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# CSX Corp. v. Children's Investment Fund Management (UK) LLP: Disclosure Requirements in the Context of Total Return Swaps

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The economic crisis prompted a renewed focus on those market participants that use equity total return swaps to obtain synthetic positions in the shares of public companies. Periodically, parties that enter into equity total return swaps have faced calls to disclose the positions that they "hold" as if they physically owned the relevant shares. The arguments in favor of disclosure are that it puts a company on notice about the accumulation of significant positions, which could be used either as a springboard for a potential takeover bid or to exert influence over the direction and/or management of the company, and that it helps investors to make fully informed investment decisions. As large synthetic positions could also potentially be used to gain influence, there is an argument that such positions also be disclosed. On the other side of the argument, those in favor of nondisclosure argue that a synthetic holding of shares provides only the economic incidents of ownership and that, without a specific agreement to the contrary between the parties to the swap, the long party to a swap has no real influence or power over the shares, and therefore the company, by virtue of its synthetic position.

A total return swap is a contract whereby one party (the long party) receives cash flows based on the performance of an underlying asset from the other (the short party). A total return swap allows a party, for a fee, to replicate ownership of an asset without actually owning it. In an equity total return swap, the underlying asset is a specified notional amount of shares in a particular company. Where the equity total return swap is cash settled, the long party receives from the short party periodic payments (or a single payment at the maturity of the swap) representing any increase in value of the relevant shares and any distributions, such as dividends. In return, the long party pays to the short party any decrease in the value of the relevant shares and interest payments calculated with reference to an agreed interest rate on a notional amount – this effectively replicates the short party loaning to the long party the funds necessary to purchase the relevant

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shares. The effect of the contract is that the long party takes the upside of the relevant company's valuation and also bears the risk of the downside, just as if the long party owned the shares outright. In equity total return swaps, the short party will typically purchase the specified shares to hedge its own position under the swap, but need not do so.[2] Further, there is usually no obligation on the long party to acquire the shares from the short party when the transaction unwinds; nor does the long party usually have the ability to direct the voting of the short party in respect of those shares. In some cases, a short party will have a policy against voting any shares that it holds as a hedge position.

In the UK, the Financial Services Authority tackled the disclosure issue a few years ago by conducting a consultation and, in June 2009, publishing rules. A detailed analysis of the UK rules are outside the scope of this article. In summary, the rules require any person that enters into a cash-settled total return swap[3] (in UK parlance a "contract for difference") that references a UK-listed share, to disclose its position (or the combined position of its total return swap holdings and physical holdings) once that position is equal to 3 percent of the relevant company's total voting rights subject to permitted exclusion.[4]

In the US, the relevant disclosure regime is set out in the Securities and Exchange Act of 1934 (the "Exchange Act") and its related rules. Recent litigation as well as the enactment of the Dodd-Frank Wall Street Reform Protection Act 2010 (the "Dodd-Frank Act") means that, at present, the applicability of Section 13(d) and 13(g) of the Exchange Act to cash-settled equity total return swaps is unclear and there is still no bright-line rule to follow.

## The Dodd-Frank Act

Section 766(b) of the Dodd-Frank Act amends Sections 13(d) and 13(g) of the Exchange Act to specifically extend beneficial ownership reporting requirements to any person who becomes or is deemed to become a beneficial owner of ***equity securities*** upon the purchase or sale of a security-based swap[5] as defined under Securities and Exchange Commission's ("SEC") rules.

Section 13(d) of the Exchange Act requires a person who acquires, directly or indirectly, beneficial ownership of more than 5 percent of certain classes of equity securities registered under the Exchange Act to file, within ten calendar days of such acquisition, a report with the SEC. Section 13(d), by its extension through Section 766(b) of the Dodd-Frank Act, could require the long party to a cash-settled equity total return swap whose swap referenced a notional amount of equity securities that, when aggregated with other equity securities, if any, beneficially owned by the long party, constitute at least 5 percent of the total outstanding shares of that class (and assuming that the class of shares was registered with the SEC), to make disclosures to the SEC as if it owned the shares.

The Exchange Act does not define the concept of "beneficial ownership," however, the SEC has promulgated rules defining a beneficial owner as someone who (i) possesses either voting power (the power to vote or direct others to vote the security) or investment power[6] (the power to dispose of or direct the disposition of the security) or (ii) uses a contract, device or any other arrangement as part of a scheme to evade reporting requirements, also known as the "avoidance rule."[7]

Section 766(e) of the Dodd-Frank Act adds a new Section 13(o) to the Exchange Act which states that a person is deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap ***only*** if the SEC determines (by rule and after consultation with prudential regulators and the Treasury Secretary) that the purchase or sale of the security-based swap provides incidents of ownership comparable to direct ownership of the underlying equity security and that it is necessary to achieve the purposes of the section that the purchase or sale of a security-based swap, or class of security-based swap, be deemed the acquisition of beneficial ownership of the equity security. To date, the SEC has not exercised its rulemaking authority under Section 13(o). Instead, in its June 2011 release (the "Release") the SEC re-promulgated certain provisions of Rule 13d-3 without change.[8]

