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ZACHARIAS V. SEC: D.C. CIRCUIT AFFIRMS SEC'S FINDING OF SECTION 5 VIOLATIONS

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In *Zacharias v. SEC*, the U.S. Court of Appeals for the District of Columbia Circuit affirmed an SEC order finding that two officers and directors of a public company and an unaffiliated third party engaged in a "scheme" to sell securities in violation of the registration requirement of Section 5 of the Securities Act, despite the fact that the only shares sold to the public were freely tradable shares owned by the third party. The Court's praise of the SEC decision as "a triumph of substance over form"[1] and the reasoning of the case (as well as the result) stand in contrast to the recent decisions of three U.S. District Courts that rejected the SEC's claims of Section 5 violations in the hedging of "PIPEs" securities.[2]

The "Swap" Transactions

Christopher Zacharias and John Carley (the "Option Holders") were officers and directors of Starnet Communications International, Inc. ("Starnet") and held options to purchase Starnet shares. Starnet registered the exercise of the options on Form S-8, but the registration statement did not cover resales of underlying shares. Thus, the Court stated that "[s]ales to the public of shares acquired by exercise of their options would have been illegal unless a registration statement under § 5 had been in effect" but noted that the Option Holders "did not . . . have a registration statement filed."[3]

Separately, Alfred Peeper controlled foreign entities (the "Peeper Entities") that held several million Starnet shares that "they could lawfully resell to the public."[4] The Peeper Entities also held warrants to purchase several million additional shares that had not yet been exercised.

The "scheme" consisted of two transactions:

Transaction 1: The Peeper Entities sold their shares of Starnet to the public, and also exercised their warrants and sold the resulting shares to the public. It appears that absent the other facts of the combined transactions, the sale of the shares initially owned by the Peeper Entities would have been legal, and the sale of the shares issued upon exercise of the warrants "would likely have been legal as well."[5]

[1] *Zacharias v. SEC*, No. 08-1134, slip op. (D.C. Cir. June 23, 2009) (per curiam) (the "Opinion") at 5.

[2] *See SEC v. Berlacher*, No. 07 Civ. 3800 (E.D. Pa. Jan. 23, 2008); *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. 2008); *SEC v. Mangan*, No. 06 Civ. 531 (W.D.N.C., Oct. 24, 2007). In these cases, the courts granted defendants' motions to dismiss SEC claims that they violated Section 5 when they sold short shares of an issuer without registration and then covered the short positions with shares purchased from the issuer in a PIPE transaction after a registration statement covering resales of the PIPE shares became effective.

[3] Opinion at 4. Presumably, because the exercise of the options was registered on Form S-8, the Option Holders could have exercised their options and immediately sold at least some of the newly issued shares under Rule 144. Such sales would have been subject to the volume, manner-of-sale and other requirements of Rule 144. However, in footnote 42 to the SEC decision, the SEC suggests that a holding period would have been required for the Option Holders to sell their option shares under Rule 144.

[4] Opinion at 3.

[5] Opinion at 4. Presumably this is because the warrants were net-share settled and the shares delivered upon exercise of the warrants had a sufficiently long holding period to be sold under Rule 144(k), which was applicable at the time of the sale.

Transaction 2: Shortly after these sales by the Peeper Entities, the Option Holders exercised their options and sold the underlying shares to the Peeper Entities in a private placement.[6] The number of shares the Option Holders so sold to the Peeper Entities was apparently equal to the number of shares the Peeper Entities sold in Transaction 1 (hence the SEC's characterization of the transactions as a "swap" of the shares sold by the Peeper Entities for the shares purchased by the Peeper Entities). It appears that this sale also would not have been problematic absent Transaction 1 – the Court explained that a "simple sale to the Peeper Entities . . . would likely have been lawful had such a sale . . . not been part of any 'chain of transactions . . . involving any public offering.'"[7]

The apparent purpose of the two transactions was to enable the Option Holders to sell their option shares at a price that reflected little or no "liquidity discount" to the prevailing market price for freely tradable shares, without having to file a registration statement. If the Option Holders had sold their shares to a buyer who did not have other shares to sell to the public, that buyer would have paid a discounted price because the shares would be "restricted" under the Securities Act and therefore illiquid. However, the Peeper Entities (a) currently owned shares, and (b) presumably intended to remain invested (but not increase their investment) in the company for the long term. Therefore, the Peeper Entities likely cared less about liquidity than a typical investor and thus were willing to pay a price that was closer to the prevailing market price. By buying shares from the Option Holders and selling an equal number of shares to the public (albeit in reverse order in this case), the Peeper Entities maintained their level of investment in Starnet.

Section 5 Violations

To argue that these facts gave rise to Section 5 violations, the SEC essentially collapsed the two transactions and treated the sales as direct sales by the Option Holders to the public. The SEC found, and the D.C. Circuit agreed, that the Option Holders and the Peeper Entities were "underwriters" under the Securities Act, and therefore no exemption was available to the Option Holders for their sale to the Peeper Entities, or to the Peeper Entities for their sale to the public.[8]

To support this argument, the SEC noted that, excluding shares underlying Starnet's warrants, the Peeper Entities owned fewer Starnet shares than the Option Holders would receive upon exercise of their options, and that by their original terms the warrants would have expired prior to the transactions in question. However, around the time of the transactions, Starnet extended the term of the Peeper Entities' warrants so that the Peeper Entities could acquire additional shares. Had Starnet not done so, the warrants would have expired, and the Peeper Entities would not have owned sufficient shares to purchase all of the option shares from the Option Holders while selling an equal number of previously-owned shares to the public. According to the SEC, this suggested that Starnet was a participant in a "scheme" to allow the Option Holders to sell indirectly the shares underlying their options to the public.

