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Appellate Decision in the *CSX* Case Highlights Need for SEC Action on Derivatives in Section 13(d) Reporting Requirements

A divided panel of the U.S. Court of Appeals for the Second Circuit has finally issued its opinion in the *CSX* case in which the District Court addressed whether the long party in a cash-settled total-return equity swap should be considered the beneficial owner of the underlying shares for reporting purposes under Section 13(d) of the Williams Act. (See our memo of June 2008 on the District Court's decision.) The majority opinion — issued nearly three years after the appeal was argued — declined to resolve the beneficial ownership issue, noting that there was disagreement within the panel on the subject. Instead, the panel considered only whether a "group" had been formed under Section 13(d) as to the shares held outright by the defendant activist funds. The majority opinion also addressed whether and under what circumstances a party should be precluded from voting shares acquired during a period when it was in violation of its disclosure obligations under Section 13(d). *CSX Corp.* v. *The Children's Inv. Fund Mgmt. (UK) LLP*, Docket Nos. 08-2899-cv, 08-3016-cv (2d Cir. July 18, 2011).

As to the District Court's finding of a "group," the majority opinion, by Judge Newman, found insufficient for appellate review the District Court's finding that a group was formed by the activities of the two funds (TCI and 3G) that suggested "concerted action" vis-à-vis CSX. The Court therefore remanded the case to the District Court for additional findings on that limited subject, as well as to reconsider the appropriateness and scope of any injunctive relief should a group violation of Section 13(d) be found with respect to the purchase of shares outright. In connection with its consideration of the group issue, the majority ruled that "activities" resulting from group action were insufficient to form a group unless — in the words of the rule — the group "act[s] together for the purpose of acquiring, holding, voting or disposing" of equity securities of the issuer.

As to the availability of injunctive share "sterilization," the majority opinion adhered to prior precedent holding that an injunction prohibiting the voting of shares acquired while in violation of Section 13(d)'s reporting requirements was not an available remedy if the required disclosure is ultimately made in sufficient time for informed action by shareholders. The opinion rejected the arguments that sterilization may be necessary to provide a "level playing field" and to deter violations of Section 13(d), relying in part on the policy notion that sterilization might injure those stockholders who, after full disclosure, choose to support an insurgent's program.

Judge Winter filed a separate opinion concurring in the result, and, unlike the majority opinion, directly addressed the issue as to whether the long party in a total-return swap transaction may be deemed to beneficially own the shares purchased as a hedge by the short counterparty. Judge Winter's opinion rejected the District Court's view that equity swaps are (in Judge Winter's words) "an underhanded means of acquiring or facilitating access to [shares] that could be used to gain control through a proxy fight or otherwise." Judge Winter instead writes that, absent an agreement on acquiring or voting the short party's hedge position, "such swaps are not a means of indirectly facilitating a control transaction. Rather, they allow parties such as

the Funds to profit from efforts to cause firms to institute new business policies increasing the value of a firm." Judge Winter rejected the position that the shares acquired by the swap dealer to hedge the swap should be deemed beneficially owned by the long party based on a review of the statutory language; other legislation that has addressed swaps — including Dodd-Frank, which granted new authority to the SEC to promulgate rules providing that "a person [] be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap"; and the SEC's ongoing and, as yet, inconclusive consideration of derivatives and beneficial ownership under Section 13(d), including its recent repromulgation of Rule 13d-3.

The *CSX* majority's determination not to address whether the long party to a total-return swap may be deemed, for purposes of Section 13(d), the beneficial owner of the underlying shares underscores the need for SEC action. We have previously set forth detailed proposals on the subject, and continue to believe that SEC action is both necessary and overdue. (See our memos of March 3, 2008, March 7, 2011, and April 15, 2011.) The concluding statement in Judge Winter's concurrence eloquently articulates the need for SEC leadership on the issue:

> Total-return cash-settled swap agreements can be expected to cause some party to purchase the referenced shares as a hedge. No one questions that any understanding between long and short parties regarding the purchase, sale, retention, or voting of shares renders them a group — including the long party — deemed to be the beneficial owner of the referenced shares purchased as a hedge and any other shares held by the group. Whether, absent any such understanding, total-return cash-settled swaps render a long party the beneficial owner of referenced shares bought as a hedge by the immediate short party or some other party down the line is a question of law not fact. At the time of the district court opinion, the SEC had no authority to regulate such "understanding"-free swaps. It has such authority now, but it has simply repromulgated the earlier regulations. These regulations, and the SEC's repromulgation of them, offer no reasons for treating such swaps as rendering long parties subject to Sections 13 and 16 based on shares purchased by another party as a hedge. Absent some reasoned direction from the SEC, there is neither need nor reason for a court to do so.

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