News Bulletin

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CSX Ramifications

The United States District Court for the Southern District of New York recently held in CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al (08 Civ. 2764 (LAK June 11, 2008)[1] that two hedge funds violated Section 13(d) of the Securities Exchange Act of 1934 ("Exchange Act") by failing to timely disclose the formation of a group and, in the case of The Children's Investment Fund, failing to timely disclose its acquisition of 5% of the outstanding equity of a U.S. publicly held railroad company, CSX Corporation, prior to launching a proxy fight for control of CSX. The defendants acquired a significant portion of their interest in CSX through the purchase of cash-settled total return equity swaps ("TRSs"). As a result, the Court considered, among other things, whether the defendants acquired "beneficial ownership" of the reference CSX stock through their swap positions. This case has been closely followed by many who regard it as yet another cautionary tale of how activist hedge funds may attempt to gain control of a company's voting stock surreptitiously in anticipation of a proxy contest. Perhaps more importantly, the case raises questions concerning whether our regulatory scheme for reporting shareholdings has kept up with financial innovation and whether "synthetic" interests in a company should be subject to ownership reporting regulations. As we discuss below, regulators in other jurisdictions are grappling with similar questions. Although the Court did not rule on the specific question of whether the defendants acquired beneficial ownership of CSX shares solely through their acquisition of the TRSs, the dicta clouds the thinking on TRSs.

Background

Between October 2006 and December 2007, a fund affiliated with The Children's Investment Fund Management (UK) LLP ("TCI") and a fund affiliated with 3G Capital Partners Ltd. ("3G") separately acquired substantial positions in CSX stock. They did so through both the purchase of stock as well as by taking the long side of cash-settled TRSs entered into with several financial institutions.

TCI and 3G attempted to pressure CSX management, first informally and then through a variety of more formal means and ultimately by launching a proxy contest. The Court focused on the fact that TCI had indicated to CSX management that it could convert its holdings into shares at any time, thereby increasing TCI's equity ownership to a substantially higher percentage. CSX filed suit against the hedge funds, claiming, in part, that their failure to adequately and timely disclose their long positions in the TRSs violated Section 13(d). CSX claimed the hedge funds failed to disclose their beneficial ownership of the shares associated with the economic positions conferred by the TRSs. TCI argued that its interest in the TRSs was not equivalent to beneficial ownership of the underlying CSX shares.

[1] The Court's decision may be found at: http://www1.nysd.uscourts.gov/cases/show.php?db=special&id=79 (the "Decision").

Synthetic Arrangements

In reporting on this case, the popular press has suggested that TRSs are yet another “tool” used by activist investors in an effort to gain control of a company, or a technique intended to acquire an ownership stake in the referenced issuer without attracting public scrutiny. Of course, these generalizations ignore that most of the $10 trillion equity derivatives market is not motivated by hedge fund activists and that there are a variety of legitimate economic reasons for entering into TRSs.

Under existing 13(d) rules, investors are required to disclose when they beneficially own more than 5% of a public company. These disclosures were intended to alert public company shareholders and the market about potential control issues. Under Rule 13d-3, a party is deemed to be the beneficial owner of securities if it “…directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.”

However, the principal objective of a TRS is to decouple voting and economic control. An investor entering into a TRS seeks economic exposure to the underlying reference asset. In a typical TRS where the underlying reference asset is common stock, the party seeking economic exposure to the underlying shares (often referred to as the “long party” or “equity payee”) pays the counterparty (the “short party” or “equity payor”), usually a financial institution that is a derivatives dealer, a cash payment (typically LIBOR plus or minus a spread), as well as any depreciation in the value of the reference asset. The cash payment represents the financing costs that the equity payee would have had to incur if it had borrowed money to buy and hold the reference shares. The counterparty, or equity payor, pays the equity payee any cash flows from the reference shares (e.g., dividends, in the case of stock), as well as the economic appreciation of the value of the reference shares. The derivatives dealer will determine whether to hedge its exposure under the TRS and will determine how to do so—which may be by purchasing the reference shares, or by entering into options or through other arrangements. The long party or equity payee cannot compel the derivatives dealer to purchase reference shares or, if the derivatives dealer purchases reference shares, cannot compel the dealer to sell such shares.

