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Tougher SEC Standards Are Clogging the PIPE-line

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A private investment in public equity (PIPE) securities offering has been among the few ways for a distressed public company to obtain necessary cash quickly in a securities offering. But PIPEs often involve the risk of significant dilution of shareholder value. Recently, the U.S. Securities and Exchange Commission (SEC) has begun scrutinizing PIPE registrations more closely. A company that is considering a PIPE offering should be aware that compliance with new standards may be necessary to complete its registration successfully.

In a typical PIPE, a company with a publicly traded class of equity securities arranges to issue restricted securities in a private placement directly to a limited group of investors. The company then immediately registers the securities on a "shelf," permitting the investors to resell the securities into public markets from time to time.

For small or distressed companies, for which there may be few other financing alternatives, the primary benefit of a PIPE may be its availability. In addition, a PIPE offers the speed and predictability of a private placement. The company has direct access to its source of financing, negotiating the terms of the investment with a small number of investors or even a single placement agent.

The private placement phase of the transaction can be completed rapidly, usually in much less time than an underwritten registered offering by the company — and typically in as few as two or three weeks. Investor due diligence is highly abbreviated and may be limited to a review of the company's SEC filings and a few conference calls with the company's management, counsel, and accountants.

A PIPE also offers advantages to investors. PIPE securities are illiquid only for a limited period. Even if the SEC opts to review the registration statement, the resale registration process normally does not take more than several months to complete. The registration statement is required to disclose only limited information about the investors, who are identified as "selling security holders." As such, the investors do not have the due diligence responsibilities and other liabilities of underwriters in an underwritten public offering.

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Finally, the price paid by the investors often reflects a discount from the securities' current market value, providing the investors with a built-in profit upon resale. The discount is usually justified as compensation to investors for the temporary illiquidity of the securities, as well as their exposure to market risk during the registration process.

In a typical PIPE, the initial group of private investors consists of perhaps 10 to 15 hedge funds, private equity funds, or other accredited or institutional investors. The securities are either of the same class as the company's publicly traded securities or are convertible into securities of such class. The private offering, which can range in size from $10 million to many tens of million of dollars, is exempt from registration under the Securities Act of 1933, as amended[1] by reason of Section 4(2) of the act and Regulation D promulgated under the act.[2]

Because the private offering is not registered with the SEC, the securities are considered to be "restricted" and cannot be resold immediately by the investors without registration under the Securities Act. To provide the investors with liquidity, in a PIPE transaction the company immediately registers the restricted securities. (If a convertible security is sold, the underlying common stock is registered for resale.) The registration process begins with the company's filing of a "shelf" resale registration statement with the SEC. Depending on the kind of PIPE involved, the registration statement is filed either shortly after the investors sign their purchase agreement or within a designated period of time after closing (*i.e.,* funding).

PIPEs must be structured carefully to comply with the registration requirements of the Securities Act. A major consideration is that the registered resale of securities by the investors to the public must constitute a valid secondary offering (*i.e.,* an offering other than by or on behalf of the issuer). If the registered resale is viewed merely as part or as a continuation of the initial issuance, then it is characterized as an indirect primary offering (*i.e.,* an offering by or on behalf of the issuer). This can create substantial legal problems, including the risk of "integration" and the loss of eligibility for shelf registration.

Avoiding a 'Burst' PIPE

The SEC's so-called integration policy was developed to prevent circumvention of the Securities Act's registration requirements. Originally, the concern was that companies might attempt to separate what otherwise would appear to be a single non-exempt offering into two or more offerings, each qualifying for an exemption. Under integration policy, if two or more offerings are integrated, the entire transaction is viewed as a single offering, and all offers and sales must comply with any claimed exemptions or other conditions applicable to the entire offering.

The legal basis for the non-integration of PIPEs derives from the SEC's Rule 152,[3] which provides a safe harbor from integration.

