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RICHARD W. WICKING
CLERK, U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

1 HELANE L. MORRISON (Cal. Bar No. 127752)
MICHAEL S. DICKE (Cal. Bar No. 158187)
2 (dickem@sec.gov)
ROBERT S. LEACH (Cal. Bar No. 196191)
3 (leachr@sec.gov)
ERIN E. SCHNEIDER (Cal. Bar No. 216114)
4 (schneidere@sec.gov)

5 Attorneys for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
6 44 Montgomery Street, Suite 2600
San Francisco, California 94104
7 Telephone: (415) 705-2500
Facsimile: (415) 705-2501

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10 UNITED STATES DISTRICT COURT
11 NORTHERN DISTRICT OF CALIFORNIA
12 SAN FRANCISCO DIVISION

13 SECURITIES AND EXCHANGE COMMISSION, **C** Case No. **06 6033**

14 Plaintiff,

COMPLAINT

SBA

15 vs.

16 GRAYCORT FINANCIAL, LLC,

17 Defendant.
18
19

20 Plaintiff Securities and Exchange Commission ("Commission") alleges:

21 **SUMMARY**

22 1. This case involves unlawful short selling practices by San Francisco-based private
23 investment fund Graycort Financial, LLC ("Graycort"), which netted the fund over \$100,000 in
24 illegal trading profits.

25 2. In connection with two public offerings in 2005, Graycort used shares it
26 purchased in the offerings to cover short sales made shortly before the offerings were priced. In
27 doing so, it violated Rule 105 of Regulation M. Rule 105 seeks to prevent traders from exerting
28 downward pressure on the market price of securities by executing short sales of issuers'

1 securities in the days before an offering is priced and then profiting by covering their short sales
2 at a lower price with shares they obtain in the offering. Such improper short selling activity can
3 artificially drive down the market price for the offered security, thus harming both the issuer and
4 the market by inhibiting the capital raising process.

5 3. To redress Graycort's unlawful conduct and to prevent future violations, the
6 Commission has brought this action and seeks a permanent injunction, disgorgement plus
7 prejudgment interest, and a civil penalty.

8 **JURISDICTION, VENUE, AND INTRADISTRICT ASSIGNMENT**

9 4. The Court has subject matter jurisdiction over this action pursuant to Sections
10 21(d)(1), 21(e), and 27 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§
11 78u(d)(1), 78u(e), and 78aa].

12 5. Venue in this Court is proper pursuant to Section 27 of the Exchange Act [15
13 U.S.C. § 78aa] and 28 U.S.C. § 1391(b)(1) because defendant Graycort resides in and transacted
14 business in this judicial district.

15 6. Assignment to the San Francisco Division of this Court is proper because a
16 substantial part of the events or omissions giving rise to claims alleged in this complaint
17 occurred in San Francisco County.

18 7. Defendant Graycort directly or indirectly made use of the means or
19 instrumentalities of interstate commerce or of the mails, or of the facilities of a national securities
20 exchange in connection with the acts, practices, and transactions alleged herein.

21 **DEFENDANT**

22 8. Defendant Graycort is a private investment fund organized as a California limited
23 liability company and is based in San Francisco, California. Graycort's investment objective is
24 to seek capital appreciation through a mixture of long term holdings and aggressive opportunistic
25 trading. One of Graycort's investment strategies is to sell stock short as a hedge against
26 declining markets or to take advantage of particular opportunities.

1 **FACTS**

2 **Overview of Rule 105 of Regulation M**

3 9. A “long” position generally exists when a trader is deemed to own a security and
4 the security either is in the physical possession or control of the broker or dealer or it is
5 reasonably expected that the security will be in the physical possession or control of the broker
6 or dealer no later than settlement. See 17 C.F.R. § 242.200(b) and § 242.200(g). Traders who
7 are “long” in a security typically expect the price of the security to rise.

