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Swaps and Section 16: Reporting and Liability Issues

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TOTAL RETURN, CASH-SETTLED EQUITY SWAPS, or “TRSs,” have been used by activist investors to build their economic exposure in target companies in addition to, or in lieu of, taking a direct ownership stake in the target.¹ The use of these derivatives can give rise to complex issues for activists who find themselves subject to Section 16 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Where the potential for becoming a Section 16 insider exists, investors should understand how their TRS positions and the complexity of these instruments can impact their reporting obligations under Section 16(a), along with their potential for Section 16(b) profit disgorgement liability, lest they stumble into reporting delinquencies and/or liability exposure.

Section 16 of the Exchange Act applies to “insiders” of any issuer, which term includes (i) any beneficial owner² of more than 10% of a class of voting equity securities that is registered under Section 12 of the Exchange Act and (ii) any executive officer or director of any issuer with a class of voting equity securities that is registered under Section 12 of the Exchange Act.

Typically, investors limit their beneficial ownership of an issuer’s equity securities to stay below the 10% threshold of Section 16. However, Section 16 can be implicated even in instances where an investor does not take any action to put itself over the 10% threshold. For example, an investor can become a greater-than-10% owner as a result of an issuer buyback

of securities and unwittingly find itself subject to Section 16. Here, the investor may only become aware that it has become a greater-than-10% beneficial owner when the issuer publicly discloses the buyback, at which point the investor will immediately become subject to Section 16 and must file a Form 3 to disclose its holdings in the issuer’s equity securities within ten days.

Additionally, if an activist investor successfully nominates a representative for election to the board of directors of a target, the investor could become subject to Section 16 if it is shown that the investor’s director-nominee serves as its deputy on the board (a so-called “director by deputization”). In such a case, the investor itself could also be treated as a director of the issuer for purposes of Section 16. Finally, the June 2008 decision in *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al.*³ resulted in the investor defendants being deemed to beneficially own the shares of common stock referenced by their TRSs, which were purchased and held by their TRS counterparties to hedge their TRS exposure, thereby putting them over the 10% threshold of Section 16.⁴

1 It should be noted that in light of the June 2008 decision in *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), there is uncertainty with respect to whether investors are required to include the shares underlying their TRS positions in their beneficial ownership calculations for purposes of Section 13 and Section 16 of the Exchange Act. The court in *CSX* found that the investors beneficially owned, under Rule 13d-3(b), the shares of common stock referenced by their TRSs which were purchased and held by their TRS counterparties to hedge their TRS exposure, because they accumulated and used their swap positions in the equity of CSX Corporation “with the purpose and effect of preventing the vesting of beneficial ownership...as part of a plan or scheme to avoid the reporting requirements of Section 13(d).” *Id.* at 553. This case is currently under appeal to the United States Court of Appeals for the Second Circuit.

2 For purposes of Section 13(d) and (g) and determining whether a person is subject to Section 16 as a greater-than-10% beneficial owner of securities, “beneficial owner” is defined under Rule 13d-3(a) as any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares “voting power and/or investment power with respect to such security.” Beneficial ownership can also be found under Rule 13d-3(b) as discussed in footnote 1 above.

3 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

4 *Id.*

The potential Section 16 implications for insiders with TRS positions that were entered into without contemplating or structuring the transaction with the consequences of Section 16 in mind can be severe.⁵ Accordingly, investors need to educate themselves on how to report TRSs and the kinds of transactions and terms that can have the potential to create profit disgorgement liability under Section 16(b).

Reporting Swaps Under Section 16(a)

In a typical TRS between an investor and a bank counterparty, upon the settlement of the TRS, the investor agrees to pay to the counterparty an amount equal to the market price of the shares of common stock underlying the TRS at the time of entering into the TRS (the “reference price”) and the counterparty agrees to pay to the investor an amount equal to the market price of those shares of common stock at the time the TRS is settled (the “settlement price”). The transaction is the economic equivalent of the investor buying these shares of common stock at the reference price and then selling those shares back to the counterparty at the settlement price.