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As the rule is interpreted by the SEC, a completed private offering will not be integrated with a subsequently commenced registered public offering.[4] In the context of a PIPE, the SEC has acknowledged that, once the initial primary offering (the private exempt issuance) has been completed, it may be followed by a valid secondary offering (the registered resale to the public).[5] But if the primary offering is not first completed, or if the secondary offering is not otherwise considered valid, the SEC will characterize the PIPE as a single "indirect" primary offering.[6]

When a PIPE is integrated into a single offering, it becomes what is called a "burst" PIPE and may not legally be able to proceed. One possible effect of a burst PIPE is loss of the Section 4(2) exemption.[7] Another possible effect is prohibited "gun-jumping."[8] And if the PIPE is viewed as single indirect primary offering, the company may be prevented from registering the PIPE on a shelf basis.

In a shelf registration, the company specifies in its registration statement that the securities being registered will be offered "on a delayed or continuous basis" pursuant to the SEC's Rule 415.[9] Shelf registration is crucial because it provides PIPE investors with a reasonable period of liquidity, allowing them to sell their securities from time to time for an extended period after the initial effective date of the registration statement.

If a PIPE involves a valid secondary offering, the shelf resale registration can be made on any of three registration statement forms: Form S-1, Form SB-1, and Form S-3. However, if a PIPE does not involve a valid secondary offering, shelf resale registration is permissible only if the PIPE securities are registered, or qualified to be registered, on Form S-3.[10]

The characterization of certain PIPE offerings as "primary," and therefore unregistrable on a shelf basis by non-"S-3 eligible" companies, has become one of the SEC's latest tools in its effort to regulate PIPEs considered abusive or "toxic." The SEC's position is that large PIPEs — those resulting in the issuance of securities amounting to more than 33 percent of a company's market capitalization — should be presumed to be primary offerings and therefore shelf-registrable only by S-3 eligible companies.

Many companies are ineligible to use Form S-3, the shortest and simplest of the registration forms. Unless it qualifies as a "small business issuer" eligible to use Form SB-1,[11] an "S-3 ineligible" company must use Form S-1, the full-length "entry-level" registration statement form available to all registrants for whom no other form is authorized or prescribed.

To use Form S-3, the registrant must be a U.S. issuer[12] and a reporting company,[13] must be current in its SEC filings,[14] and cannot have suffered material payment defaults on its debt, preferred stock, or leases.[15] For this reason, distressed companies typically cannot use Form S-3. In addition, if their PIPEs are characterized as a primary offering, healthy but small-cap or microcap companies also cannot use Form S-3, which may not be used for the registration of any primary offering by a company having a "public float" of less than \$75 million.[16]

> By restricting large PIPE shelf registration eligibility to S-3 eligible companies, the SEC effectively has placed a cap on the size of most PIPE registrations.

Because shelf registration is crucial to a PIPE, the SEC, by defining shelf registration eligibility, can control which PIPE registrations are declared effective. By restricting large PIPE shelf registration eligibility to S-3 eligible companies, the SEC effectively has placed a cap on the size of most PIPE registrations.

Even S-3 eligible companies are likely to be unable or unwilling to carry out any PIPE registration considered to involve a primary offering. As discussed earlier, a finding that a PIPE registration represents a single private offering creates substantial integration problems. And in a primary offering, the selling investors are deemed to be underwriters of the offering in the same way as a traditional investment banker in a registered public offering. In a primary offering, each investor would be required to be identified as an underwriter and to provide certain information called for in various items of the registration statement forms. In a primary offering, each investor would become subject to civil liability under Section 11 of the Exchange Act for deficiencies in the registration statement.

Most PIPE investors are unwilling to provide such information or accept such liability. PIPE investors who might be willing to accept liability as underwriters certainly would require the full panoply of the underwriter's traditional protections: representations and warranties, indemnity, conflict letters, opinions, and extensive due diligence. The speed and efficiency associated with PIPEs would be lost.

