

ALLEN & OVERY



Equity swaps and beneficial ownership:

Lessons learned from *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*

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Introduction

Pre-CSX Rule on Ownership Disclosure

- Williams Act of 1968 amends U.S. Securities Exchange Act of 1934, Rule 13(d) to mandate the disclosure of substantial accumulation of an issuer's securities
- Owners of equity swaps generally do not have a disclosure requirement under Rule 13(d) of the U.S. Securities Exchange Act of 1934, as amended (the "Act") because no voting or investment power as defined in Rule 13(d) exists
- "Masked Ownership" - Since ownership positions are hidden, owners of equity swaps have the ability to significantly influence voting or disposition of the securities of a company

*CSX Corporation v. The Children's Investment Fund
Management (UK) LLP, et al.*
(08 Civ. 2764 (LAK) (SDNY June 11, 2008))

Overview:

- Equity Swaps may not be used to evade reporting requirements of Sections 13(d) and (g) of the Act
- The U.S. District Court for the Southern District of New York ruled that two hedge funds had violated the Act by **intentionally evading** federal disclosure requirements through the use of total return cash-settled equity swaps to **avoid obtaining beneficial ownership of the underlying shares** to which those swaps had given them economic exposure

Players

- *Plaintiff*: CSX Corporation and its wholly owned subsidiary, CSX Transportation Inc. (together “CSX”)
 - Publicly traded operator of one of the U.S.’s largest rail systems
- *Defendant*: The Children's Investment Fund Management (UK) LLP, the Children’s Investment Fund Management (Cayman) LTD and The Children’s Investment Master Fund (together “TCI”)
 - London based hedge fund
- *Additional Defendant on Counterclaim*: 3G Fund L.P., 3G Capital Partners L.P. and 3G Capital Partners Ltd. (collectively “3G”)
 - Cayman Islands based hedge fund

Background

Late 2006

TCl begins entering into equity swap transactions referencing shares of CSX with various financial institution counterparties

End of 2006 and Thereafter

TCl amasses swaps referencing 8.8 percent of CSX's outstanding shares and continues to build its swap position

TCl investigates possibility of a leveraged buyout of CSX, formalizes its LBO proposal and presents it to representatives of Morgan Stanley, CSX's financial advisor, who in turn, relay it to CSX

3G begins to focus on CSX

Background

February 2007

3G acquires large blocks of CSX stock, acquiring more than 4 percent of the company's outstanding shares by the end of March 2007

August 2007

3G begins to enter into equity swap transactions referencing CSX's shares, giving it economic exposure to an additional 0.8 percent of shares outstanding

Despite TCI's attempts to pressure CSX into accepting its LBO proposal over the course of 2007, CSX rejects proposal

TCI and 3G then decide to convert some of their swaps into actual ownership and launch a proxy contest to gain control or substantial influence over CSX

Background

December 2007

The funds file a Schedule 13D with the SEC, disclosing that they formed a group and intended to conduct a proxy solicitation to, among other things, nominate directors for five of the company's twelve board seats

According to Schedule 13D, the funds collectively owned 8.3 percent of CSX's shares, and had swaps referencing almost 12 percent of CSX's shares but disclaim beneficial ownership of the underlying shares referenced by the swaps

17 March 2008

CSX brings suit against TCI and 3G

Proceedings: CSX Arguments

- Violation of Disclosure Requirements:
 - TCI violated the reporting requirements of §13 of the Act because shares referenced in the swaps were beneficially owned by TCI and thus should have been counted for purposes of determining the existence of the 5 per cent threshold for disclosure
 - Both funds violated §13 by failing to timely disclose the formation of a group

- Beneficial Ownership because:
 - Indirect voting and investment power (§13(d) – 3(a) of the Act)
 - TCI shares were acquired "with the purpose or effect of changing or influencing the control" of CSX and because TCI's ability to convert its derivative shares to actual shares and its relationships to the swap counterparties gave TCI indirect voting and investment power
 - Part of a "plan or scheme" to evade (§13(d) – 3(b) of the Act)
 - TCI was careful to keep its actual share ownership below 5 percent at all times and the swaps were part of a "plan or scheme" to evade reporting requirements

Proceedings: TCI's Arguments

- The equity swaps gave TCI nothing more than economic exposure to CSX stock and carried none of the other indicia of actual ownership
- Its swap counterparties had not been contractually obligated to purchase CSX shares in connection with the swaps, but had done so voluntarily in order to hedge their position
- There were no pre-existing arrangement or agreements with its counterparties to purchase such hedge shares or vote them in any way

Proceedings: *Amicus* Brief of SEC

- Letter from the Division of Corporation Finance stated that “as a general matter, a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements”
- Letter also referred to the concept of a “plan or scheme” (though in the context of suggesting that such is generally not the case in a swap transaction)