Section 16(a) imposes reporting obligations on insiders of an issuer with respect to their holdings and transactions in the issuer’s “equity securities”, which term includes “derivative securities” such as TRSs. The SEC has not proscribed any one method of reporting TRSs for purposes of Section 16(a). Instead, it has said that any manner that provides an adequate description of the instrument is appropriate.⁶ In order to be “adequate,” the following information must be included: “(1) the date of the transaction; (2) the term; (3) the number of underlying shares; (4) the exercise price (i.e., the dollar value locked in); (5) the non-exempt disposition (acquisition) of shares at the outset of the term; (6) the non-exempt acquisition (disposition) of shares at the end of the term (and such earlier dates, if any, where events under the equity swap cause a change in a call or put equivalent position); (7) the total number of shares held after the transaction; and (8) any other material terms.”⁷

Swaps and Section 16(b) Profit Disgorgement Liability

Section 16(b) requires insiders to disgorge to the issuer any profit derived from any sale and purchase or purchase and sale of an issuer’s equity securities within a period of less than six months (the “short-swing period”). In order to determine the amount of disgorgable profits under Section 16(b), it is therefore necessary to determine when a “sale” or “purchase” is deemed to have occurred under Section 16. For insiders subject to Section 16, the entry into of a TRS by a long party generally is deemed to be a purchase of the number of shares of common stock to which the TRS relates at a price equal to the reference price. The settlement of a TRS by the long party generally is deemed to involve (i) the termination of a derivative security, which is exempt from Section 16(b)⁸, (ii) the purchase of the underlying common stock at a price equal to the reference price, which is generally exempt from Section 16(b)⁹ and (iii) a non-exempt sale of the underlying common stock at a price equal to the settlement price.

Interim Settlements and Rollovers

While the principles above may appear straightforward, numerous questions arise with respect to the application of the Section 16(a) reporting guidelines and the principles underlying Section 16(b) when dealing with transactions in TRSs due to their complexity. For example, some TRSs provide for interim settlements, such as quarterly, prior to the final settlement date of the TRS. These interim settlements generally will be required to be reported as a settlement of

the TRS and an entry into of a new TRS position and may be matchable transactions for purposes of Section 16(b).¹⁰ Additionally, it is common for a long party to a TRS to decide to continue its economic exposure to the issuer’s stock upon the expiration of the TRS by “rolling over” the TRS with its counterparty on its settlement date (by settling its existing TRS and simultaneously entering into a new TRS). This likely will result in a non-exempt sale at the time that the existing swap is settled and a non-exempt purchase at the time the new swap is entered into. Presumably, if the settlement and new execution of the TRS are done simultaneously, the Section 16(b) sale at the settlement and purchase at the rollover will have the same price for Section 16(b) matching purposes¹¹ and will not create profit disgorgement issues by themselves. However, if the insider has effected or will effect any other Section 16(b) sale or purchase within the preceding or subsequent six months, the profit disgorgement rules may be implicated.

It is not uncommon when building a swap position to enter into multiple TRSs with expiration dates that succeed each other by periods of less than six months. It is important to note that the Section 16 purchase that occurs at the rollover of one swap will be matchable with the Section 16 sale or sales that occur upon the settlement of TRSs that take place within a period of less than six months.

5 Subsequent to the CSX decision, a Section 16(b) profit disgorgement action was brought against the investor defendants to recover any short-swing profits they may have realized as Section 16 insiders. The total disgorgable profits realized by the investors on their short-swing transactions, which were predominately comprised of transactions in TRSs, was alleged to be as much as \$137.6 million. The action was settled for a total of \$11 million.

6 SEC Release No. 34-37260, § IV. H (May 31, 1996).

7 *Id.*

8 Rule 16b-6(b).

9 *Id.*

10 SEC Release No. 34-34514 (Aug. 10, 1994), fn 106, and SEC Release No. 34-37260 (May 31, 1996), fn 142. This will be the case to the extent that an interim settlement causes a change in an insider’s call or put equivalent position.

11 Rule 16b-6(c)(1) provides that, when matching identical derivative securities, profits are calculated by matching the prices at which the derivatives were bought and sold. When matching non-identical derivative securities relating to the same class of underlying securities or a derivative security and the underlying security to which it relates (i.e., the common stock), the SEC’s rules do not dictate a formula for calculating recoverable profits. Instead, Rule 16b-6(c)(2) establishes a “cap” on recoverable profits by providing that the recoverable profit may not exceed the difference between the market price of the security underlying the derivative(s) on the date of purchase and sale. Subject to that maximum, the determination of recoverable profits is left to the courts. Rule 16b-6(c)(2) provides, however, that a court “may” measure recoverable profits as if the short-swing transaction involved identical derivative securities—that is, if the insider purchased a derivative security, by matching the purchase against a hypothetical sale of an identical derivative security valued as of the actual date of the matching sale, or, if the insider sold a derivative security, by matching the sale against a hypothetical purchase of an identical derivative security valued as of the actual date of the matching purchase.