Traditional vs. Structured PIPEs

PIPEs can be broadly classified as traditional or structured. In a traditional PIPE, investors commit to purchase a specified number of shares, usually of common stock, at a fixed price. The price of the securities paid by the investors often reflects a discount from the current market price. In contrast, structured PIPEs involve the issuance of convertible securities (either debt securities or preferred stock), usually at a price that is either variable or that contains a "reset" mechanism that automatically adjusts the conversion price downwards (*i.e.,* allows the investor to acquire more shares) if the market price of the common stock falls below the conversion or reset price fixed at the time of issuance.

Structured PIPEs are especially common with small or distressed companies. In a structured PIPE, the company can receive its capital early, without delays caused by lengthy SEC review. This is because structured PIPEs close, and the investors fund, immediately upon signing of a purchase agreement, which takes place well before the PIPE registration is ready to be declared effective. (In a traditional PIPE, in which investors must commit to a specified amount of common stock without the price protections available to convertible security holders, the investors usually require that the funding be contingent upon the SEC's indication that it is prepared to declare the effectiveness of the registration statement.) In addition, structured PIPEs are common with small and distressed companies because convertible debt securities or preferred stock typically provide investors with greater rights over the company and can contain conversion terms that provide investors with necessary price protection.

Whether traditional or structured, any PIPE that involves issuance of a security at a discount from its current market value can expose a company's public shareholders to the risk of significant dilution. Depending on the size of the PIPE offering in relation to the company's market capitalization, the amount of the dilution may become major. However, in structured PIPEs, in which the amount of securities issuable upon conversion is indeterminate and variable, the precise amount of dilution may be much more difficult to determine and properly disclose.

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As a result, the concerns of officials in the SEC's Division of Corporation Finance, which is responsible for reviewing registration statements, have centered primarily on registrations of structured PIPE registrations involving "convertible securities where the securities are convertible into a large number of shares of common stock relative to the issuer's outstanding shares and where there is insufficient disclosure about the market impact and cost of these transactions." [17]

Indeed, the dilutive effect of a PIPE offering can be disastrous in the case of certain kinds of structured PIPEs referred to as "toxic" or "death spiral" PIPEs. These involve a convertible PIPE security in which the conversion price or conversion ratio is tied to a percentage discount to the market price of the underlying common stock. The effect is that the conversion price fluctuates based on the market price of the underlying common stock. The lower the market price of the common stock is at the time of conversion, the greater the number of shares that the company must issue upon conversion.

In toxic PIPEs, the conversion price or ratio typically reset only downward to protect the investor, but not upward to protect the company. Furthermore, as the company is required to issue more stock upon conversion, its stock price drops further, causing the stock to enter a death spiral.[18] Unless the securities have a cap or floor that limits such adjustments, the extent of potential dilution is very great.

New Screening Process

In a new screening process for PIPE registrations, the SEC is now applying its shelf registration and form eligibility requirements more stringently and is imposing new and specific disclosure requirements. Starting in 2006, the Division of Corporation Finance began to apply the screening process to PIPE offerings then in registration (*i.e.,* for which a registration statement had been filed but not yet declared effective). The stated purpose of the screening process was to identify potential problematic transactions and to enhance disclosure where appropriate.

The staff's inquiries focused on the availability of shelf registration in PIPE transactions by issuers not eligible to use Form S-3 when the amount being registered is disproportionately large in relation to the issuer's capitalization. The increased level of scrutiny had the effect of delaying or even halting the registration process for the affected companies.

By the end of 2006, the accumulation of stalled PIPE registrations had attracted national media attention.[19] SEC officials were quick to disclaim any intention to kill deals and said they merely were enforcing existing registration requirements. One SEC official was quoted as saying: "We have not told anyone that they cannot do these deals, we've just told them that they have to register them appropriately."[20]

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SEC officials also have denied that the commission's actions represent any shift in policy. "The staff's response to these transactions has…drawn attention due to the mistaken view that we are reconsidering our approach to PIPE transactions. I'll be very clear about this — the staff's view of PIPE transactions has not changed; we have simply addressed the recent developments where convertible note transactions are structured in an abusive manner."[21]

Nevertheless, the recent scrutiny has been perceived as a shift in the SEC's position by some securities lawyers, who report that the SEC previously has permitted the registration of PIPE offerings equal to many times the value of the issuer's capitalization.

