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A legal update from Dechert's Mergers and Acquisitions Group

District Court Rules Activist Funds Violated SEC Reporting Rules Relating to Disclosure of Swaps and "Group" Status

Highlights

- U.S. District Court holds that activist investors violated Section 13(d) reporting requirements in advance of proxy contest with CSX
- Ownership of cash-settled total return equity swaps found to be part of plan or scheme to avoid disclosure of ownership position by activist investors
- Hedge funds with common target shareholdings must exercise caution when communicating or coordinating activity as court finds activists constituted a group for purposes of Section 13(d)
- Court does not preclude activist investors from voting their CSX shares citing limited authority under Section 13(d) precedent
- The decision has been appealed and may lead to SEC clarification in this area

An activist investor fund, The Children's Investment Fund ("TCI"), violated Section 13(d) of the Securities Exchange Act of 1934 and the rules thereunder by failing to timely disclose in a Schedule 13D filing with the SEC its beneficial ownership of cash-settled, total return equity swaps, according to Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York in *CSX Corp. v. The Children's Investment Fund Management (UK) LLP, et al.* (S.D.N.Y., No. 08 Civ. 02764). The court also held that TCI and another defendant, 3G Fund ("3G"), had formed a reportable "group" under Section 13(d) well before the time the defendants reported their status as such, despite the lack of a written agreement and the stated intent on the part of the two funds not to do so. The investor funds have appealed the court's ruling to the Second Circuit Court of Appeals, and CSX has appealed the limited remedy granted it by the court in its decision.

Background

Section 13(d) and the rules thereunder require that, subject to certain exceptions, a person who acquires beneficial ownership of more than 5% of a class of equity securities of SEC registered companies must file a Schedule 13D within 10 days after such acquisition. A "person" may include any two or more persons or entities that agree to act as a group for the purpose of acquiring, holding or disposing of a company's securities.

The CSX case has been closely watched by activist hedge funds, who seek to improve returns in public equity investments by influencing management at their portfolio companies, as well as by public companies wary of the sudden appearance of activist funds holding a significant ownership position. While appealed by both the investor funds and CSX, the decision may in some cases force activist investors to go public with an ownership position or group formation before accumulating a targeted owner ship level, which can depress returns if public announcement generates an increase in the target's stock price. More fundamentally, the court's finding that ownership of non-voting cash-settled derivatives formed the basis for a plan or scheme to evade reporting requirements highlights the risk that courts may view complex ownership or other legal structures as "form over substance" and apply the federal securities laws in a way that is broader than anticipated by many practitioners or, perhaps, the SEC.

Cash-Settled Total Return Equity Swaps—What Are They?

Cash-settled total return equity swaps are a common form of derivative financial instrument used by hedge funds and other investors to maximize their investment returns. The swaps in question provided that the long counterparty—TCI—receive the market appreciation and cash distributions with respect to the reference securities (here, CSX common stock) in exchange for payments to the short parties—various banks and other financial institutions—of any market depreciation in the reference securities and periodic interest based on the market value of the referenced securities at the time the swaps were entered into. Long parties can maximize notional share appreciation via swaps through leverage and tax efficiencies. Cash-settled swaps also, importantly, often permit the long party to build synthetic equity appreciation in a company without premature marketplace disclosure.

Short counterparties enter into cash-settled swaps typically to maximize cash flow. The short parties often hedge their exposure by purchasing the reference securities. They are the beneficial owners of the hedged securities and control the right to vote or dispose of such securities. Many short parties maximize fee income by lending out the hedged securities to third parties to cover short positions. In this case, the borrower of the hedged shares controls the voting rights. In the CSX case, Judge Kaplan discussed at length the hedging policies of the short parties. He noted that the parties often vary as to their voting practices, but that some are influenced by their long party customers' wishes. There was some disputed evidence as to the effect of the CSX short parties' actual voting patterns and their efforts to retrieve hedged securities that were out on loan in the marketplace so that the short parties could recapture the vote in connection with record dates. There was also disputed evidence as to efforts by the defendants to orchestrate the placement of the swaps with short parties in order to avoid SEC reporting requirements by the short parties and maximize "friendly" voting results as to any hedged securities.

