# *CSX Corporation v. The Children's Investment Fund:* Total Return Swaps as Evasions of Section 13(d) Reporting

By J.B. Heaton

The Children's Investment Fund (TCI), a large hedge fund with its principal place of business in London, is best known as a shareholder activist. A shareholder activist invests in companies (referred to as "targets") and then seeks to influence the target to take actions that the shareholder activist believes will increase the value of the shareholder activist's investment in the target. Shareholder activism is socially valuable when it forces targets to take value-increasing actions they might otherwise not have taken.[1]

But shareholder activists face a significant free-rider problem. They invest all or most of the effort in persuading target managements to take value-increasing actions but must share the benefits with passive shareholders who bear none of the costs of that effort. Because target share prices tend to react immediately to news of potential activism,[2] it is difficult for shareholder activists to profit from investments they make after news of their efforts becomes public. This makes it important for shareholder activists to invest secretly, in amounts large enough to make their potential benefits outweigh the costs of their efforts. The ability to accumulate secret positions is limited, however, by laws and regulations that force the disclosure of beneficial ownership of shares within a specified time when beneficial ownership exceeds a certain percentage. In the United States, that time is 10 days on Schedule 13D for active five percent shareholders and 45 days after the end of the calendar year on Schedule 13G for passive five percent shareholders.[3]

## The *CSX* Case

In *CSX Corp. v. Children's Investment Fund Management (UK) LLP*,[4] CSX, the target, accused TCI of violating section 13(d) of the Securities Exchange Act of 1934 (Exchange Act) by failing to disclose its beneficial ownership of shares in CSX. Rule 13d-3(a) defines "beneficial ownership" broadly:

> [A] beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:
> 1. Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
> 2. Investment power which includes the power to dispose, or to direct the disposition of, such security.[5]

TCI successfully defended the charge that it had voting power or investment power over the disputed shares because it held the largest part of its position in total return swaps (TRSs) that only referenced CSX Corporation shares, not the shares themselves.

TCI accumulated TRSs referencing approximately 14 percent of CSX Corporation's shares, and nearly all of TCI's counterparties accumulated shares to hedge those large TRS positions. The court refused to hold that TCI had or shared voting power or investment power over the shares that TCI's counterparties purchased to hedge their short positions in the TRSs. But under Rule 13d-3(b), one is "deemed" a beneficial owner if one "directly or indirectly . . . uses . . . any . . . contract, arrangement, or device with the purpose or effect of . . . preventing the vesting of [beneficial ownership of a security] as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g)[.]" Thus, if TCI used the TRSs (which are contracts) for the purpose or effect of preventing the vesting of beneficial ownership of a security as part of a plan or scheme to evade the requirement of reporting the accumulation of shares of CSX, then TCI should be "deemed" a beneficial owner, and its failure to disclose the shares held by its TRS counterparties was a violation of section 13(d). That failure, if it existed, deprived the capital markets, including CSX, of information to which it was statutorily entitled.

Judge Kaplan held that TCI had indeed used the TRSs for the purpose or effect of preventing the vesting of beneficial ownership of a security as part of a plan or scheme to evade the requirement of reporting the accumulation of shares of CSX. Judge Kaplan observed that the goal of section 13(d) of the Exchange Act "is to alert the marketplace to every large, rapid aggregation or accumulation of securities . . . which might represent a potential shift in corporate control."[7] Although Judge Kaplan did not set out an analysis of the term "evade," the word is well understood in law to mean avoidance of a wrongful kind. For example, in one case, the question was whether a particular transaction had the principal purpose "to evade or avoid liability" for certain pension benefits under 29 U.S.C. § 1392(c), and the court found that "[t]he verb 'evade' means '[t]o escape or avoid by cleverness or deceit.'"[8]

There is at least an argument that there was nothing particularly clever about using TRSs to avoid reporting requirements. The idea that TRSs could provide economic


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exposure while not requiring section 13(d) or (g) exposure had been the subject of commentary for some time.[9] But to the CSX court, the case was really about avoiding disclosure by deceit or concealment where good faith requires disclosure. The court found that TCI understood that the purpose of using TRSs was "the ability to purchase without disclosure to the market or the company":

> TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX, which would have been the product of front-running that it expected would occur if its interest in CSX were disclosed to the market generally. Indeed, TCI acquired only approximately 4.5 percent in physical CSX shares to remain safely below the five percent reporting requirement until it was ready to disclose its position.[10]

But by far the most damning evidence was that TCI had "carefully distributed its swaps among eight counterparties so as to prevent any one of them from acquiring greater than five percent of CSX's shares and thus having to disclose its swap agreements with TCI."[11] Judge Kaplan found that "TCI emails discussed the need to make certain that its counterparties stayed below five percent physical share ownership, this in order to avoiding triggering a disclosure obligation on the part of a counterparty."[12] This was a reasonable finding in light of the purposes of section 13(d). That there was a potential for a shift in corporate control was clear; TCI investigated both the possibility of a leveraged buyout of CSX and the possibility of securing significant board representation. The accumulation of shares in the hands of TCI's counterparties did represent a potential shift in corporate control, not because the counterparties would group together to seek change at CSX, but because TCI was already doing so, especially where TCI's counterparties could settle the swaps by delivering the hedging shares to TCI.

The counterargument, of course, is that TCI's efforts to avoid a five percent accumulation of shares with any particular counterparty was designed not to prevent the vesting of beneficial ownership of the CSX shares with TCI so as to evade the reporting requirements of section 13(d), but instead to ensure that the benefits of nondisclosure legitimately obtained through the use of TRSs was not destroyed by the necessity of a counterparty reporting its own five percent ownership, which in turn would alert the market to someone's interest in economic exposure to CSX.

Commentary such as that by Hu and Black strongly suggests that TCI did not believe it was breaking the law.[13] However, even if TCI did not believe it was breaking the law (and surely it did not; the case is clear that TCI was up front with CSX about its TRSs), Rule 13(d)-3(b) does not require intent to break the law but, rather, intent to avoid disclosure by deception. This intent—evidenced by the effort to spread TRSs out to avoid triggering any disclosure by TCI's counterparties—was reasonably inferred from the evidence, with the court concluding that "[t]he evidence that TCI created and used the TRSs, at least in major part, for the purpose of preventing the vesting of beneficial ownership of CSX shares in TCI and as part of a plan or scheme to evade the reporting requirements of Section 13(d) is overwhelming."[14]

TRSs are derivatives contracts that derive their value by referencing some underlying asset price, interest rate, or index level.* TRSs that reference common stock give their "long" counterparty the right to receive the value of any increase in the price of the underlying shares plus the value of any cash distributions like dividends. TRSs obligate their long counterparty to pay to the "short" counterparty the value of any decline in the value of the shares plus interest. Typically, the short counterparty—usually a swap dealer such as a broker-dealer—purchases actual shares of the underlying stock to hedge the risk of price increases and dividend payments that it faces by being short the TRS. A hedged TRS is economically equivalent to

(1) a loan from the short to the long in an amount equivalent to the current cost of purchasing the shares,
(2) interest paid from the long to the short for that loan,
(3) allowing the short to hold the shares as security against the loan, and
(4) marking the shares to market and paying to each other an amount more or less than the last mark.

* *See generally*, Christopher L. Culp, Risk Transfer: Derivatives in Theory and Practice (2003).

## Unanswered Questions

The *CSX* decision leaves interesting questions unanswered. First, is there any way after *CSX* to secretly accumulate an economic exposure of more than five percent that need not be disclosed under section 13(d)? The answer is yes, but it is unlikely. The problem for TCI was that even if it did not want its TRSs to result in any accumulation of shares for hedging purposes, its counterparties would be unwilling to take on the downside risk of CSX stock except in exchange for a payment that compensated its agreement not to hedge the shares in any way. Hedging by, for example, purchasing call options on the security would likely just push the hedging back to the options dealer and would defeat TCI's goal of achieving economic exposure without share accumulation. It is difficult to estimate the price that an investor like TCI might have to pay a broker-dealer for a TRS that was not to be hedged in any

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way so as to avoid any resulting share accumulation. Secret accumulation of economic exposure would be possible, of course, by paying this amount, but the value of secrecy (i.e., the gains from accumulating large positions before disclosure was required) would have to be large enough to warrant the additional payment.