In a February 2007 speech before the Annual Conference on Securities Regulation and Business Law in Dallas, John White, director of the Division of Corporation Finance, acknowledged that the SEC staff's treatment of PIPE resale registration statements had "drawn a lot of attention lately." He emphasized that in registrations involving the conversion of a potentially large amount of securities where there is inadequate disclosure, the staff's concerns were two-fold: "[W]e are not worried only about disclosure — we are also concerned about the shelf registration system being used in circumstances not intended to be covered by the rules."[22]

The SEC has taken pains to emphasize that it has not changed its historical position on PIPEs. This means that the SEC continues to regard PIPEs as permissible, provided they comply with applicable securities laws and regulations, as well as previously announced SEC no-action letters and other interpretations. But the SEC's screening process clearly will eliminate many PIPE offerings, particularly structured PIPEs issued by small or distressed companies.

What to Expect

As a practical matter, what can a company now expect during the PIPE registration process? At this point, there is little guidance, and no rule-making proposals or any further written guidance is expected. Nevertheless, it appears that companies submitting shelf resale registration statements for PIPEs can expect comments if the PIPEs involve or are convertible into a disproportionately large number of shares of the issuer's outstanding common stock or if the registration statement does not contain adequate disclosure of the market impact and cost of the transaction.[23]

Staff comments are likely to focus on two issues: Is shelf registration available? Is there full disclosure of the costs and risks?

Regarding shelf registration, the staff has taken the view that a disproportionately large PIPE can be reasonably presumed to be a "primary" rather than a valid "secondary" offering. Logically, this rationale would seem to apply to both traditional and structured PIPE, and issuers of either type should assume that large offerings will be viewed as primary. As mentioned earlier, a primary offering can be registered on a shelf basis only if the company is S-3 eligible. Accordingly, if the company is not S-3 eligible, the SEC staff can be expected to request an analysis of the basis on which the company has concluded that the registration should be treated as a secondary offering. Registrants of large PIPEs that are not S-3 eligible must therefore be prepared to make a convincing demonstration.

If the company is S-3 eligible, the staff can be expected to request that the registration statement comply with the requirements applicable to primary offerings. For example, each investor must be identified as an "underwriter" rather than as a "selling security holder."

Regarding the adequacy of disclosure, the SEC staff is likely to request that the PIPE registration statement address certain specific items, including any or all of the following:[24]

- The determination of the number of shares to register
- The dollar value of the securities registered for resale
- The amount of all fees and all payments made to the selling investors, their affiliates,

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or any other party, such as a placement agent, in connection with the PIPE

- The amount of all proceeds to the issuer and amount deducted from the proceeds
- Possible profits from the conversion of the securities (including profits as a result of a market discount built into the conversion formula)
- Prior transactions among the issuer and the selling investors
- Relationships among the selling investors and between the selling investors and the issuer
- The issuer's intention or ability to make payments under the terms of any debt securities
- The dilutive effect of the conversion
- The identities of natural persons with voting or investment power over the securities registered on behalf of the selling investors
- The short positions of the selling investors known to the issuer

The size of PIPE registration customarily is measured with respect to the issuer's public float, which ordinarily is defined by the SEC as the aggregate market value of the issuer's voting and non-voting common equity held by non-affiliates.[25] "Common equity" is defined as any class of common stock or an equivalent interest, including but not limited to a unit of beneficial interest in a trust or a limited partnership interest.[26] An "affiliate" of a specified person or a person "affiliated" with a specified person is a person who directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the specified person.[27]

The value of an issuer's outstanding common equity is to be computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of the common equity, in the principal market for the common equity as of a date within 60 days prior to the date of the filing of the registration statement.