[6] This was a so-called "Rule 4(1½) transaction."

[7] Opinion at 4 (citing 17 C.F.R. §§ 230.144(a), (d)).

[8] In a November 14, 2000 "Current Issues and Rulemaking Projects" publication, the SEC said the following about a structure it coined a "gypsy swap":

> 11. "Gypsy Swaps"
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> A private purchaser wishes to invest directly in an issuer but hopes to acquire unrestricted securities. Through arrangements and understandings with the issuer, a stockholder with shares that are either restricted securities currently eligible for sale under Rule 144 or unrestricted securities sells the shares to the private purchaser. At about the same time, the issuer sells an equivalent number of shares to the stockholder. The Division's view is that the shares taken by the private purchaser from the stockholder will be restricted securities within the meaning of Rule 144(a)(3). The holding period will date to the private acquisition. A public resale of the shares acquired from the stockholder without regard to the conditions of Rule 144 would raise serious issues under Section 5 of the Securities Act for all parties to the transactions.

It is not clear whether the Court felt that this facilitation by Starnet was necessary to find a Section 5 violation. The Court focused on the fact that the Option Holders "arranged"[9] these transactions with the Peeper Entities, noting that "the Peeper Entities' initial sales to the public were occasioned by the assurance that the shares would be replaced by those held by the Starnet officers,"[10] rendering the two transactions "connected."[11] The Court recited the definition of "underwriter" in the Securities Act in relevant part as: "'any person who has purchased from an issuer with a view to . . . the distribution of any security, or participates . . . in any such undertaking.'"[12] Based on this definition, the Court agreed with the SEC that the Option Holders and the Peeper Entities were "underwriters," noting that a person does "not have to be involved in the final step of the distribution to have participated in it," but rather that a person who was a "necessary participant" or "substantial factor" in a distribution is an underwriter.[13]

The Option Holders argued that they did not know that the Peeper Entities had sold shares. Without discussing whether there was enough evidence to find that the Option Holders actually knew about the sales by the Peeper Entities, the Court concluded that there was substantial evidence that the Option Holders knew *or should have known*. Thus, the Court appears to have articulated a standard by which the Option Holders were deemed underwriters because they "knew or should have known" about "connected" sales to the public of otherwise freely tradable shares by an unaffiliated third party.[14] While the facts of this case are clearly different from those of the recent PIPEs enforcements cases,[15] this Court's expansive reading of the definition of "underwriter" seems somewhat at odds with those district courts' narrow reading of Section 5.[16]

Reporting Violations and Remedies

The Court considered the SEC's finding that Starnet's public disclosure was inadequate because it did not disclose the scheme. The SEC concluded that because the scheme violated Section 5, Starnet could be subject to losses from rescission claims. The Court ultimately determined that it was "far from clear" that Starnet faced a material risk of rescission, in part because the parties with the most viable rescission claim against Starnet would be the Option Holders and, possibly, the Peeper Entities, neither of whom would be likely to bring such a claim (or prevail if they did). The Court also noted that because the share price had risen since the Section 5 violations, public holders would be unlikely to seek rescission even if they had a right to do so. The Court therefore remanded this issue to the SEC for further consideration.

Finally, the Court discussed the appropriate measure of disgorgement penalties against the Option Holders. The SEC ordered, and the Court affirmed, that the Option Holders disgorge 100% of the proceeds of the sales to the Peeper Entities. One member of the three-judge panel dissented, however, arguing that the proper amount of the

[9] Opinion at 4.

[10] Opinion at 8.

[11] Opinion at 9.

[12] Opinion at 8 (citing 15 U.S.C. § 77b(a)(11)).

[13] Opinion at 6.

[14] Note that the SEC argued that the Option Holders should be liable even if they did not know or should not have known about the sales to the public because "strict liability" applies under Section 5, but the Court concluded that it did not need to resolve this question.

[15] *See supra* note 1.

[16] The Court also found that Thomas Kaufmann, the broker who arranged the sales by the Option Holders to the Peeper Entities, had violated Section 5. Kaufmann argued, among other things, that he relied on opinions of counsel that the transactions were lawful. The court declined to resolve whether reliance on an opinion of counsel is a legitimate defense to a Section 5 violation, noting that the broker "points to several letters from various lawyers involved in the scheme opining on the legality of *portions* of the transactions at issue in this case, but not one of them addresses the legality of the swap transaction that enabled the option holders to exercise their options through the Peeper Entities' sales to the public." Opinion at 12-13.

disgorgement is the amount of profit that the Option Holders made as a direct result of their violation. The dissent argues that the correct measure of damages should be the difference between the proceeds received and the value of the options surrendered, which should also be the difference between the proceeds and the value of the restricted shares (taking into account the fact that they could not be lawfully sold to the public without registration).

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