The Court's Ruling

In the course of events leading up to the litigation relating to the ongoing proxy fight between the parties, TCI acquired cash-settled swaps from more than a half dozen investment banks. The cash-settled swaps collectively gave TCI the right to the economic returns associated with ownership of 13.6% of the outstanding stock of CSX. This accumulation of economic interest was accomplished without TCI's acquiring any actual shares of CSX. TCI did not disclose in a Schedule 13D report that it held the cash-settled swaps until it and 3G filed a Schedule 13D disclosing that they had formed a group and that they each owned more than 4% of the actual shares of CSX. This filing was made months after TCI had acquired cash-settled swaps giving it economic rights with respect to more than 5% of the outstanding stock of CSX. The court held that it did not have to decide whether ownership of cash-settled swaps generally constituted beneficial ownership of the underlying security, which defendants strongly contested because, according to the court, "TCI created and used the cash-settled swaps with the purpose and effect of preventing the vesting of beneficial ownership . . . in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d)." For that reason alone, the court held that under Rule 13d-3(b), TCI "thus is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures" created by the cash-settled swaps.

In so holding, the court sidestepped the views expressed by the Staff of the SEC's Division of Corporation Finance, whose Deputy Director, Brian V. Breheny, wrote a letter as *amicus curiae* (responding to certain legal questions of Judge Kaplan, but not addressing factual issues and not expressing the opinion of the Commissioners) to the effect that "taking steps with the motive of avoiding reporting and disclosure generally is not a violation of Section 13(d) unless the steps create a false appearance" of non-ownership of a security. In the Staff's view, "the long party's underlying motive for entering into the swap transaction generally is not a basis for determining whether there is a 'plan or scheme to evade.'"

Although Judge Kaplan devoted a significant portion of his opinion to whether ownership of the cash-settled swaps in and of itself constituted beneficial ownership under Rule 13d-3(a), he declined to rule on that question. The court instead relied on the "plan or scheme to evade the reporting requirements" language of Rule 13d-3(b) for its holding. While the swap contracts were by their terms cash-settled, provided no voting rights, and lacked any provision for TCI to direct the vote of shares, if any, held by the counterparty, the court noted that a focus on TCI's technical rights under the swap agreements "exalt[ed] form over substance" and that "[a]ny determination of beneficial ownership that failed to take account of the practical realities of [the securities markets] would be open to the gravest abuse." Judge Kaplan observed that cash-settled swaps needn't be settled in cash and the ease with which a party could unwind them in kind, purchasing actual shares held long by their counterparties to the swap. Judge Kaplan also cited other facts which he indicated could be taken to imply that TCI had "a significant ability to affect how voting power or investment power will be exercised." In support of this holding, the court noted testimony of a TCI officer that one of the purposes for using the cash-settled swaps was to avoid SEC disclosure and efforts to restrict counterparty ownership of the hedged shares to under 5%.

The court also held that, based on the specific facts presented, TCI and 3G had formed a group for the purposes of Section 13(d) reporting approximately ten months before filing their Schedule 13D. Citing precedent, the court noted that an allegation that persons have formed a group involves the assertion that "two or more persons reached an understanding, explicit or tacit, to act in concert to achieve a common goal" and that "[g]roup members need not 'be committed to acquisition, holding, or disposition on any specific set of terms.'" "Instead, the touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective." Among the relevant facts cited by the court were a pre-existing relationship between TCI and 3G prior to formation of the group (in part because a 3G fund invested in TCI), the parties' exchange of views and information regarding CSX, similar purchase patterns following meetings of representatives of TCI and 3G, alleged lack of credibility of TCI and 3G representatives, and parallel proxy fight preparations.

As a remedy for the violations of Section 13(d) by TCI and 3G and certain of their principals (who were held jointly and severally liable under Section 20(a) of the Exchange Act by virtue of their controlling positions), the court enjoined them from future violations of Section 13(d). The court also considered the additional remedy sought by CSX of "sterilizing" the shares acquired by TCI and 3G following their failure to timely file Schedule 13D reports and thereby barring them from voting the shares at the upcoming CSX meeting, but concluded that it was prevented from doing so as a result of Second Circuit precedent. *Treadway Cos., Inc. v. Care Corp.,* 638 F.2d 357 (2d Cir.1980). *Treadway* suggested that, ordinarily, corrective disclosure is the appropriate remedy for Section 13(d) violations, absent irreparable harm such as may result from "effective control" acquired as a result of such violations. However, the court added with respect to the sterilization remedy that if "it were free to grant such relief, it would exercise its discretion to do so."