Second, would a long party to a TRS (which does not itself confer beneficial ownership within the meaning of Rule 13d-3(a)) be willing to report the accumulated shares of its short counterparties if asked? Does the long party have an obligation to do so? The answer seems to be no. Without beneficial ownership, the person is not a beneficial owner under Rule 13d-3(a). But without the purpose or effect of using the TRS to evade the reporting requirements—presuming the long party's willingness, if asked, to report the accumulated shares of its short counterparties—Rule 13d-3(b) places no obligation on the long counterparty to do so. The example highlights the problems of a reporting regime that cannot capture the accumulation of shares from TRSs except when the long counterparty intends to evade reporting, in which case, by assumption, reporting will not be forthcoming. If disclosure of accumulations of shares is desirable, it may be necessary to require the disclosure by a long party of all TRSs that, if hedged, would amount to more than five percent of the outstanding shares of the company whose shares underlie the TRSs.

But if TRSs are contracts that can lead long parties to be "deemed" beneficial owners of their referenced securities (at least when the short counterparty purchased the actual securities as a hedge), how does this fit with the statutory exemption from regulation of TRSs? Under 15 U.S.C. § 78c-1(b)(1), a "security-based swap agreement" is not a "security." Except with respect to disclosure by corporate insiders under section 16(a) of the Exchange Act, the Securities and Exchange Commission is prohibited from "(A) promulgating, interpreting, or enforcing rules; or (B) issuing orders of general applicability; under this title . . . in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement[.]"[15] Although not discussed in *CSX*, this regulatory limitation (versus sympathy with those using TRSs) may have motivated the opposition of the Division of Corporate Finance to any finding that TRSs give beneficial ownership to their long parties.[16] Had the commission argued otherwise, it would have been in the uncomfortable position of arguing that TRSs gave beneficial ownership of securities despite being outside its regulatory jurisdiction.

## Conclusion

Judge Kaplan began his *CSX* opinion with the following tough language:

> Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law.

Especially where the relevant law provides for liability when there is intent to evade a legal requirement, *CSX* serves as a reminder that such provisions are designed to sweep up those who are a little too clever about "the line dividing legal from illegal," however much they may genuinely hope to stay on the right side of the line. That is the takeaway from *CSX* for lawyers advising clients such as hedge funds, which, out of a combination of powerful financial incentives and fiduciary duties to their investors, seek every possible legal advantage in the extremely competitive capital markets. ✺

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1. *See, e.g.*, Alon Brav, Wei Jang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008).
2. *See id.*
3. 17 C.F.R. § 240.13d-1.
4. CSX Corp. v. Children's Investment Fund Management (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008).
5. 17 C.F.R. § 240.13d-3(a).
6. *CSX*, 562 F. Supp. 2d at 550 (citing 204 Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 380 (2d Cir.1980)).
7. SUPERVALU, Inc. v. Bd. of Trs. of Sw. Pa. & W. Md. Area Teamsters & Employers Pension Fund, 500 F.3d 334, 344 (3d Cir. 2007) (citing AM. HERITAGE DICTIONARY 634 (3d ed. 1992)); accord United States v. Scharton, 285 U.S. 518 (1932) ("'Evasion' implies avoidance by device or strategy or concealment where good faith requires disclosure. . . .").
8. *See, e.g.*, Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, Reforms*, 61 BUS. LAW. 1011 (2006) (discussing the problem of Schedule 13D and 13G reporting of shares used to hedge equity derivatives).
9. *CSX*, 562 F. Supp. 2d at 549.
10. *Id.* at 529.
11. *Id.* at 549.
12. See Hu & Black, *supra* note 11.
13. *CSX*, 562 F. Supp. 2d at 548–49.
14. 15 U.S.C. § 78c-1(b)(1)(A), (B).
15. *See, e.g., CSX*, 562 F. Supp. 2d at 547.


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