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SEC Staff Advises that 13D Disclosure Requirements Do Not Extend to Total Return Equity Swaps

The Staff of the SEC has sided with an activist hedge fund investor – and against a 13D disclosure requirement for holders of cash-settled total return swaps – in litigation relating to a proxy fight between the investor and CSX Corp. *CSX Corporation* v. *The Children's Investment Fund Management (UK) LLP, et al.* (S.D.N.Y., No. 08 Civ. 02764). At issue is whether TCI violated § 13(d) by failing to disclose beneficial ownership of CSX shares referenced in cash-settled, total return equity swaps. TCI entered into swaps with eight counterparties, which in aggregate gave TCI economic upside on a position equivalent to more than 14% of CSX's shares, with a notional value in excess of $2.5 billion. It is alleged that most if not all of the swap counterparties hedged their exposure by accumulating an equal position in CSX shares.

In a June 4 letter to the district court, the Staff of the SEC's Division of Corporation Finance stated that "standard cash-settled equity swap agreement[s]" do not confer either voting or investment power to the swap party over shares acquired by its counterparty to hedge the relevant swaps, a "conclusion [that] is not changed by the presence of economic or business incentives that the counterparty may have to vote the shares as the other party wishes or to dispose of the shares to the other party." The Staff thus rejected CSX's position that the investment funds had acquired beneficial ownership over CSX shares acquired by the counterparties to hedge their exposure to the swaps and were therefore subject to reporting requirements under Rule 13d-3.

The Staff also concluded that the motive of the party entering the swap transaction – whether to avoid reporting requirements or for financial or tax reasons – does not provide a basis for determining whether the party has engaged in an impermissible "plan or scheme to evade" reporting requirements under Rule 13d-3(b). The Staff instead said that "a plan or scheme to evade" exists only when the party enters into a swap or similar transaction with the intent to create a false appearance. Without excluding the possibility of a different rule in certain "rare" or "egregious" situations, the Staff concluded that "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."

It is important to note that the Staff's views do not represent the formal position of the Commission and were tailored to the narrow questions posed by the judge in this litigation. Moreover, the judge is not bound by the Staff's views and it remains to be determined whether the investors in CSX will be found by the court to have improperly avoided their 13D reporting obligations or otherwise engaged in illegal conduct on the particular facts of this case.

Nor does the Staff's letter address the policy implications of the increased use of equity swaps and other synthetic ownership arrangements. As we have written previously, absent reform to account for the increased use of non-traditional derivative and synthetic investment arrangements, § 13(d) and similar disclosure rules will not serve the purpose of alerting the marketplace to rapid and substantial stock accumulations. The difficult technical problems raised in the *CSX* case and the Staff's letter not only confirm the need for regulatory reform, but also suggest that such reform is best undertaken in the context of a considered rulemaking process – providing certainty and clarity to all market participants – rather than through *ad hoc* and necessarily fact-specific litigation.

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