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The Release addresses concerns of the SEC that, absent re-adoption of Rule 13d-3, Section 766 could be interpreted to exempt a person dealing in security-based swaps from the reporting requirements of Sections 13(d) and (g) and therefore allow an investor to use a security-based swap to obtain an influential or control position in a public company without disclosure. The re-promulgation of the rules preserves the application of existing beneficial ownership rules to persons who purchase or sell security-based swaps after the effective date of new Section 13(o) (i.e., July 16, 2011). As applied to security-based swaps, the SEC has confirmed that under Rule 13d-3, a person is considered a beneficial owner of an equity security underlying a security-based swap if any of the following apply:[9]

- The security-based swap provides a person, directly or indirectly, with exclusive or shared voting and/or investment power over the underlying equity security (whether or not such person has acquired the underlying equity security) (Rule 13d-3(a)).[10]

- A person uses the security-based swap as a means to divest or prevent the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements of Sections 13(d), 13(g) or 16 of the Exchange Act (Rule 13d-3(b)).

- The security-based swap gives a person the right to acquire the underlying equity security within 60 days or holds the right with the purpose of changing or influencing control of the issuer of the underlying equity security (Rule 13d-3(d)(1)).

In the Release, the SEC expressly states that the re-adoption of the rules is intended only to preserve the regulatory status quo and that the SEC staff is "engaged in a separate project to develop proposals to modernize reporting under Sections 13(d) and (g)." This suggests then that, although at present long parties to total return swaps seem to have escaped the disclosure obligations of the Exchange Act, the relief may be short-lived.

## The CSX Decision

In July 2011, the appeals court for the second circuit issued its opinion in the case of *CSX Corporation v. The Children's Investment Fund Management et al*. The opinion was much-anticipated by the derivatives market looking for clarification, or at least guidance, as to whether the long party to a cash-settled equity total return swap could be deemed to be the beneficial owner of shares held by the short party for the purposes of Section 13(d). No such clarification was forthcoming.

The case was first brought in March 2008 by CSX Corporation ("CSX") against The Children's Investment Fund Management (UK) LLP ("TCI UK"), The Children's Investment Fund Management (Cayman) Ltd., ("TCI Cayman" and together with TCI UK, "TCI"), 3G Fund L.P., ("3G Fund"), 3G Capital Partners L.P., ("3G LP") and 3G Capital Partners Ltd., (together with 3G Fund and 3G LP, "3G" and 3G, together with TCI, the "Funds"). The circumstances of the case are as follows: TCI and 3G, both hedge funds, accumulated positions (both by direct cash investments and through total return swaps) in CSX and later sought to elect a minority of candidates to the board of CSX at CSX's annual shareholders' meeting in early 2008. CSX filed suit against the Funds claiming that the Funds had failed to comply with the disclosure requirements of Section 13(d) of the Exchange Act and seeking an injunction against the Funds, barring them from future violations of Section 13(d) and preventing them from voting their shares at the CSX annual shareholders' meeting. The District Court held that the Funds had violated Section 13(d) and granted an injunction against future violations but did not enjoin the funds from voting the CSX shares. Unsurprisingly, appeals and cross-appeals followed.

The general basis of CSX's claim was that TCI breached Section 13(d) because it failed to disclose its beneficial ownership of the CSX shares held by its counterparty (the short party to the swap transaction) that were referenced in cash-settled equity total return swaps and that 3G and TCI together violated Section 13(d) by failing to disclose the formation of a group.[11] CSX argued that the total return swaps referencing CSX shares

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vested beneficial ownership in the Funds of the CSX shares held by the bank counterparties and therefore triggered disclosure obligations under Section 13(d) on the part of the Funds.

The opinion issued by the District Court[12] in June 2008 held that TCI violated its disclosure obligations under the Exchange Act. This holding was of concern to the swaps market. In its opinion, the District Court deemed TCI to be the beneficial owner of all CSX shares held by its total return swap counterparties. In determining whether TCI was the beneficial owner of the CSX shares held by the various bank counterparties, the District Court considered Rule 13d-3(a) (whether TCI had investment or voting power) and Rule 13d-3(b) (whether TCI engaged in avoidance of disclosure obligations). Ultimately the District Court decided the issue on the grounds of avoidance under Rule 13d-3(b) and deemed TCI to be the beneficial owner of the relevant shares because TCI had created and used the swaps with the purpose and effect of preventing the vesting of beneficial ownership as part of a scheme or plan to evade the applicable reporting requirements. The District Court focused on TCI's history of spreading the swaps around so that no one bank counterparty maintained positions of 5 percent or more and TCI's practice of transferring the swaps to banks that TCI believed were favorably disposed to its voting preferences. As noted above, the District Court's decision was based on Rule 13d-3(b) and specific facts that tended to show that TCI had tried to avoid the disclosure regime. Importantly, the District Court did not base its decision on Rule 13d-3(a) and therefore **did not rule** on whether owning a long position in a swap necessarily vests beneficial ownership, leaving the issue open for future determination and therefore creating uncertainty in the swaps market. No wonder the decision of the Court of Appeal was eagerly awaited.