Exactly what percentage of the issuer's public float may be the subject of a PIPE registration is somewhat unclear. However, based on public statements by SEC officials, a PIPE registration covering shares of common stock in an amount equal to more than one-third of the issuer's public float can be expected to attract SEC attention.[28] As a practical matter, many securities lawyers conservatively recommend that to avoid any risk of SEC staff comments issuers do not attempt to register securities amounting to more than 25 percent of their public float.

How can a registrant demonstrate that its PIPE offering is secondary? The SEC staff has indicated only that the analysis depends on the facts and circumstances. However, the staff also has signaled that convertible securities whose conversion price is variable and other "toxic" securities are less likely to pass muster. On the other hand, a PIPE registration is more likely to withstand scrutiny as a valid secondary offering if there is a large number of selling investors that are unaffiliated with each other or the issuer, none of which is selling a large number of securities.[29]

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The SEC staff has indicated that it will permit a PIPE offering to include the registration of an additional tranche in an amount equal to as much as an additional 33 percent once the initial PIPE registered offering is complete with respect to a particular selling security holder. For this purpose, the SEC will consider an initial PIPE registration to be complete after the later of the expiration of (a) six months after the effective date of the initial PIPE resale registration statement or (b) 60 days after sale of "substantially all" the shares registered for a particular selling securityholder.[30]

Ensuring Successsful Registration

The following points may be helpful for chief financial officers and turnaround managers seeking to have a successful PIPE offering:

- ***Limit the size of the PIPE.*** If possible, raising less than the threshold amount of capital that attracts SEC comments (*i.e.,* a third of the issuer's public float) may be the simplest alternative for avoiding registration delays and blockages.
- ***Use traditional PIPEs when possible.*** The dilutive effect of traditional PIPEs, which involve the issuance of a specified number of securities at a fixed price, tends to be somewhat easier to determine than the dilution involved in structured PIPEs. As a result, the disclosure issues may be perceived by the SEC as less acute. For this reason, issuers may wish to use traditional rather than structured PIPEs when possible.
- ***Take advantage of the additional permissible tranche.*** A company may be able to increase the amount of its aggregate registrable PIPE offering by dividing its offering into two tranches, with registration of the second tranche to follow the completion of the first. This approach depends, of course, on patient and cooperative investors.
- ***Design and negotiate a PIPE to maximize chances for a successful registration:***
  - Be in a position to demonstrate that the PIPE securities to be registered cannot, or are unlikely to, amount to more than 33 percent of the issuer's public float. To accomplish this, negotiate for the smallest discount acceptable to the investors. In the case of convertible securities, obtain a cap on the maximum number of securities or a floor on the amount of the conversion price.
  - Make sure that the PIPE transaction documents contain a prohibition on investor short selling during all relevant periods.
  - Arrange for the largest possible number of selling investors that is still consistent with the private nature of the transaction, and make sure that none are affiliated with each other or the issuer.
  - Negotiate at arm's length for the best terms available. By avoiding transactions with affiliates and negotiating hard to cap or reduce transaction fees and costs, a company is less likely to trigger SEC requests for special or additional disclosure in the registration statement.
- ***Anticipate SEC disclosure requests.*** By making sure that the registration statement squarely addresses the anticipated SEC disclosure requests, a company can better avoid extensive and potentially delaying SEC comments during the registration process. To prepare some of the appropriate disclosure, the company may need to prepare investor questionnaires seeking information regarding investor relationships, short positions, and other items.

Immediate Repercussions

The SEC's new policy clearly has immediate repercussions. Most obviously, the new standard effectively caps PIPE resale shelf registrations

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at one-third of a company's public float. In addition, the policy strongly discourages PIPE registrations of a size that approaches this limit (*e.g.,* 20 percent or more of the issuer's public float) unless the transaction has been structured to enable the issuer to demonstrate convincingly, if challenged by the SEC during the registration process, that the registration is based on a valid secondary offering. Given the additional disclosure requirements, in the short term companies may expect longer registration periods and higher legal fees.