Practice Points

13D Cash-Settled Swap Reporting

Prior to this decision, many practitioners, with the SEC Staff's blessing, had taken the position that long cash-settled swaps do not fall within Schedule 13D reporting requirements for beneficial ownership of equity securities. In other words, if the investor beneficially owned 5% or less of a class of equity securities, no Schedule 13D reporting requirement was triggered even if the investor owned long cash-settled swaps in respect of securities hedged by counterparties exceeding 5%. If the investor otherwise triggered a Schedule 13D report, the cash-settled swaps would be reported supplementally under item 6 with respect to contracts relating to securities of the issuer. While the court did not rule that cash-settled equity swaps will always result in beneficial ownership for purposes of Section 13(d), the "plan or scheme" analysis employed by the court may alter practice in this area.

In light of the court's decision, it can be expected that many investors contemplating large cash-settled swap investments will take a conservative position until the court's decision is clarified on appeal to the Second Circuit, or by SEC rulemaking. For instance, these investors could either include (with an appropriate disclaimer) the cash-settled swaps in addition to any equity securities in the Schedule 13D 5% trigger analysis, or not acquire so many cash-settled swaps as to implicate the 5% trigger (either alone or in conjunction with any shares actually owned by the investor). Either way, this could limit the accumulation of long exposure to a security prior to a public disclosure and possibly diminish returns on investment. In addition, the Section 13(d) beneficial ownership definition or close variations are used in other areas setting triggers relevant to activist investors, including Section 16 reporting for 10% shareholders, change of control agreements, anti-takeover statutes, and poison pill rights plans. Accordingly, even if activist shareholders report cash-settled swaps conservatively under Schedule 13D, their use may be limited in some situations pending clarification.

Both long parties and their swap counterparties will need to review the nature of their interactions regarding the counterparties' hedging and voting policies involving securities underlying the derivatives. The court commented extensively on TCI's and 3G's alleged influence over their counterparties and knowledge of their trading and voting patterns. Although the court did not rule on the technical issue of whether this influence itself constituted beneficial ownership of the underlying shares, the court was clearly concerned about this aspect in light of its characterization of the "commercial realities" of counterparty behavior with respect to hedged securities.

SEC Response

The SEC may take action in this murky area. In connection with the appeal of the court's decision, the SEC could weigh in with a full *amicus curiae* brief interpreting its own rule. This would presumably support the Staff's legal position expressed in the Staff letter, but perhaps not.

More broadly, the SEC could address via rulemaking the treatment of cash-settled derivatives in the reporting area. This will be a difficult task, as the SEC will need to balance the need for marketplace flexibility in the fast changing derivative arena with the public's legitimate expectation to timely learn of substantial economic positions in issuers, whether or not the positions include the typical voting and dispositive attributes of conventional equity securities. This is a particularly acute concern in situations where investors take activist positions, which might form a natural line of demarcation on reporting in the cash-settled derivatives area.

If the SEC reviews the reporting requirements in this area, it is possible the SEC will also review other Section 13(d) issues which frequently arise, such as the relatively limited remedies available under Section 13(d) or the "10 day window" (which was not at issue in the case). Under the window, investors have up to 10 days after triggering the 5% threshold to file an initial Schedule 13D. During this gap, the investor may continue to accumulate securities unbeknownst to the market. The SEC's recent efforts to accelerate reporting in the Section 16 and Form 8-K areas to promote "real time" reporting could be a natural segue into this area.

Activist ''Wolfpacks'' and Group Formation

As discussed, the court held that TCI and 3G had formed a "group" required to report under Schedule 13D almost a year before the parties actually filed as such. The court was quick to dismiss the defendants' views that they were cognizant of the group issue and dealt with it adequately by means of their frequent group disclaimers, by noting that "the Exchange Act is concerned with substance, not incantations and formalities." The court noted prior case law that the existence of a 13D group turns on "whether there is sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [members] for the purpose of acquiring, holding, or disposing of securities." The court did not address whether short swap counterparties, who often hold equivalent long positions in CSX shares as hedges, form a group with the cash-settled swap holder. Communications among investors and the sharing of common goals as evidenced by similar trading patterns do not, in and of themselves, trigger an "understanding" between the parties and 13D group status. However, group formation remains a gray area and investors should proceed with caution.

Issues for Clarification on Appeal

The investor funds and CSX have appealed the court's ruling. TCI and 3G can be expected to focus on the court's potentially controversial analysis concluding that the use of cash-settled swaps constituted a scheme or arrangement to evade the Schedule 13D reporting requirements. The funds may also appeal the holding that the existing record was sufficient to establish the earlier formation of a group, although the fact intensive nature of the court's finding in this area may hinder its appealability.

CSX has requested the Second Circuit to limit prior precedent holding that curative disclosure alone, and not broader injunctive relief such as divestment or prohibition of voting shares, is the proper remedy for 13D violations absent egregious violations resulting in a change in effective control of the issuer.

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