Unfortunately, the Court of Appeal chose not to determine when a party to a cash-settled equity total return swap must comply with the disclosure requirements of Section 13(d), citing disagreement within the panel. The Court of Appeal instead chose to consider only whether a group violation of Rule 13d-3 had occurred with respect to the CSX shares held outright by the Funds. In its judgment, the higher Court remanded the issue of group violation to the District Court, citing the need for specific evidence of whether a group existed for purposes of the CSX shares that were held outright by the Funds. The Court of Appeal held that, because the District Court's finding that a group violation had occurred was based upon the combination of shares held outright by the Funds and those shares that the District Court deemed the Funds to beneficially own, further review was required to assess whether a group violation had occurred only with respect to shares held outright by the Funds. The majority decision of the higher Court did not focus on the beneficial ownership issue at all. Judge Lewis Kaplan, in the Court's majority opinion, explained that ultimately it was unnecessary to explore the issue of beneficial ownership as the case was decided on the basis of whether a group had formed within the meaning of Section 13(d). The opinion of the Court of Appeal therefore gave no clear answer as to the question of beneficial ownership by long parties to a total return swap.

Perhaps of more interest to the derivatives market are the comments of Judge Ralph K. Winter in his concurring opinion.[13] While the concurring opinion is not binding, Judge Winter's opinion specifically addresses the question of beneficial ownership and provides a well-reasoned analysis as to the circumstances in which a long party to an equity total return swap could be treated as the beneficial owner of the short party's shares. In his concurring opinion, Judge Winter analyzed each of the relevant parts of Rule 13d and effectively refuted the arguments put forward by the District Court on the issue of beneficial ownership.

Rule 13d addresses the issue of a person obtaining control or influence over the issuer of equity securities:

## Investment Power – Rule 13d-3(a)

CSX argued that TCI had investment power over the CSX shares owned by its counterparties because TCI knew that those counterparties would purchase CSX shares to hedge their short positions and would then sell such shares once

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the swap transaction matured.[14] In Judge Winter's view, simply knowing or expecting that a person may purchase or sell shares is insufficient to attribute investment power to another. A counterparty can choose to hedge all, some or none of its short position and may do so by purchasing shares, entering into hedges or both. Therefore Judge Winter reasoned that, in the absence of some other agreement governing disposition of the shares, simply having a long position does not constitute having investment power either directly or indirectly.

## Voting Power – Rule 13d-3(a)

As noted above, there is no evidence that TCI's counterparties agreed to vote their CSX shares in accordance with the instructions of TCI, nor was this suggested at the original hearing. CSX argued that TCI selected its swap counterparties on the basis of which way TCI believed those counterparties would vote their shares. Judge Winter opined that voting power requires more than a belief or expectation that a party will vote in a certain way or the selection of a counterparty that is more inclined to vote in a manner favorable to the long party's interests, even if coupled with evidence that the counterparty was chosen because it is viewed as holding sympathetic voting objectives; holding such views is not the same as having the ability to control voting.

In reaching his conclusions as regards Rule 13d-3(a), Judge Winter focused particularly on the language of the Exchange Act and current SEC rules. Judge Winter pointed out that the language of the Exchange Act does not require disclosure of the intent to obtain control or an equity position of influence, but instead requires precise action. In Judge Winter's view, the doctrine of harmonization of interpretation required him to look to interpretations of and case law related to Section 16 of the Exchange Act in interpreting Section 13(d), as both rely fundamentally on the concept of beneficial ownership.[15] Judge Winter's opinion focused on the fact that in 1991, the SEC harmonized Section 16's interpretation of beneficial ownership with the corresponding provision of Section 13(d) and concluded that such case law should be used to interpret Section 13(d). In so interpreting, Judge Winter found a largely mechanical interpretation that does not focus on the "intent" of the actors.

## Avoidance Rule – Rule 13d-3(b)

Judge Winter acknowledged that one purpose of total return swaps could be to avoid disclosure. However, he argued that a desire to avoid disclosure is not, in and of itself, sufficient to be caught by Rule 13d-3(b). Such desire must be coupled with the prevention of the vesting of beneficial ownership and that such evasion is not present where the swap provides no means of control.

