

Beware of “Gypsy Swaps” and Other Unlawful Transactions Involving Free-Trading Stock

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“Gypsy Swaps” are a transaction structure that has been employed by stock promoters for many years. When a private purchaser buys stock from an issuer in a private placement transaction, that private purchaser acquires restricted securities that he cannot immediately sell in the open market. Because this dissuades most investors from investing in small cap stocks, promoters often attempt to structure transactions in a way that provides the new investor with unrestricted, “free-trading” stock. A Gypsy Swap is such a transaction.

The SEC’s view is that Gypsy Swaps are a means to evade the registration requirements of the Securities Act of 1933, as amended (the “Securities Act”), and violate Section 5 of the Securities Act. Issuers and investors should be wary of transaction structures that appear legitimate on their face, but constitute a Gypsy Swap arrangement in violation of the securities laws. For a Section 5 violation, the SEC can impose bar orders, disgorgement, and civil penalties for all participants of the swap.

The Gypsy Swap Transaction

When an issuer sells stock to a new investor, unless the stock is registered under applicable securities laws the new investor acquires restricted stock. Restricted stock is subject to transfer and resale restrictions and the investor is required to hold the stock for a period of time (typically either 6 months or 12 months) before the stock can be sold into the market under Rule 144.

In a Gypsy Swap, the issuer approaches an existing stockholder who holds free-trading stock and is a long-term investor with no desire to immediately sell his shares in the open market. The issuer matches that individual with a new investor desiring free-trading shares. Through an arrangement and understanding with the issuer, the existing stockholder sells his free-trading stock to the private purchaser, claiming an exemption from registration under Section (4)(a)(1) of the Securities Act. At about the same time, the issuer makes the existing stockholder whole by issuing him an equivalent number of restricted shares at steeply discounted price. The Gypsy Swap transaction is valuable to the original stockholder because he is able to increase his shareholdings for either nominal or no additional consideration.

Regulations

Sections 5(a) and (c) of the Securities Act prohibit the “sale” and “offer for sale” of any securities unless a registration statement is in effect or there is an applicable exemption from registration. Among the various exemptions from registration is Section 4(1), which exempts from the registration requirement “transactions by any person other than an issuer, underwriter, or dealer.” The term “underwriter” is defined to mean “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security....” (Securities Act, Section 2(11), 15 U.S.C. § 77b(a)(11)). Individual investors who are not securities professionals may be deemed “underwriters” within the statutory meaning of that term if they act as links in a chain of securities transactions from issuers or control persons to the public.



The SEC's view is that the original stockholder's resale of his free-trading securities to the new investor violates Section 5 because the issuer is a necessary participant in the transaction. Without the original stockholder being made whole for participating in the transaction, he would not participate. As a result, the shares taken by the private purchaser from the original stockholder will be restricted securities within the meaning of Rule 144(a)(3). The holding period for the new investor will commence on the closing of his purchase from the original stockholder, which means the new investor will not obtain the benefit of the original stockholder's holding period under Rule 144.

Conclusion

The SEC has very clearly maintained that Gypsy Swaps are violations of Section 5 of the Securities Act of 1933, carrying both monetary and other civil penalties, including disgorgement, to all participants. Issuers and investors are wise to keep in mind that a Gypsy Swap is just one method of structuring a transaction to evade the registration requirements of Section 5 of the Securities Act. Any transaction whereby the issuer facilitates providing free-trading shares to a new investor should be scrutinized and reviewed by counsel for potential violations and alternative, legal structures.

John is the firm's Business and Technology Team leader, and concentrates in the areas of corporate, securities and mergers and acquisitions. John has significant experience in the representation of public companies and investors, acting as outside general counsel to many small-cap issuers.