In a TRS, the long party or equity payee does not have the right to vote the underlying reference shares and does not have any other indicia of ownership relating to the reference shares. An ISDA/SIFMA amicus brief focused on the abstract question of whether a cash settled TRS should be deemed to confer beneficial ownership of the reference assets. The amicus brief noted that, “The standard ISDA Master Agreement and related forms of schedule, definitions, and transaction confirmation that govern the legal rights and obligations of parties to equity swaps do not convey to the long party either title to the underlying shares or any contractual right to acquire or to direct its counterparty’s acquisition or disposition of shares, or the voting of shares, if any, acquired by the counterparty.”[2] Along the same lines, in a letter submitted to the General Counsel of the SEC by Professor Bernard S. Black, Black noted that he was not aware of a U.S. market practice where it is seen as “…appropriate for a swap counterparty to contact a dealer and attempt to persuade it to vote in a particular way. Such efforts may exist, especially for non-U.S. companies, but they are not the norm for U.S. companies and did not occur in this case.”[3]

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[2] Brief of Amici Curiae International Swaps and Derivatives Association, Inc. ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA"), CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al., No. 08 Civ. 2764 (S.D.N.Y. June 2, 2008), available at http://www.sifma.org/regulatory/briefs/2008/TCIFAmicusbrief-CSXCorp.pdf

[3] Letter from Professor Bernard S. Black to Brian G. Cartwright, General Counsel of the Securities and Exchange Commission, dated May 29, 2008, CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al., No. 08 Civ. 2764 (S.D.N.Y. June 4, 2008), Exhibit A to the Defendants’ Response to the Plaintiff's June 2, 2008.

This position was echoed by the SEC in the letter submitted to the Court by Brian V. Breheny, Deputy Director, Division of Corporation Finance (the "SEC Letter"), responding to the Court's questions regarding "beneficial ownership." The SEC noted that "[T]he Division believes that interpreting an investor's beneficial ownership under Rule 13d-3 to include shares used in a counter-party's hedge, absent unusual circumstances, would be novel and would create significant uncertainties for investors who have used equity swaps in accordance with accepted market practices understood to be based on reasonably well-settled law."[4]

Unusual Circumstances

In this instance, there were a number of unusual facts and circumstances. The SEC in its letter noted that a person who entered into a swap with the intention of creating a false appearance or evading the beneficial ownership provisions might, in fact, be deemed a beneficial owner. Although the Court could have focused in its decision on the unique fact pattern presented in this case and the ample evidence of "evasion," the Court, instead, chose to explore various aspects of "beneficial ownership."

The Court focused on CSX's contention that TCI had the power to influence the decision of the counterparties to purchase the reference assets(s)--in this case, CSX shares--and to vote those shares in a manner beneficial to TCI if TCI launched a proxy contest, thereby conferring beneficial ownership of the CSX shares on TCI. The Court noted that TCI had taken pains to spread its TRS contracts among a number of counterparties so that no counterparty would be likely to acquire in excess of 5% of CSX's shares and thus be required to report the purchase, and the associated TRS, on Schedules 13D filed by the counterparties.[5] The Court also focused on the fact that regardless of the original terms of the TRSs, which called for cash settlement only, the TRSs could be quickly and easily modified to provide for physical settlement, or delivery of the shares of CSX stock purchased to hedge the counterparties' exposure, the purchase of which was the only "practical alternative" to hedge the counterparty's position.[6]

Ultimately, the Court did not find it necessary, despite its long analysis and clear direction of thought, to rule as to whether ownership of a swap by itself resulted in beneficial ownership of the underlying shares.

The Court ruled that TCI and 3G were using the TRSs as a "plan or scheme to evade the reporting requirements" in violation of 13d-3(b). Under SEC rules, if the 13d-3(b) elements are met, the relevant parties may be deemed beneficial owners of a security, even if those parties are not the actual owners. The Court outlined the three elements that must be satisfied in order for 13d-3(b) to apply:

> i. the use of a contract, arrangement, or device;
>
> ii. with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership;
>
> iii. as part of a plan or scheme to evade the reporting requirements of Section 13(d) or (g)[7]

The Court determined that the TRSs themselves satisfied the first element. It then determined that the totality of evidence presented at trial, including comments attributed to the CFO of TCI (who explicitly stated that TRSs were used to avoid disclosure), TCI emails discussing the need for the counterparties' hedged holdings of the

[4] Amicus Curiae Letter of the Division of Corporate Finance of the Securities and Exchange Commission at 2, CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al., No. 08 Civ. 2764 (S.D.N.Y. June 4, 2008), Exhibit A to the Defendants' Response to the SEC Amicus Letter.
[5] A recognized advantage of using a TRS is the ability to achieve exposure to an asset without the need to disclose the investment.
[6] Decision at 61 Note 188 (Citing TR., June 9, 2008, at 27:33.)
[7] Decision at 65.

underlying stock to remain below 5% and TCI's admitted motivation to avoid paying a higher market price on the market for CSX shares (which would have likely resulted if it had disclosed its position) satisfied the second and third elements.[8]

The Court also ruled that TCI and 3G violated Section 13(d)(3) by failing to timely disclose that they had formed a partnership "for the purpose of acquiring, holding, or disposing of securities." The Court explained that "an allegation that persons have formed a [13(d)(3)] group is analogous to a charge of conspiracy."[9] The Court went through a litany of facts, which it held demonstrated the existence of a "group," explaining that the evidence showed "the parties' activities were products of concerted action notwithstanding the defendants' denials."[10]

The Court's sole remedy for these violations, however, was a partial injunction preventing further violations of Section 13(d). The Court refrained from ordering any remedies beyond this. TCI and 3G will still, absent successful appeal by CSX, be allowed to vote their shares and the Court did not grant an award for damages. Both CSX and the defendants have filed appeals.

