capital Raised (\$Billion)
Common Stock	4,972	\$89.75
Common Stock - Reset	98	\$0.81
Common Stock - Shelf Sale (Registered Direct)	576	\$14.07
Convertible - Company Installment (Self-Amortizing)	318	\$2.27
Convertible - Fixed	2,700	\$59.27
Convertible - Floating	1,278	\$20.66
Convertible - Reset	218	\$3.98
Non-Convertible Debt/Preferred Stock	63	\$2.56
Structured Equity Line	717	\$0.22

Table 3 Distribution of PIPEs by Industries

Sector	N	Capital Raised (\$Billion)
Consumer- Non-Cyclical (Healthcare)	2985	\$37.60
Communications	2155	\$38.78
Technology	1495	\$15.87
Industrial	1246	\$10.71
Consumer- Cyclical	785	\$13.57
Energy	698	\$23.75
Consumer- Non-Cyclical (Non-Healthcare)	552	\$5.72
Financial	512	\$40.23
Basic Materials	309	\$2.19
Diversified	153	\$1.31
Utilities	38	\$3.80
Other	12	\$0.06

Table 4 Primary Investors in the PIPE Market

Investor Type	Amount of Capital Invested
Hedge Fund Manager	\$49,239.83
Pension/Government Funds	\$26,489.10
Corporation	\$26,033.99
Mutual Fund/Institutional Advisor	\$24,887.45
Buyout Firm/Private Equity	\$18,863.19
Venture Capital Firm	\$8,483.09
Broker/Dealer	\$7,450.14
Bank	\$3,943.72
Insurance	\$1,811.63
Charitable/Educational/Family Trust	\$ 497.73