

NASD
OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION,

Complainant,

v.

HILARY L. SHANE (CRD No. 3210308)

Respondent.

DISCIPLINARY PROCEEDING
No. CMS040208

HEARING OFFICER:

COMPLAINT

Note for electronic delivery this complaint:

The issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD Regulation in which findings as to the allegations in the complaint have not been made and does not represent a decision as to any of the allegations contained in the complaint. Because this complaint is unadjudicated, you may wish to contact the respondent before drawing any conclusions regarding the allegations in the complaint.

SUMMARY

1. The Department of Market Regulation seeks sanctions against Respondent Hilary L. Shane for violating Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated thereunder, Section 5 of the Securities Act of 1933, and NASD Conduct Rules 2110, 2120, and 3370.

2. By making false representations about her investment intent, Shane obtained the right to acquire 475,000 shares of Compudyne Corporation (“Compudyne” or “CDCY”) in a private placement. Shane then engaged in unlawful insider trading by selling CDCY short while in possession of material, non-public information about the company and the private placement.

Shane engaged in the unlawful distribution of unregistered securities when she sold CDCY short with the intent to cover the short sales with securities that were not yet registered. Shane also caused First New York Securities, L.L.C. (“FNY”) to fail to make and annotate an affirmative determination for short sales of Compudyne securities.

THE RESPONDENT AND JURISDICTION

3. After graduating from Princeton, Shane earned a doctorate in finance in 1995 from the Wharton School. From 1995 to 1999, she was an unregistered research analyst with J.P. Morgan, Odyssey Partners, and J&W Seligman. Shane was first registered with NASD in July 1999, as a general securities representative at FNY. She remained registered with FNY until January 2, 2003, when the firm filed a Form U-5 on her behalf. She has not been registered with NASD since that date. Shane holds Series 7 and 55 licenses.

4. At all times relevant to this Complaint, Shane was registered with NASD and subject to its jurisdiction. NASD has jurisdiction over this matter under Article V, Section 4, of NASD’s By-Laws, which provides that a registered person shall be subject to the filing of a Complaint for conduct which commenced prior to termination, provided that the Complaint is filed within two years after the effective date of termination.

OTHER ENTITIES RELEVANT TO THIS ACTION

5. FNY, where Shane was registered during the time of the actions giving rise to this Complaint, has been a member firm since 1985. Its principal place of business is in New York City.

6. Compudyne is a Maryland-based company whose common stock is traded on the NASDAQ National Market System. Through various subsidiaries, Compudyne provides physical and electronic security products and services to jails, prisons, courthouses, and other

government buildings; produces bullet, blast, and attack resistant windows and doors; and provides specialty engineering and security services to U.S. Government intelligence agencies.

7. On September 10, 2001, CDCY closed at \$8.25, on volume of 700 shares. When the markets re-opened on September 17, 2001, CDCY rose to \$18.10 before closing that day at \$13.00. In the three weeks from September 17 to October 8, 2001, CDCY fluctuated between a low of \$9.33 and a high of \$19.55. During this period, trading volume averaged approximately 330,000 shares per day, and there were approximately five million shares outstanding, with a float of approximately 1,300,000 shares.

8. Friedman Billings Ramsey & Co., Inc. (“FBR”), has been a member firm since 1989. Its principal place of business is in Arlington, Virginia. It served as Compudyne’s placement agent during 2001. At the same time, Shane was a brokerage client of FBR.

FACTS

Compudyne decides on a PIPE offering

9. In or about September 2001, Compudyne entered into an investment banking relationship with FBR to raise capital by means of a private placement. Compudyne and FBR agreed to structure the private placement as a so-called “PIPE,” or a “private investment in public equity.”

10. A PIPE is a private offering whereby accredited investors agree to privately purchase securities issued by a reporting company on the condition that a re-sale registration statement will be effective within a certain period of time. Once the SEC approves the registration statement, the investors obtain their shares, which they can then sell to public investors on the open market.

11. In the Compudyne PIPE, as set forth in a September 27, 2001, “Confidential Private Placement Memorandum” (“PPM”), the company offered to sell 1,080,000 new shares of

common stock and arranged for the sale of another 1,370,000 shares of common stock and warrants controlled by William Blair Mezzanine Capital Partners II (“Blair”). The sale of the new shares would allow Compudyne to retire about \$9 million in debt owed to Blair and would generate, before expenses, additional cash of approximately \$7 million for Compudyne.

Shane learns about the Compudyne PIPE

12. On or about September 27, 2001, FBR began to market the PIPE offering to its clients.

13. Not later than September 28, 2001, FBR registered representative Paul Dell’Isola called Shane, who was a regular client, to discuss the Compudyne PIPE.

14. Using a script prepared by Compudyne’s counsel, and without initially divulging Compudyne’s identity, Dell’Isola told Shane that FBR represented an issuer in the electronic security sector that might soon sell some equity. He told her that the deal would be structured as a PIPE and that, if she were interested, he would disclose who the issuer was and the terms of the potential PIPE transaction, so long as Shane agreed to keep the information he was about to give her confidential.