## SEC Regulatory Authority

In concluding, Judge Winter noted that in 2002, Congress[16] stated that the SEC had no authority to regulate security-based swaps but that with the passing of the Dodd-Frank Act, the SEC now holds such authority. The Dodd-Frank Act came into force after the District Court's 2008 decision. Judge Winter noted that the re-promulgation of Rule 13(d) by the SEC addressed SEC concerns that it previously had no authority to regulate security-based swaps and that without re-promulgation, Rule 13(d) would not apply unless the SEC exercised its authority under Section 13(o) of the Dodd-Frank Act. Judge Winter argues, therefore, that the District Court had no legal basis for deciding that Section 13(d) applied to the total return swaps as the SEC had no power at that time to regulate such instruments.

It remains to be seen whether and how the SEC will finally clarify the issue by promulgating rules under its Section 766 powers or whether the District Court will revisit this issue when it reviews certain aspects of the case on remand.

There remains as much uncertainty in the market regarding beneficial ownership issues around cash-settled equity total return swaps as existed both prior to the CSX case and the enactment of the Dodd-Frank Act. While it is clear that physically settled total return swaps trigger beneficial ownership in the underlying shares on the part of the long party, there is no bright-line rule as regards cash-settled total return swaps. What is

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clear is that, until the SEC exercises its authority under Dodd-Frank, whether beneficial ownership attaches with respect to cash-settled equity total return swaps will be highly fact-specific. Holding the right to direct the voting of the underlying shares or to acquire such shares will tend to show that beneficial ownership exists; on the other hand, a specific provision in any documentation that specifically renounces all voting rights would tend to suggest the opposite. For now, long parties should exercise caution in exercising any sort of control over the underlying shares held by their counterparty.

**NOTES**

1 Ian Cuillerier is a partner and Claire Hall is an associate in the derivatives practice of White & Case. Ian is based in the New York office and Claire is based in the Los Angeles office.

2 Alternatively, the short party may hedge by entering into an off-setting total return swap, or use a combination of the two approaches assuming the short party desires to hedge some or all of its position.

3 Note that physically settled equity total return swaps were, and continue to be, covered by the UK disclosure regime and therefore a counterparty to a physically settled equity total return swap has disclosure obligations.

4 The UK requirements can be found in Chapter 5 of the UK Disclosure and Transparency Rules.

5 The definition of security-based swap was added to the Exchange Act by Section 761(a) of the Dodd-Frank Act and is defined as a swap on a narrow-based security index, a single security, loan or interest in a loan, or the occurrence or non-occurrence of an event relating to a single security or narrow-based security index that directly affects the financial statements, condition or obligations of the issuer; Section 712(d) of the Dodd Frank Act requires the SEC, together with the Commodity Futures Trading Commission (the "CFTC"), to jointly further define certain terms, including the term "security-based swap." The SEC and CFTC have published several notices of proposed rulemaking relating to such defined terms although final definitions have not yet been published. As drafted, the currently proposed definition of security-based swap would include a cash-settled equity total return swap.

6 Rule 13d-3(a).

7 Rule 13d-3(b).

8 See *Beneficial Ownership Reporting Requirements and Security-Based Swaps*, Release No. 34-64087 [76 FR 15874] and *Beneficial Ownership Reporting Requirements and Security-Based Swaps* Release No. 34–64628 [76 FR 34579].

9 The Rule 13d-3 standards are applied on a case-by-case basis to determine whether a person is or becomes a beneficial owner. A physically settled trade or a cash-settled trade that specifically allows a long party to direct voting could be caught by the disclosure requirements and legal advice should be sought in each case.

10 As noted above, the long party typically has no voting rights over the underlying shares and the short party may not actually own the referenced shares.

11 From October 2006, TCI entered into total return swaps relating to approximately 14 percent of the outstanding common stock of CSX and over that time also accumulated a physical stake of about 4.2 percent. Separately, 3G built a combined physical and synthetic position in CSX of just less than 5 percent.

12 *CSX Corp. v. The Children's Investment Fund Management (UK) LLP et al.*, 562 F Supp 2d 511 (S.D.N.Y.) June 11, 2008).

13 A concurring opinion is one that agrees with the decision of the court, but sets out a judge's personal view of certain aspects of the decision and such judge's reasoning in reaching the decision. The majority opinion is binding law however, although a concurring opinion does not carry the same precedential weight as a majority opinion, it may be cited in future cases as guidance to the court.

14 It was accepted in the case that short counterparties generally do purchase the underlying shares as a means of hedging their short positions.

15 Section 16 of the Exchange Act requires disclosure by certain company insiders that are beneficial owners of 10 percent of a company's shares.

16 By way of the Commodity Futures Modernization Act of 2000 (the "2000 Act").

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