8 10. A “short” position generally exists when a trader sells a security which the seller
9 does not own or which it has borrowed. See 17 C.F.R. § 242.200(a). To deliver the security to
10 the purchaser, a short seller will borrow the security, typically from a broker-dealer or an
11 institutional investor. The short seller later closes out the position by purchasing equivalent
12 securities on the open market and returning the security to the lender. Where a short seller
13 purchases equivalent securities on the open market to close out its short position, the profit or
14 loss is the difference between the price at which it sold the security and the price of the security
15 purchased to return to the lender. The transaction is profitable if the price of the security
16 decreases after the short sale and the short seller is able to obtain the security on the open market
17 for less than it was sold short. Accordingly, traders who sell stock “short” typically expect the
18 price of the stock to decrease.

19 11. Rule 105 of Regulation M makes it “unlawful for any person to cover a short sale
20 with offered securities purchased from an underwriter or broker or dealer participating in the
21 offering, if such short sale occurred during the shorter of: [t]he period beginning five business
22 days before the pricing of the offered securities and ending with such pricing; or [t]he period
23 beginning with the initial filing of [a] registration statement or notification on Form 1-A and
24 ending with the pricing” (the “Rule 105 restricted period”) [17 C.F.R. § 242.105(a)].

25 12. Downward price pressure can result from such short sales or from short sales by
26 others attracted by seeing shorting activity in the market. This downward pressure can
27 negatively distort the offering price, which generally is set at a discount to the then-market price.
28 In addition, because offerings generally are priced below market value, a trader who sells short

1 | shortly before the pricing date and covers with offering shares (and thus violates Rule 105)
2 | unfairly increases his chances of making money.

3 | 13. Rule 105 seeks to prevent such artificial short selling activity and help ensure that
4 | offering prices are based upon open market prices determined by supply and demand, rather than
5 | artificial forces.

6 | **Graycort's Unlawful Trading in Nutrisystem, Inc.**

7 | 14. Graycort participated in a June 2, 2005 "follow-on offering" of Nutrisystem, Inc.
8 | ("NSI") securities. A "follow-on offering" is an issuance of additional securities by an issuer
9 | who is subject to the reporting requirements of either Section 13 or 15(d) of the Exchange Act.
10 | The NSI offering was for cash, made pursuant to a registration statement filed under the
11 | Securities Act of 1933, and was conducted on a firm commitment basis. Graycort obtained the
12 | NSI offering shares from an underwriter participating in the offering.

13 | 15. As discussed below, Graycort sold shares short during the Rule 105 restricted
14 | period. It then obtained shares in the offering. Later, Graycort entered into a series of purchase
15 | and sale transactions that had no legitimate economic purpose or substance, but which had the
16 | effect of giving the false appearance that Graycort covered its Rule 105 restricted period short
17 | sales with shares purchased in the open market rather than with offering shares.

18 | 16. The NSI offering was priced after the close of trading on June 1, 2005 at \$11.00
19 | per share. Accordingly, the Rule 105 restricted period was from May 26, 2005 to June 1, 2005.

20 | 17. During the Rule 105 restricted period, Graycort established a 70,000 share short
21 | position in NSI with three transactions consisting of 10,000 shares sold short at \$11.8087, 50,000
22 | shares sold short at \$11.9071, and 10,000 shares sold short at \$12.5467.

23 | 18. On the morning of June 2, 2005, Graycort obtained a 100,000 share allocation of
24 | the NSI offering at \$11.00, purportedly resulting in a 70,000 share short position and a 100,000
25 | share long position. Graycort sold the excess 30,000 share long position for a profit soon after
26 | the market opened on June 2, 2005.

27 | 19. Because the offering shares were priced below each of its previous short sales,
28 | Graycort effectively had locked in a profit of \$68,909.

1 20. After it obtained its offering shares, over the next two days, Graycort entered into
2 a series of contemporaneous purchase and sale transactions (each involving 70,000 shares – the
3 same number of shares it was short) which had the effect of giving the false impression that it
4 covered its Rule 105 restricted period short sales with shares purchased on the open market
5 rather than with offering shares.