Expiration and Settlement Dates

Investors should also keep in mind that the expiration date of a TRS must be at least six months after the date that the TRS is entered into to avoid potential Section 16(b) issues. A shorter term would result in a Section 16(b) purchase upon entry into of the TRS and a Section 16(b) sale upon settlement of the TRS at its expiration, both occurring within the short-swing period. Of course, even where the expiration date of the TRS is six months or more from the time the TRS is entered into, there may be unforeseen events that cause the long party to desire to settle the TRS prior to the expiration date. If this happens within less than six months of the date the TRS was entered into and at a time when the TRS reference price is less than the settlement price (as any long party would hope), then the profit the insider would have made on the TRS transaction could be disgorgable under Section 16(b). Thus, while the ability to settle a TRS prior to the expiration date is a term frequently seen in TRS contracts, a Section 16 insider must be prepared to commit to six months of exposure from the time the TRS is entered into, or possibly longer if the insider has effected any other matchable transactions, in order to avoid profit disgorgement liability.

The relevant “settlement date” for Section 16 purposes is the date that the term of the swap ends and the settlement price becomes fixed. Generally, it is on this date that the insider will be deemed to have a sale for Section 16 purposes. Although swap contracts typically provide for a standard T+3 settlement (on which date the owing party will deliver the amount due under the swap contract to its counterparty), this is not the relevant date for Section 16 purposes. This distinction must be kept in mind in order to ensure timely reporting¹² and to properly structure transitions to be outside of the Section 16 six-month window.

Cancellations and Amendments

The cancellation of a TRS and the entry into of a new TRS can also result in a sale and purchase for purposes of Section 16(b). This is true regardless of whether the terms of the new TRS are identical to the terms of the original TRS. This can occur, for example, when canceling a swap and entering into a new swap with identical terms but for an adjustment to the reference price of the swap. It can also occur when canceling an existing swap and entering into a new swap with another counterparty.¹³

Insiders should also be mindful about amending any material terms of a TRS during the life of the swap because this may be treated as a settlement of the existing swap and the entry into of a new swap, a potential non-exempt purchase and sale under Section 16(b). Amendments that have been deemed to be significant include a change in the conversion price or term of a derivative security.¹⁴ Although it may be in the interest of both parties to agree to an amendment, such as a change in the method of determining the settlement price, from a business perspective, Section 16 considerations may restrict an insider’s ability to do so without consequence. In the case of a simultaneous acquisition and disposition, there should be no difference in the market price of the underlying securities and, therefore, no recoverable profit. The acquisition and disposition could, however, be matched against any other transactions in the issuer’s securities within the prior or subsequent six-month period.

Conclusion

The issues that need to be contemplated when engaging in transactions in TRSs as a Section 16 insider are numerous. It is always prudent to fully analyze the surrounding facts and potential consequences before an insider enters into a new TRS or engages in any transactions with respect to an existing TRS. Insiders also need to determine how the entry into, and subsequent settlement of, a TRS may affect their ability to engage in future transactions in an issuer’s securities free from Section 16(b) profit liability. ■

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- 12 Transactions by insiders must be reported on a Form 4 within two business days of the applicable transaction.
 - 13 This is distinguishable from a direct assignment of an existing swap to a new counterparty where the existing swap is never cancelled. Where the derivative security is never cancelled, there is no change in the insider’s derivative security position and, accordingly, it should not be deemed to be an event for purposes of Section 16.
 - 14 See SEC Release No. 34-29131, fn 35; Knight-Ridder, Inc., SEC No Action Letter, Jan. 27, 1992; *Lerner v. Millenco, L.P.*, 23 F. Supp. 337, (S.D.N.Y. 1998); and *Analytical Surveys, Inc. v. Tonga Partners, L.P.*, 2008 WL 4443828 (S.D.N.Y. September 29, 2008).

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