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OSC Notice Suggests Growing Interest in Disclosure of Equity Swap Positions

In the Ontario Securities Commission's ("OSC") Corporate Finance Branch Report (OSC Staff Notice 51-706) (the "Notice") issued September 12, 2008, under the heading "Developing Issues", the OSC stated that it is aware of studies which indicate that equity swaps and similar strategies are being used by sophisticated investors to build up significant economic positions in issuers while avoiding triggering public disclosure requirements.

Section 102.1 of the *Ontario Securities Act*[1] generally requires disclosure of an acquisition of voting or equity securities (or securities convertible into voting or equity securities) which results in the acquiror holding more than 10 percent of the outstanding securities of a class of an issuer (or 5 percent in certain cases while a bid for securities is outstanding). The disclosure requirement is with respect to securities that are beneficially owned, or over which control or direction is exercised.

The Notice states that OSC staff are aware that other jurisdictions have introduced reforms to their disclosure requirements in response to the strategies noted above and that a review of "the potential use of derivatives to avoid early warning requirements and similar securities law requirements based on the concepts of beneficial ownership and control or direction" is underway.

The OSC staff's review may have been prompted by recent developments in other jurisdictions, including the recent decision of the United States District Court for the Southern District of New York (the "Court") in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP et al.*[2] ("CSX") and the different result reached in that case from the OSC's decision in *Sears Canada Inc., Re*[3] ("Sears").

[1] R.S.O. 1990, c. S-5.
[2] 562 F. Supp. 2d 511 (S.D. N.Y.).
[3] (2006), 22 B.L.R. (4th) 267 (OSC).

CSX Corporation v. The Children's Investment Fund Management (UK) LLP et al.

In CSX, the Court was asked to decide whether there was a failure to satisfy reporting requirements where the use of derivatives provided an economic interest in an issuer. The defendant hedge funds had acquired a significant economic interest in CSX Corporation without acquiring legal ownership of shares by entering into cash-settled equity total return swaps. The funds' goal was ultimately to elect a number of directors to the CSX Corporation board. The Children's Investment Master Fund ("TCI") in particular had built up a large economic interest through the use of such swaps. TCI had been careful to engage in swaps with a number of counterparties, each swap representing an interest in fewer shares than would be required to trigger any reporting or disclosure obligation for any individual counterparty.

Of interest in the decision was the indication that the Court may have been prepared to treat an economic interest in securities through cash-settled equity total return swaps as constituting beneficial ownership for the purpose of public disclosure requirements.

The Court reasoned that TCI knew that its counterparties would be required to purchase and sell shares of CSX Corporation based on the number of shares referenced by the swaps in order to hedge their respective positions. The Court also analyzed the level of control TCI exerted over the votes associated with the reference shares. While the Court did not ultimately decide the issue, the Court found that although there was nothing in the swap agreements requiring the counterparties to vote the CSX Corporation shares with TCI, or at all, TCI was aware of the voting habits of its counterparties and in fact shifted its interest towards those counterparties more likely to vote in its favour as the proxy battle neared.

While the Court ultimately did not address whether the cash-settled equity total return swaps represented beneficial ownership of the reference shares under the applicable securities regulations,[4] the Court deemed the defendants to have acquired beneficial ownership based on applicable anti-avoidance provisions.

The CSX case has been heard on appeal by the United States Court of Appeals for the Second Circuit which recently released a summary order affirming part of the Court's decision. A full opinion is forthcoming.[5]

Re Sears Canada Inc.

In Ontario, the use of cash-settled equity total return swaps in the context of a take-over bid was considered by the OSC in a case predating the CSX decision by nearly two years.

On August 8, 2006, the OSC released its decision in Sears in which it considered whether the early warning requirements for take-over bids had been complied with in the context of a going private transaction. The OSC also considered whether the use of cash-settled equity total return swaps to avoid public disclosure of a position in an issuer was "abusive of the capital markets" so as to engage the OSC's public interest jurisdiction.