Over the intermediate term, the SEC's registration standards can be expected to lead PIPE investors and issuers and their professional advisors to modify the PIPE structure to facilitate registration. It is possible, for example, that future PIPEs are more likely to feature smaller pricing discounts, lower conversion rates, conversion caps, more numerous small investors, lower expenses, or public sales of PIPE securities in consecutive tranches over longer periods of time. However, it may be many months before it will be possible to evaluate the success of any such efforts fully.

For the moment, it seems clear that by imposing a cap, the SEC is forcing companies to limit the size of their PIPE registrations and thereby causing them to raise less capital, spread out capital raising over a longer period of time, or seek financing through other means. This places a greater burden on small and distressed companies, which depend more heavily on quick access to urgently needed capital infusions than do larger healthy companies, for which there are many other financing alternatives.

While PIPE offerings by distressed companies can be highly costly and risky to public shareholders, they may also represent the company's last best chance to correct its financial course before bankruptcy — the "ultimate Hail Mary pass."[31] CR

[1] 15 U.S.C. Section 77a-77aa (the Securities Act).

[2] The exemption provided by Section 4(2) covers "transactions by an issuer not involving any public offering." 15 U.S.C. Section 77d(2). Regulation D, promulgated by the SEC in 1982, provides issuers with a safe harbor from the Securities Act registration requirement. 17 C.F.R. Section 230.501 *et seq.* Regulation D is intended to provide issuers with greater certainty than reliance solely on Section 4(2), which can be somewhat unclear in its application.

[3] Rule 152 states that the phrase "transactions by an issuer not involving a public offering" in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement. 17 C.F.R. Section 230.152.

[4] See Verticom, Inc., 1986 SEC No-Act. LEXIS 751 (avail. Feb. 12, 1986), which reversed LaserFax, Inc., 1985 SEC No-Act. LEXIS 1982 (avail. Sept. 16, 1985); see also Vulture Petroleum Corporation, 1987 SEC No-Act. LEXIS 1597 (avail. Feb. 2, 1987) and Quad City Holdings, Inc., 1993 SEC No-Act. LEXIS 619 (avail. Apr. 8, 1993).

[5] The SEC staff considers the private placement to have been "completed" for purposes of Rule 152 if commitments are in place from all investors subject only to conditions outside their control so that there is no further investment decision. See Black Box Incorporated, 1990 SEC No-Act. LEXIS 926 (avail. June 26, 1990); Squadron, Ellenoff, Pleasant & Leher, 1992 SEC No-Act. LEXIS 363 (avail. Feb. 28, 1992). The SEC staff has specifically confirmed that PIPE transactions are permissible under Rule 152 if executed in this manner. See Division of Corporation Finance Manual of Publicly Available Telephone Interpretations Supplement — March 1999, available at www.sec.gov/interps/telephone/phonesupplement1/htm (hereinafter, "SEC Telephone Interpretations"), #3S(b).

[6] See SEC Telephone Interpretations, #3S(b) and #4S.

[7] The filing by the company of the registration statement (*i.e.,* which constitutes the commencement of a public offering) causes the company to lose the availability of the Section 4(2) private offering exemption with respect to the offer or sales made to the initial investors, thereby causing the company to have offered or sold unregistered non-exempt securities in violation of Section 5 of the Securities Act. See 17 C.F.R. Section 230.502(c).

[8] By having offered its securities to some investors in the offering before the filing of the registration statement, the company may violate the SEC's "gun-jumping" restrictions on registered public offerings. (Under 15 U.S.C. Section 77(c), no public offering, either orally or in writing, is permitted prior to the initial filing of the registration statement.)

[9] See 17 C.F.R. Section 230.415(a)(5).

[10] See 17 C.F.R. 230.415(a)(4); 17 C.F.R. 230.415(a)(1)(x).