Implications

Even though the Court's decision could have widespread repercussions in various contexts, including rebalancing baseline corporate governance practices and tactical responses by issuers and their management to proxy contests for corporate control, we anticipate that it will have even broader implications for the derivatives market.

Although the Court's language is not entirely clear, the decision signals that the Court is receptive to arguments regarding more inclusive definitions of "beneficial ownership" that may extend to synthetic arrangements.

In particular, absent clarifying rulemaking by the SEC and the CFTC, investors and counterparties may be required to develop and implement tracking systems to determine if they could be deemed, either through presently contemplated transactions or other unrelated activities (including investment banking relationships, proprietary trading and other derivatives transactions) to have significant influence over voting or dispositive transactions, which could give rise to required reporting under Section 13(d) of the Exchange Act, or could be deemed to be part of a "group" for Section 13(d) purposes. We anticipate that there will be closer scrutiny and potential rulemaking regarding the kinds of arrangements that should be disclosed.

Because Section 16 of the Exchange Act references Section 13 for the initial determination of beneficial ownership, investors and counterparties also may find themselves liable for short-swing profits if they were to be deemed to beneficially own in excess of 10% of a publicly traded equity security and one or more transactions in such securities were to yield a profit within a six month time frame.

Until this regulatory landscape is clarified, and at the very least, any appeal(s) of the decision are decided, derivatives dealers may wish to consider seeking representations from their counterparties regarding their intentions for entering into TRSs.

[8] See the Court's discussion of these two factors between pp.65-72.
[9] Decision at 73.
[10] Rule 13d-5(b)(1) "When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group [emphasis added] formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Sections 13(d) and 13(g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons."

Cash-Settled Swaps in the UK

In the UK, regulators have been considering similar issues since last fall. Outside of a formal offer period in respect of the shares of a public company, in the UK, the holder of a cash-settled derivative position (contract for differences) in respect of a share listed on a regulated market or a prescribed market is not obliged to disclose its interest publicly, so long as it has no enforceable right to acquire the listed share, nor control the voting rights in respect of that share.[11]

In November 2007, the Financial Services Authority issued a consultation paper discussing three possible approaches to the question of whether to require disclosure of such contracts for differences. Option 1 (which the FSA hinted strongly would not be adopted) was to change nothing in the existing regime. Option 2 (which seemed to be the FSA's preferred option initially) was for the holder of a cash-settled long position in such shares to aggregate these interests with any actual shares or voting rights it may hold for disclosure purposes UNLESS certain proposed new "safe harbour" requirements are satisfied. These are that (a) under the terms of the instrument, the holder is precluded from exerting any influence over voting rights, (b) under the terms of the instrument, further arrangements/understandings in relation to any potential sale of the underlying shares are prohibited and (c) the holder of the instrument be required to state explicitly that it has a genuine intention not to acquire or obtain access to the shares referenced in the transaction.

In addition to this affirmative disclosure obligation on the instrument holder, Option 2 also proposed to grant additional powers to the listed company itself, entitling it to make a reasonable request for details of a holding of such an instrument that the company believes the holder possesses, where the underlying referenced shares are in excess of 5% of the total shares, and where the above "safe harbour" requirements are not satisfied.

Option 3 was to oblige the holder of the contract for differences to make disclosure (separately from any disclosure of voting interests already required by DTR) of such instruments in any case where the holding referenced by the contract for differences is in excess of 5% of the total shares of the limited company.

Comments were invited on this consultation paper by February 12, 2008. Responses to the consultation paper have not yet been published by the FSA, but ISDA, for one, has published its response to the FSA. This response urged re-consideration of Option 1, on the basis that strict enforcement of the existing regime was the most appropriate option, in its view. Failing this, ISDA effectively discounted Option 3 and then made substantive comments on Option 2. These comments suggested removing the requirement for the holder of the long position (equity amount receiver) to declare an intention not to acquire the underlying shares (in favour of a representation that the equity amount receiver has no intention to acquire the shares) – a subtle difference.

ISDA also suggested some standard contractual wording intended to satisfy the "safe harbour" provisions when inserted into the contractual agreement creating the contract for differences.

Anecdotal evidence suggests the reactions of other market participants can be predicted by their roles – listed companies generally prefer Option 3, brokers generally prefer Option 3 as being more administratively workable than Option 2. There has been no news from the FSA since February. Originally, the new regulation (whether Option 2, 3 or something different) had been scheduled to come into force in September 2008.

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[11] A right to acquire listed shares, or to acquire voting rights in respect of listed shares, of at least 3% (for shares in a listed UK company) or 5% (in respect of a listed non-UK company) obliges the holder to notify such interest to the share issuer under the UK's Disclosure and Transparency Rules (DTR), which implement the EU Transparency Directive.

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