15. Shane agreed to keep the information confidential.

16. In reliance on Shane’s agreement to keep the information confidential, Dell’Isola told Shane that Compudyne was the issuer in question and gave her additional information about the PIPE offering.

17. After talking to Shane, Dell’Isola instructed that a copy of the Compudyne Purchase Agreement and PPM be sent to Shane. On September 28, 2001, FBR sent the documents to Shane’s residence by overnight courier.

18. The information that Compudyne and FBR gave to Shane about the PIPE deal and about Compudyne’s financial plans included material non-public information.

19. The Purchase Agreement received by Shane contained a warranty that the purchaser was “acquiring the number of shares set forth in Section 2 above in the ordinary course of its business and for its own account for investment only and with no present intention of distributing any of such Shares.”

Shane begins to sell Compudyne while in possession of material, non-public information

20. Beginning on Friday, September 28, 2001, at 3:08 p.m., after talking to Dell’Isola, Shane began to sell CDCY short in two FNY proprietary accounts and in the accounts of two hedge funds whose trading she controlled. Shane continued selling CDCY short on Monday, October 1, increasing the total short position for the four accounts to 17,200 shares by the end of trading on October 1.

21. On Tuesday, October 2, beginning at about 9:41 a.m. and continuing until about 9:43 a.m., Shane sold short another 5,000 shares of CDCY. By 9:43 a.m. on October 2, Shane had increased the total short position in the four accounts to 22,200 shares.

22. Beginning at about 10:30 a.m. on October 2, Shane attended a “roadshow” conducted by Compudyne’s CEO and CFO, at FNY’s offices. During the roadshow, Compudyne reiterated that the private placement was confidential.

23. Beginning at about 11:30 a.m. on October 2, Shane sold short approximately 38,600 more shares of CDCY, increasing the total short position in the four accounts to a total of approximately 60,800 shares by the end of the day.

24. On Wednesday, October 3, Shane engaged in more short selling of CDCY, and some buying, increasing the total short position for the four accounts to approximately 88,100 shares by the end of the day.

25. On Thursday, October 4, Shane continued to sell CDCY short, and also bought shares, reducing the firm's net short position to approximately 53,100 shares by the end of the day.

26. Shane continued to buy CDCY on Friday, October 5, bringing all four accounts flat in CDCY by the end of the day.

27. The profits from the trading in CDCY that Shane directed from September 28 through October 5, 2001, were approximately \$56,151.

Shane decides to invest in the Compudyne PIPE

28. Sometime between about October 1 and October 5, Shane indicated to FBR that she was interested in buying 500,000 shares of CDCY in the PIPE, at \$14.00 per share.

29. Shane did not tell FBR or Dell'Isola that she had sold CDCY short or that she planned to sell CDCY short in the future.

30. Shane did no trading in CDCY on Monday, October 8.

31. On or about October 8, Compudyne and FBR agreed to "price" the PIPE at \$12.00 per share.

32. At 5:38 p.m. on October 8, Shane faxed the first page and the signature page of two Purchase Agreements to FBR. She elected to purchase 237,000 shares of CDCY for herself, in an account she held at FNY, and 238,000 shares for an FNY-affiliated hedge fund that she managed, FNY Millennium Partners, L.P. ("Millennium").

33. By submitting the signed Purchase Agreements, Shane represented to FBR and Compudyne that she and Millennium intended to hold the securities for investment purposes and had no intention of distributing the shares.

34. FBR and Compudyne relied on Shane's representations. Had FBR or Compudyne learned that Shane had already sold CDCY short or intended to sell short in the immediate

future, Shane likely would not have been allowed to arrange to purchase 475,000 shares of CDCY.

Shane again trades CDCY while in possession of material non-public information

35. Beginning on Tuesday, October 9, at 8:22 a.m., Shane again began to sell short CDCY stock in two accounts: her personal account and Millennium's account. But the existence and terms of the PIPE transaction were not made public until 11:44 a.m. that day. Between 8:22 and 11:44 a.m. on October 9, Shane, on behalf of herself and Millennium, amassed a total short position of approximately 122,900 shares of CDCY.

Shane continues to distribute unregistered PIPE shares

36. Shane continued to sell CDCY after 11:44 a.m. on October 9. From October 9 through October 30, 2001, the sales were made at prices ranging from a low of about \$12.41 to a high of about \$17.00.

37. By the time of the effective registration of the shares at the end of the trading day on October 29, 2001, Shane's and Millennium's combined short positions totaled approximately 455,000 shares.

38. From October 9 through October 29, 2001, Shane intended to profit by covering the short sales of CDCY with the shares that she and Millennium were entitled to buy at \$12.00 per share when the shares became registered.

39. At the close of the trading day on October 29, 2001, the SEC declared effective the registration statement for the Compudyne PIPE shares.

