

## Issues

### Should the SEC expand its disclosure requirements regarding Private Investments in Public Equity (PIPE) in order to prevent investments that have the potential to lead to a “death spiral”?

The so called “Death Spiral” loans are a type of Private Investment in Public Equity. The investor extends a loan to a company in exchange for convertible debt.

➤ A convertible security, such as bonds or preferred stock, can be converted into a different security--typically shares of the company’s common stock.(1)

Typically, this type of loan allows the lender to convert his/her debenture at any time into shares of common stock.

➤ A “typical death spiral loan” does not state a predetermined number of shares, but instead it allows for a flexible conversion rate which is always less than the market rate at the time of conversion.

➤ Thus, the lower the price of the stock, the more shares are necessary to be issued at the conversion. If we have a \$1,000,000 loan, we will need 500,000 shares if the price is \$2 a share, or 1,000,000 shares if the price drops to \$1 per share.

This opens the door for the investor to benefit by manipulating the price downward. By shorting the stock and driving the price down, the investor can then cover his/her short position with the convertible debenture at anytime .

➤ The conversion will, in turn, cause a dilution of the stock, driving down its price, hence the name “death spiral”.

These types of loans are pursued by companies who desperately need money but do not want to go through the usual channels to obtain it. The deals are closed fast, usually within a month, and, because of loopholes in SEC regulations, do not need to be disclosed on financial statements submitted to the SEC.

## Statutory and Regulatory Concerns.

In the US, securities are regulated by:

- Securities Act of 1933 –for primary markets
- Its main purposes are to compel full disclosure to the public of all material information and to prevent fraud and misrepresentation in the interstate sale of securities.(2)
- Section 5 prohibits the selling of unregistered securities.(3).

### Exemptions from Section 5:

- Section 4(2) states that registration requirements will not apply to “transactions by an issuer not involving any public offering”.(4)
- Rule 506 is also a “safe harbor” from the registration requirements of Section 5.(5)
- Securities Exchange Act of 1934 - for secondary markets.
- Rules 13d-1, 13d-3 and 14d-1 require an offeror who acquires five percent or more of a company’s common stock, exercisable within sixty days, to disclose the purpose of the purchase in question.
- SEC has not considered toxic PIPE investors to be true offerors because they are selling the stock short and not actually acquiring the stock for themselves.
- Regulation Fair Disclosure requires that when an issuer (the company) discloses material nonpublic information to certain individuals or entities (in our case the investor), the issuer must make public disclosure of that information.(4).
- This provision applies only to the issuer, it does not cover the intentions of the private offeror.
- The SEC has not viewed the investor as an issuer even though the eventual conversion could lead to obtaining control over the devalued company.

## Analysis

In July of 2015, MannKind (MNKD), a small cap pharmaceutical company, relied in part on a stock-for-debt transaction to cover a \$100 million convertible loan.(6). The price per share decreased from a high of \$7.32 in June of 2015 to a low of \$0.64 in January of 2016.



- PIPE transactions have a dual nature: the first component is a private offering, followed by the second component, a public offering.
- “Death Spiral” loans rely on the differences between public and private offerings that are progressively becoming more “blurred and distorted by technological advances and evolving trading practices”.(7)
- Toxic PIPE investments are done “under the radar”(8), in part because current regulations do not require disclosure of the investors’ intentions to initiate short selling which leads to a death spiral.
- The SEC has tried to go after toxic PIPEs in a few different instances, by arguing that short selling under these conditions violates Section 5. Another argument brought forth by the SEC was that such investors are guilty of insider trading.(9)
- Courts have so far contradicted the SEC’s public position on short selling and insider trading by PIPE investors. (10)
- Current regulations offer an umbrella of protection for toxic PIPEs that lead to a death spiral.

## Conclusion

We will conclude by arguing that the SEC should extend disclosure requirements to cover investors’ intentions.

- Whether or not the investor decides to short the stock has significant consequences on the company’s stock value.
- From a legal point of view, short selling frequently leads to the PIPE investors indirectly acquiring five percent or more of the target company.
- By short selling and causing the dilution of the company’s stock, the investors can gain control of the company, similarly to the control held by issuers or significant investors.
- The above mentioned classes are required by the SEC to disclose their intent with regard to their investments.
- Such a requirement should be extended to the PIPE investors.
- From an ethical point of view, extending disclosure requirement would level the playing field.
- This would not prevent such deals from forming, but it would allow the unsuspecting public to make a more informed decision regarding their own investments in the company subject to a toxic PIPE.

- (1) www.sec.gov.
- (2) Lerner, Leib M.. 2003. *Disclosing Toxic Pipes, The Business Lawyer* 58 (2). American Bar Association: 655–88. <http://www.jstor.org/stable/40688136>.
- (3) Section 5,15 U.S.C. §77e
- (4) Section 4(2),15 U.S.C. §77d(2)
- (5) 17 CFR 230.506
- (6) Adam Feurestein ,07/29/2015, *MannKind Relies on “Death Spiral” Financing to Help Settle Looming Debt*. [www.thestreet.com](http://www.thestreet.com) .
- (7) Hon. Steven M.H.Wallman. *Report of the Advisory Committee on Capital Formation and Regulatory Processes* .PLI Corp. Law & Practice Course. Handbook Series No. B4-7141.1996 .
- (8) Lerner, Leib M.. 2003. *Disclosing Toxic Pipes, The Business Lawyer* 58 (2). American Bar Association: 655–88. <http://www.jstor.org/stable/40688136>.
- (9) Douglas J. Hoffer *Quagmire: Is the SEC Stuck in a Misguided War Against PIPE Financing*, *The Tennessee Journal of Business Law*, Vol. 12.
- (10) Complaint, *SEC v Mangani*. 598 F Supp. 2d 731 (W.D.N.C. 2006) (No. 3:06-cv-531).