6 21. Specifically, on June 2, 2005, through two separate brokers, Graycort at 9:05 a.m.
7 Eastern Daylight Time (“EDT”) entered a market order to buy 25,000 shares and at 9:06 a.m.
8 EDT entered a market order to sell 25,000 shares. The orders were filled at 9:36 a.m. EDT and
9 9:38 a.m. EDT, respectively, at the same price. Graycort purported to use the shares it purchased
10 in the open market to cover part of its Rule 105 restricted period short sales.

11 22. Later that day, through two separate brokers, Graycort at 2:59 p.m. EDT entered a
12 market-on-close order to sell another 25,000 shares and at 3:00 p.m. EDT entered a market-on-
13 close order to purchase another 25,000 shares. (A market-on-close order is an order which is to
14 be executed as a market order as close as possible to the end of the day). Both orders were filled
15 at 4:01 p.m. EDT, at the same price. These orders also crossed each other in the market, *i.e.* one
16 broker sold 25,000 shares owned by Graycort to another Graycort broker. Again, Graycort
17 purportedly used the shares it purchased in the open market to cover part of its Rule 105
18 restricted period short sales.

19 23. On June 3, 2005, through two separate brokers, Graycort at 10:09 a.m. EDT
20 entered a limit order to sell 10,000 shares and at 10:10 a.m. EDT entered another limit order to
21 purchase 10,000 shares. (A limit order is an order to buy a specific quantity of a security at or
22 below a specified price, or to sell it at or above a specified price). Graycort used the same limit
23 price for both these orders. The sell order was filled at 10:15 a.m. EDT and the buy order was
24 filled between 10:16 a.m. EDT and 10:31 a.m. EDT. The buy and sell orders were filled at
25 prices \$.02 apart. Graycort purported to use the shares it purchased in the open market to cover
26 part of its Rule 105 restricted period short sales.

27 24. Shortly thereafter, through two separate brokers, Graycort at 10:41 a.m. EDT
28 entered a limit order to sell another 10,000 shares and at the same time entered a limit order to

1 purchase an additional 10,000 shares. The sell order was filled at 10:47 a.m. EDT and the buy
2 order was filled between 10:55 a.m. and 11:59 a.m. EDT. Graycort purported to use the shares it
3 purchased in the open market to cover the remaining portion of its Rule 105 restricted period
4 short sales. The combined average prices for all Graycort's June 3, 2005 purchase and sale
5 transactions in NSI differed by \$.06.

6 25. Graycort's contemporaneous purchase and sale transactions in NSI had no
7 legitimate economic purpose or substance and served only to disguise the fact that Graycort used
8 offering shares to cover its short sales in violation of Rule 105. Because each set of orders were
9 entered and executed at similar times, the transactions had little, if any, market risk, and merely
10 provided Graycort with a means of locking in the identical, or nearly identical, profits it would
11 have achieved had it immediately applied the offering shares to its Rule 105 restricted period
12 short sales.

13 26. Accordingly, Graycort violated Rule 105 by unlawfully covering its Rule 105
14 restricted period short sales with offering shares. Graycort's trading in NSI resulted in an
15 unlawful profit of \$68,909.

16 Graycort's Unlawful Trading in Perini Corporation

17 27. Graycort participated in a December 15, 2005 follow-on offering of Perini
18 Corporation ("PCR") securities. The PCR offering was for cash, made pursuant to a registration
19 statement filed under the Securities Act of 1933, and was conducted on a firm commitment basis.
20 Graycort obtained the PCR offering shares from an underwriter participating in the offering.

21 28. As discussed below, Graycort sold shares short during the Rule 105 restricted
22 period. It then obtained shares in the offering. Later, Graycort entered into a purchase and sale
23 transaction that had no legitimate economic purpose or substance, but which had the effect of
24 giving the false impression that Graycort covered its Rule 105 restricted period short sales with
25 shares purchased in the open market rather than with offering shares.