40. On October 30, 2001, Shane sold approximately another 20,000 shares, reaching a total short position in CDCY of approximately 475,000 shares in the two accounts, the amount of the shares she had agreed to purchase in the PIPE.

Shane covers her short position with PIPE shares

41. On or about October 31, 2001, Shane covered the combined 475,000-share short position using the 475,000 shares of CDCY that she bought in the PIPE for \$12.00 per share.

42. The total profits from covering the short positions established by Shane on October 9, 2001, before 11:44 a.m. totaled approximately \$315,216.

43. The additional profits from the CDCY short selling directed by Shane after 11:44 a.m. on October 9, 2001, but before the close of trading on October 29, 2001, were approximately \$764,818. Thus, the total profits from Shane's selling of CDCY from October 9 through October 29, 2001 totaled \$1,136,185.

Failures to make affirmative determinations

44. From on or about October 9 through on or about October 29, 2001, Shane caused FNY to execute short sales of 455,000 shares of CDCY, in approximately 975 separate transactions, without making, or keeping a record of making, an affirmative determination as to each transaction that the shares would be available for delivery by settlement date.

CAUSE ONE

Shane Obtained PIPE shares on false pretenses

(Violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120)

45. The preceding paragraphs of this Complaint are realleged here.

46. In the Purchase Agreements, Shane falsely represented that she and Millennium were buying CDCY for investment purposes and had no present intention of distributing the shares, and thus she induced Compudyne to agree to sell 475,000 shares to them.

47. By engaging in the foregoing conduct, Shane, directly or indirectly, by use of means or instrumentalities of interstate commerce, intentionally or recklessly employed a device, scheme or artifice to defraud, made untrue statements of fact, and engaged in an act, practice, or course of business which operated or would operate as a fraud or deceit in connection with the purchase or sale of a security, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2110 and 2120.

CAUSE TWO

Shane Traded CDCY While in Possession of Material, Non-Public Information

(Violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, and NASD Conduct Rules 2110 and 2120, and also violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933, thereby violating NASD Conduct Rule 2110)

48. The preceding paragraphs of this Complaint are realleged here.

49. In September and October 2001, Shane was in possession of material, non-public information about CDCY, including but not limited to information that: a key private investor's shares, and additional company shares equal to 20% of the shares outstanding, would be sold to private investors; the private and new shares entering the market through the PIPE would almost double the existing float in CDCY; and the new shares would soon become available for sale to the public at a cost to purchasers of \$12 per share, considerably below the market price.

50. By trading CDCY while in the knowing possession of this information, Shane directly or indirectly, by use of means or instrumentalities of interstate commerce, intentionally or recklessly employed a device, scheme or artifice to defraud or engaged in an act, practice, or

course of business which operated or would operate as a fraud or deceit in connection with the purchase or sale of a security, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2110 and 2120.

51. Because it occurred in the offer or sale of a security, this conduct also violated Section 17(a)(1) and 17(a)(3) of the Securities Act of 1933, and thereby violated NASD Conduct Rule 2110.

CAUSE THREE

Shane Unlawfully Distributed Unregistered Securities by Selling Shares of CDCY before Their Registration

(Violations of Section 5 of the Securities Act of 1933 and thereby of NASD Conduct Rule 2110)

52. The preceding paragraphs of this Complaint are realleged here.

53. From on or about October 9, 2001, through on or about October 29, 2001, Shane sold CDCY for her own account and for the account of Millennium without borrowing shares and while intending to cover the sales with shares from the PIPE.

54. By engaging in the foregoing conduct, Shane, directly or indirectly, made use of the means or instruments of transportation or communication in interstate commerce or of the mails to sell securities for which no registration was in effect and to which no exemption applied, in violation of Section 5 of the Securities Act of 1933, thereby violating NASD Conduct Rule 2110.

CAUSE FOUR

Shane Caused FNY to Fail to Make and Annotate an Affirmative Determination that Shares were Available for Settlement in each of Hundreds of Transactions

(Violations of NASD Conduct Rules 3370 and 2110)

55. The preceding paragraphs of this Complaint are realleged here.

56. Between on or about October 9, 2001, and on or about October 29, 2001, Shane caused FNY to fail to make and annotate an affirmative determination that shares were available for delivery in each of approximately 975 separate short sale transactions of CDCY, in violation of NASD Conduct Rules 3370 and 2110.

Prayer for Relief

WHEREFORE, the Department of Market Regulation respectfully requests:

A. Findings of fact and conclusions of law that Respondent Hilary Shane committed the violations charged and alleged herein;

B. An order imposing sanctions on Respondent Hilary Shane in accordance with NASD Rule 8310, including disgorgement of all profits realized from improper trading in CDCY;

C. An order imposing such costs of any proceeding against Respondent Hilary Shane as are deemed fair and appropriate under the circumstances, in accordance with NASD Rule 8330; and

D. An order granting all further relief, legal or equitable, that is warranted under the circumstances.

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