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Decision in *CSX* on Derivatives and Beneficial Ownership Reporting
Requirements – Extreme Caution Flag and Roadmap for Regulatory Reform

In a major judicial statement on a key tactic used by activist stockholders, Judge Lewis A. Kaplan's opinion yesterday in *CSX Corporation* v. *The Children's Investment Fund Management (UK) LLP, et al. (S.D.N.Y.)*, powerfully makes the case for regulatory reform to address the prevalence of derivative positions that impact the overarching Williams Act goal of alerting the marketplace to significant stock accumulations that may signal a corporate control shift. At the same time, the decision also takes a large step forward toward filling the current gap in regulation with interpretive doctrine that will protect the securities markets and the cause of public disclosure as contemplated by the Williams Act. While the opinion did not resolve whether under current SEC regulations the long side of cash-settled total return swaps – entered into for substantial portions of a company's outstanding shares, in circumstances where a control purpose can reasonably be supposed – can itself convey beneficial ownership of its counterparty's hedge shares, it cogently documents the uses and abuses of derivatives by activist stockholders and lays bare the strong need for regulatory reform. Indeed, the Court's fact-specific ruling that TCI's swaps (covering over 14% of CSX's shares, with eight separate counterparties, and a notional value in excess of $2.5 billion) ran afoul of the "anti-evasion" provision of current SEC Rule 13d-3(b) should be read as a clear warning against continued attempts by activist stockholders to use derivatives to evade public reporting. The analysis in the opinion underscores that regulatory reform is best undertaken via the rulemaking process, which can provide certainty and uniformity to all market participants – rather than fact-specific adjudications applying existing regulatory concepts in a necessarily *post hoc* and *ad hoc* manner.

Judge Kaplan's opinion catalogues the advantages an activist stockholder obtains by utilizing swaps to avoid public disclosure: maximizing the activist's profit potential by avoiding the market bidding up the shares in anticipation of a control contest; allowing the activist to time strategically the disclosure of its intent to influence corporate policy (in the Court's word, "it permits a long party to ambush an issuer with a holding far greater than 5 percent"); and enabling the activist to swiftly acquire the referenced shares by unwinding the swaps in-kind at the time of its choosing should the counterparty consent to do so (or, even if settled in cash, timing the counterparty's disposition of the hedge into the market to suit the activist's goals).

While TCI had no legal right to vote or dispose of the hedge shares – the two indicia of beneficial ownership under current SEC regulations – the Court noted that existing precedent requires inquiry into whether there exists a significant ability to affect how voting and investment power will be exercised. Despite the absence of any contractual obligation on the counterparty's part to acquire shares as a hedge or to make shares available in the unwind of the swaps, the Court found that TCI in fact intended that the counterparties would hedge on a virtual share-for-share basis (as they in fact did). The Court noted that "[n]one of these counterparties is in the business, so far as running its swap desk is concerned, of taking on the stupendous risks entailed in holding unhedged short (or long) positions in significant percentages of the shares of listed companies." Similarly, the opinion notes that the option available to TCI and its counterparties to unwind in kind (as the Court put it, by nothing more than "the stroke of a pen or the transmission of an email") meant that "the hedge positions of the counterparties hang like the sword of Damocles over the neck of CSX."

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The Court found no explicit agreement concerning the voting of hedge shares and observed that institutional policies vary (ranging from not voting at all, to permitting counterparty influence on the vote, to voting in their sole discretion, to having no policy). Nonetheless, the Court observed that substantial hedge positions necessarily "significantly alter[] the corporate electorate" in one of three ways: by eliminating the hedge shares from the voting universe; by subjecting their voting to the control or influence of the counterparty; or placing the vote in a financial institution that has no economic interest in the issuer but knows that its future swap business may depend on voting in the "right" manner from the perspective of the swap counterparty.

The opinion stopped short of deciding the beneficial ownership question per se, choosing instead to rely on the anti-evasion rule of SEC Rule 13d-3(b) to hold that TCI was "deemed" to be the beneficial owner of the hedge shares. Under Rule 13d-3(b), any person who uses a contract, arrangement or device with the purpose of preventing the vesting of beneficial ownership as part of a plan or scheme to evade the disclosure required by outright ownership is deemed to be the beneficial owner of the shares. The Court found there to be "overwhelming" evidence that TCI had created and used the swaps for primarily that purpose.

Judge Kaplan's opinion also highlights the substantial relationships and parallel investments often carried out – in most cases surreptitiously – by activist funds seeking to influence corporate control, and found that TCI and 3G Capital Partners had formed a group at least ten months before making any disclosure. Constrained by binding precedent, and in light of the fact that corrective disclosure had already been made, Judge Kaplan declined to enjoin voting of the CSX stock acquired while in violation of Section 13(d); however, Judge Kaplan explicitly noted that if the Court "were free to grant [sterilization], it would exercise its discretion to do so." Judge Kaplan ultimately enjoined defendants from future violations of Section 13(d).

Whether or not an appeal or other further proceedings in the *CSX* case yields additional learning or a stronger form of remedy, Judge Kaplan's decision is a strong challenge to the use of derivatives by activist stockholders bent on concealing their true economic position for their own ends. The opinion greatly illuminates the need for thorough regulatory reform, noting the evidence that use of derivatives has become "a standard technique [in the hedge fund industry] to avoid disclosure" of large stakes in public companies. The Court's emphasis on eschewing "formalistic arguments" in favor of "the purpose of the law" provides an excellent guidepost for that reform. In Judge Kaplan's words: "The securities markets operate in the real world, not in a law school contracts classroom. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse."

In the meantime, even pending a more comprehensive regulatory reform, it will be prudent for holders of economic ownership equivalent positions of more than 5% to make prompt public disclosure just as would be required for holdings of actual shares, and for public companies to insist on such disclosure for the benefit of their shareholders and the securities markets.

Theodore N. Mirvis
Adam O. Emmerich
William Savitt
Adam M. Gogolak