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[4] The applicable rule is Rule 13d-3(a) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.13d–3(a) (2007):

> For the purposes of sections 13(d) and 13(g) of the Act 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] The appeal was heard by the Court of Appeals in August 2008. On September 15, 2008, in a summary order, the United States Court of Appeals for the Second District affirmed the lower court's decision not to enjoin the voting of the shares. Only this issue was decided and a full opinion dealing with all issues raised in the appeal will follow. *CSX Corporation v. The Children's Investment Fund Management (UK) LLP et al.*, 2008 U.S. App. LEXIS 19788 (2nd Cir. 2008).

Sears Holdings Corporation, the majority shareholder of Sears Canada Inc., offered to acquire all of Sears Canada Inc.'s outstanding shares but was opposed by a number of hedge funds, including some which held significant economic interests in Sears Canada Inc. through positions in cash-settled equity total return swaps.

The OSC found that the hedge funds did not have any disclosure obligations under the relevant early warning requirements as there was insufficient evidence to hold that the cash-settled equity total return swaps gave the hedge funds beneficial ownership or control or direction over the Sears Canada Inc. shares. In particular, the OSC noted the lack of evidence of any understanding between the hedge funds and the swap counterparties that shares used to hedge the swaps would be made available to be voted by the funds.

With respect to whether the hedge funds' actions were "abusive of the capital markets", the OSC similarly found that there was insufficient evidence to indicate that the conduct was abusive. However, the OSC indicated that there

> "might well be situations, in the context of a take-over bid, where the use of swaps to "park securities" in a deliberate effort to avoid reporting obligations under the [Securities] Act and for the purpose of affecting an outstanding offer could constitute abusive conduct sufficient to engage the Commission's public interest jurisdiction."

The submissions of the OSC staff to the OSC on the matter were consistent with the OSC's decision. Staff submitted that, although the funds' total economic interests exceeded the 10% early warning reporting threshold, the funds were not off-side their reporting obligations.

With respect to exercising control over the reference shares, OSC staff noted that if there was an understanding with the swap counterparty to vote the shares, or to make them available to be voted, then the fund should be considered to exercise control over the reference shares for the purpose of calculating the extent of its holdings. However, OSC staff cited Australian and New Zealand decisions where cash-settled equity total return swaps were found not to shift control to the swap participant.[6] The New Zealand court found that even though the "commercial reality" was that the shares could be re-acquired on demand, this did not give rise to an enforceable agreement. In the Australian case, the court determined that *de facto* power to control the shares did not amount to an interest that would trigger that jurisdiction's disclosure obligation.

Finally, while it was the submission of OSC staff that the use of swaps in a deliberate effort to avoid reporting for the purposes of affecting an offer may constitute abusive conduct, they were unconvinced that in the case at hand the funds' disclosure practices "were sufficiently abusive of the capital markets to engage the [OSC]'s public interest jurisdiction."

Conclusions

The OSC's decision and the OSC staff's submissions in Sears suggest that there is generally nothing requiring market participants to disclose positions represented solely by cash-settled equity total return swaps, provided that the "control" thresholds were not met through voting arrangements or otherwise, and so long as such positions were not so egregious as to invoke the OSC's public interest jurisdiction.

However, the more recent U.S. federal court decision in CSX together with the OSC Corporate Finance Branch staff's recent interest in this matter as identified in the Notice suggests that participants should be cautious about engaging in such transactions if the aggregate number of shares of a single issuer referenced by such transactions would exceed the applicable disclosure threshold and that future clarification or amendments may be forthcoming.

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[6] *Glencore International AG (ACN 114 271 055) v. Takeovers Panel*, [2006] FCA 274; *Ithica (Custodian) Ltd. v. Perry Corporation*, [2004] 1 N.Z.L.R. 731 (N.Z.C.A.).

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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