[11] To use Form SB-1, a somewhat simplified registration form developed by the SEC to decrease the burdens of raising capital for small business issuers, a company must be a "small business issuer," defined generally as a U.S. or Canadian issuer, the revenues and "public float" of which each are less than $25 million. Furthermore, the amount of an offering that can be registered on Form SB-1 is limited to $10 million in any continuous 12-month period. Furthermore, a small business issuer may use Form S-B only if it has not registered more than $10 million of securities in any continuous 12-month period. In determining whether the company has registered more than $10 million during a 12-month period, the amount of securities being registered on the Form SB-1 generally must be added to all previous registered offerings during that period. See 17 C.F.R. Section 230.405.

[12] A registrant on Form S-3 must be organized under federal law or the laws of any state, territory, or the District of Columbia and must have its principal business operations in the United States or its territories. See Form S-3, General Instructions, Section I.A.1.

[13] A registrant on Form S-3 must have a class of securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 or a class of equity securities registered pursuant to Section 12(g) of the Exchange Act or be required to file reports pursuant to Section 15(d) of the Exchange Act. See Form S-3, General Instructions, Section I.A.2.

[14] The company must have been subject to the requirements of Section 12 or Section 15(d) of the Exchange Act and must have filed all the material required to be filed pursuant to Section 13, 14 or 15(d) for a period of at least 12 calendar months immediately preceding the filing of the registration statement on Form S-3 and generally must have filed in a timely manner all reports required to be filed during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement. See Form S-3, General Instructions, Section I.A.2 and 3.

[15] The company and its subsidiaries must not, since the end of the last fiscal year for which certified financial statements of the issuer and its subsidiaries were included in an Exchange Act report: (1) have failed to make any required dividend or sinking fund payment on preferred stock, or (2) defaulted on the terms of any borrowing or on any long-term lease, which defaults in the aggregate are material to the financial position of the issuer and its subsidiaries, taken as a whole. See General Instructions to Form S-3, Part I.A.5.

[16] See Form S-3, General Instructions, Section I.B.1.

[17] *Id.*

[18] The "death spiral" can be further exacerbated by giving PIPE investors the incentive to use short selling to drive the market price lower, thereby increasing the number of shares issuable to them upon conversion. The short sales are executed in advance of the closing of the offering with the intention of covering positions with the shares to be issued by the company. In a number of well-publicized incidents, some hedge funds and other professional investment firms have been prosecuted successfully for such activities, which can

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constitute insider trading, market manipulation, and other violations of federal securities laws.

[19] "SEC Slows Flow of PIPE Deals to a Trickle," *The Wall Street Journal,* December 27, 2006, page C1.

[20] *Id.*

[21] "Speech by SEC Staff: "The Promise of Transparency – Corporation Finance in 2007," by John W. White, Director of Corporation Finance, U.S. Securities & Exchange Commission, February 23, 2007, before the 29th Annual Conference on Securities Regulation and Business Law, Dallas, Texas, reported at www.sec.gov/news/speech/2007/spch022307jww.htm.

[22] *Id.*

[23] Much of the following analysis of the SEC's new PIPE screening process is based on remarks by SEC officials at the Securities Regulation Institute sponsored by Northwestern University in San Diego in January 2007, as such remarks are reported at www.thecorporatecounsel.net/blog/archive/001342.html and www.thecorporatecounsel.net/blog/archive/001380.html (hereinafter collectively, the "Corporate Counsel Reports").

[24] See Corporate Counsel Reports

[25] See, *e.g.,* Part I.B.1 of the General Instructions to Form S-3.

[26] 17 C.F.R. Section 230.405.

[27] *Id.*

[28] See Corporate Counsel Reports

[29] See Corporate Counsel Reports

[30] *Id.*

[31] "PIPEs: Quick Financing, the Hail Mary Pass and New Investors," Financial Engineering News, http://www.fenews.com/fen41/inside_black_box/black_box.html.

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