26 29. The PCR offering was priced after the close of trading on December 14, 2005 at
27 \$23.75. Accordingly, the Rule 105 restricted period was from December 8, 2005 to December
28 14, 2005.

1 30. During the Rule 105 restricted period, Graycort established a 25,000 share short
2 position consisting of 10,000 shares sold short at \$25.3381, 10,000 shares sold short at \$25.45,
3 and 5,000 shares sold short at \$24.485.

4 31. On the morning of December 15, 2005, Graycort obtained a 125,000 share
5 allocation of the PCR offering at \$23.75, purportedly resulting in a 25,000 share short position
6 and a 125,000 share long position. Graycort sold the excess 100,000 share long position soon
7 after the market opened on December 15th.

8 32. Because the offering shares were priced below each of its previous short sales,
9 Graycort effectively had locked in a profit of \$36,556.

10 33. On December 15, 2005, after it obtained its offering shares, Graycort
11 contemporaneously bought and sold 25,000 shares (the same number of shares it claimed to be
12 short) in two transactions which had the effect of giving the false impression that it covered its
13 Rule 105 restricted period short sales with shares purchased on the open market rather than with
14 offering shares.

15 34. Specifically, before the market opened, through two separate brokers, Graycort at
16 8:52 a.m. EDT entered a market order to sell 25,000 shares and at 9:16 a.m. EDT entered a
17 market order to purchase 25,000 shares. Both orders were filled at 9:34 a.m., at the same price.
18 Graycort purported to use the shares it purchased in the open market to cover its Rule 105
19 restricted period short sales.

20 35. Graycort's contemporaneous purchase and sale transactions in PCR had no
21 legitimate economic purpose or substance and served only to disguise the fact that Graycort used
22 offering shares to cover its short sales in violation of Rule 105. Because the orders were entered
23 and executed at similar times, they had little, if any, market risk, and merely provided Graycort
24 with a means of locking in the identical, or nearly identical, profits it would have achieved had it
25 immediately applied the offering shares to its Rule 105 restricted period short sales.

26 36. Accordingly, Graycort violated Rule 105 by unlawfully covering its Rule 105
27 restricted period short sales with offering shares. Graycort's trading in PCR resulted in an
28 unlawful profit of \$36,556.

1 **CLAIM FOR RELIEF**

2 **Violations of Rule 105 of Regulation M Against Graycort**

3 37. Paragraphs 1 through 36 are realleged and incorporated herein by reference.

4 38. By engaging in the conduct set forth above, Graycort covered its Rule 105
5 restricted period short sales in NSI and PCR with shares obtained in the NSI and PCR follow-on
6 offerings.

7 39. By reason of the foregoing, Graycort violated, and unless restrained and enjoined
8 will continue to violate, Rule 105 of Regulation M [17 C.F.R. § 242.105(a)(1)].

9 **PRAYER FOR RELIEF**

10 WHEREFORE, the Commission respectfully requests that the Court:

11 I.

12 Enter an order: (1) enjoining defendant Graycort from violating Rule 105 of Regulation
13 M [15 U.S.C. §§ 78u(d)(1) and 78u(e)]; (2) requiring Graycort to disgorge ill-gotten gains and
14 pay prejudgment interest [15 U.S.C. §78u(d)(5)]; and (3) imposing a civil penalty against
15 Graycort [15 U.S.C. § 78u(d)(3)]; and

16 II.

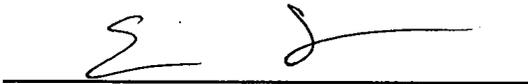
17 Retain jurisdiction of this action in accordance with principles of equity and the Federal
18 Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees
19 that may be entered, or to entertain any suitable application or motion for additional relief within
20 the jurisdiction of this Court; and

21 III.

22 Grant such other and further relief as the Court may deem appropriate.
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1 Dated: September 28, 2006

2 Respectfully submitted:

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5 By: 
6 Erin E. Schneider

7 Attorney for Plaintiff
8 SECURITIES AND EXCHANGE COMMISSION
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