Proceedings: Court's Focal Points

– Court focused on the following main points in considering whether to treat TSI as the beneficial owner of the CSX stock:

(1) TSI's economic ability to influence whether the counterparties disposed of CSX stock, as TCI knew that the counterparties hedged with CSX's shares

(2) The potential for TCI to influence if and how some of the counterparties voting the CSX shares that they held; and

(3) TCI's ability to acquire the CSX shares by settling the equity swaps even though the swaps normally provided for cash settlement

Holding

- §13(d)-3(a): Court declines to specifically address
 - Court declined to decide the question of whether TRS contracts “in and of themselves” confer beneficial ownership of the underlying securities on the long counterparties under §13(d)-3(a)
 - Court found it was not necessary to reach this question because of decision on §13(d)-3(b)

- §13(d)-3(b): TCI found to be beneficial owner
 - TCI intentionally entered into equity swaps with the purpose and intent of preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of §13(d)
 - Court reasoned that TCI concealed precisely what §13(d) was intended to make public
 - Concern that TCI and its counterparties could agree to unwind the swaps in a manner that would allow TCI to acquire the hedge shares on demand

Holding

- The District Court enjoined further violations of §13(d)
- Court concluded that it lacked discretion to “sterilize” the voting power of the shares that were acquired before a Schedule 13D was ultimately filed because under Second Circuit precedent, the facts did not support a finding that either CSX or other shareholders had suffered irreparable harm

Looking Forward: Implications on Equity Derivatives Markets

- Calls into question basic expectation that the long party to a total return swap (“TRS”) does not acquire beneficial ownership of the reference securities absent a supplemental arrangement outside of the TRS that provides a contractual right to vote or dispose of such securities
- Future use of TRSs where the primary perceived benefit is the avoidance of reporting beneficial ownership comes into question
 - Court inferred that the use of TRSs by “activist investors” raises the issue that such transactions might be indicia of a plan or scheme to evade the reporting requirements of §13(d) and must be examined in each case
- Court’s endorsement of conducting case-by-case inquiries concerning whether a plan or scheme existed will be costly, timely, and provide uncertainty

Looking Forward: Implications on Equity Derivatives Markets

- Basis of the Act’s jurisdiction in doubt
 - The holding may be in contradiction with §3A of the Act, which forbids the Securities and Exchange Commission from taking actions that impose registration and reporting requirements with regard to security-based swap agreements, except as expressly permitted by §16 of the Act (i.e. to prevent fraud, insider trading, or market manipulation)
- Change in definition of Ownership could have far reaching implications
 - Determining whether a person or group is a 10 percent owner for purposes of §16 under the Act is based on the same §13(d) definition so it is possible that §16 plaintiffs may rely on this decision in making claims against stockholders with swaps that would put them above 10 percent
 - The definition of ownership in §13(d) is also used in most “poison pill” plans, change of control provisions and many other corporate governance provisions relevant to corporate control issues

Looking Forward: Effect of Dodd-Frank Act

- §766 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“Dodd-Frank Act”), amends the Act by adding Section 13(o), which becomes effective on July 16, 2011 and provides: “

“[f]or purposes of this section and section 16, a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the SEC, by rule, determines after consultation with the prudential regulators and the Secretary of the Treasury, that the purchase or sale of the security-based swap, or class of security-based swap, provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of this section that the purchase or sale of the security-based swaps, or class of security-based swap, be deemed the acquisition of beneficial ownership of the equity security.”

- Absent rulemaking under §13(o), §766 may be interpreted to render the beneficial ownership determinations made under §13(d)-3 along with the accompanying case law such as the CSX case inapplicable to a person who purchases or sells a security-based swap

Looking Forward: SEC Response

- SEC proposal letter of 17 March 2011 seeks to preserve the current state of affairs with respect to equity swaps and beneficial ownership
 - Proposal to readopt without change the relevant portions of Rules 13(d)-3 and 16(a)-1
 - As stated in the proposing release, “[the change] is neither intended nor expected to change any existing administrative or judicial application or interpretation of the rules”
 - In effect, the CSX case survives the Dodd-Frank Act and is subject to additional rule-making by the SEC

- SEC proposal letter also confirms that the staff is “engaged in a separate project to develop proposals to modernize reporting” under Sections 13(d) and (g)
 - Intent inferred in proposal that the SEC is considering proposing rules to address equity swaps directly

Questions?

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-INTERNET SOURCE LIST:

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 - <http://dodd-frank.com/sec-proposes-to-adopt-same-13d-rules-for-security-based-swaps/>
 - <http://www.sec.gov/rules/proposed/2011/34-64087.pdf>
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-DOCUMENT SOURCE LIST:

- Contact ryan.dunmire@allenoverly.com for copies of cases, PDF files, and other documents used in preparation of the presentation