Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Spotlight On Total Return Swaps

Stacey Slaughter Shane St. Hill

Law360, New York (May 01, 2014, 1:08 PM ET) -- Total return swaps, which share characteristics with both interest rate swaps and credit default swaps, have operated as obscure financial derivative products. TRS have gained heightened attention recently due to various investigations and regulatory scrutiny, such as questions about Libor and ISDAfix rate manipulation. Nevertheless, litigation concerning TRS has remained relatively infrequent. This article highlights sample cases that concern this obscure product.

One issue regarding TRS arose before the Southern District of New York and the Second Circuit concerning whether the total return receiver is the "beneficial owner" of the underlying referenced asset for purposes of determining liability for violations of the Exchange Act.

In CSX Corp. v. The Children's Investment Fund Management (UK) LLP, the Southern District of New York examined whether defendants violated Section 13(d) of the Securities and Exchange Act of 1934.[1] Defendants were hedge funds that sought to wage a proxy contest over the plaintiff railroad company in order to drive up the value of its stock.

Congress passed the Williams Act, which enacted what now is Section 13(d) of the Exchange Act, to address the increasing frequency with which hostile takeovers were being used to effect changes in corporate control. The purpose of Section 13(d) in particular was "to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."[2]

In CSX Corp., defendants accumulated TRS referenced to CSX stock in late 2006 and early 2007. The TRS provided defendants with substantially the same economic benefits as ownership of the underlying CSX stock, except defendants were not record-holders of CSX stock. So, for example, defendants could not vote the referenced shares directly.

The court addressed three issues, one of which was whether TCI, as a holder of TRS referenced to CSX stock, beneficially owned the referenced CSX stock for purposes of Section 13(d) of the Exchange Act. The court ultimately held that it was not necessary to decide the question for purposes of finding a violation of the Williams Act, but it concluded that "substantial reasons" existed to conclude that TCI was the beneficial owner of the referenced CSX shares pursuant to Rule 13d-3(a). That rule states:
(a) 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.

(b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of [sic] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.[3]

The court noted that this provision on "beneficial ownership" is generally construed broadly.[4] The court determined that "there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties."[5]

The court explained that, "TCI significantly influenced the banks to purchase the CSX shares that constituted their hedges because the banks, as a practical matter and as TCI both knew and desired, were compelled to do so. It significantly influenced the banks to sell the hedge shares when the swaps were unwound for the same reasons."[6]

Moreover, on the issue of voting power, the court also found that there was "reason to believe that TCI was in a position to influence the counterparties, especiallyDeutsche Bank, with respect to the exercise of their voting rights."[7] Despite finding that there was substantial reason to consider TCI the beneficial owner of shares of CSX common stock, the Southern District of New York did not find that the TRS themselves conveyed beneficial ownership.

Three years later on appeal, the Second Circuit did not reach the question of whether the TRS holder is the beneficial owner of underlying reference shares held by the TRS counterparty. Based on the Southern District of New York's decision, parties in TRS transactions should be aware of the fact that plaintiffs, the U.S. Securities and Exchange Commission, or courts may cite the following as evidence of beneficial ownership of the underlying TRS reference shares:

(1) TRS counterparties buying reference assets to hedge their exposure;

(2) the long party having the practical ability to cause the counterparties to deliver the hedge shares to the long party; and

(3) the long party having the practical ability to influence voting of the underlying shares.

Some argue that the CSX Corp. cases have made investors "keenly aware of the ramifications of going across 10 percent ... unless you know you are going to be a long-term holder."[8]

Another issue concerning TRS arose before the Southern District of Indiana on whether defendants' use of TRS to acquire preferred stock violated Sections 10(b), 13(e), 14(a) and 14(e) of the Securities Exchange Act.[9] In Corre Opportunities Fund LP v. Emmis Comms. Corp., plaintiffs brought a motion for preliminary injunction against the defendants[10]

Plaintiffs were shareholders of defendant Emmis as a result of Emmis' 1999 issuance of 2,875,000 shares of preferred stock.[11] In 2011, Emmis realized the benefits to its capital structure of repurchasing its preferred stock, so Emmis' senior management negotiated financing that would enable Emmis to repurchase its preferred stock.[12]

One of Emmis' goals was to acquire the preferred stock and to preserve the voting rights of preferred stock acquired.[13] Under Indiana law, any shares of preferred stock that Emmis acquired through outright purchases would have to be retired and could not be voted, so the repurchase proposal included a plan to structure the preferred stock repurchases through TRS transactions and TRS voting

agreements.[14]

This meant that preferred shareholders would be offered a price per share for certain interests in their preferred stock, and although they would lose the economic rights in those shares, they would retain record ownership of the stock. Emmis would enter into voting agreements with these preferred shareholders pursuant to which the shareholders would agree to vote their shares as Emmis directed.[15]

The board approved the proposal, and Emmis was able to acquire and secure voting control of 56.8 percent of the outstanding preferred stock. In addition, Emmis created an employee benefit plan trust ("retention plan trust") to which it could issue 400,000 shares of preferred stock to be voted as directed by the board.[16] This enabled Emmis to acquire voting control over two-thirds of the preferred stock.[17]

Plaintiffs then filed a preliminary injunction motion alleging that the defendants' acquisition of preferred stock through TRS transactions and the reissuance of preferred stock to the retention plan trust violated federal securities laws and Indiana state law.

As to federal securities laws, plaintiffs contended that if the TRS transactions were not deemed "sales" of the preferred stock, then the defendants violated Section 14(a) of the Securities Exchange Act by failing to file a proxy solicitation statement in connection with their solicitation of irrevocable proxies from the preferred shareholders who participated in the TRS transactions.[18] Section 14(a) provides:

(1) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 78l of this title.

(2) The rules and regulations prescribed by the commission under paragraph (1) may include (A) a requirement that a solicitation of proxy, consent or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer; and (B) a requirement that an issuer follow a certain procedure in relation to a solicitation described in subparagraph (A).

The purpose behind the proxy solicitation rules is to ensure that shareholders who retain an economic interest in a corporation but are asked to relinquish voting rights receive adequate notice so the shareholder is able to make an informed decision regarding whether to relinquish those rights.[19]

However, Section 14a-2 sets forth an exception, which provides that disclosures required in accordance with proxy solicitations are not required for "any solicitation by a person in respect of securities of which he is the beneficial owner."[20]

The court found that this exception, which does not require disclosures because the voting rights follow the economics of the stock, applied to the TRS transactions because Emmis acquired both the economic and voting rights of the stock.[21] Therefore, the plaintiffs were found unlikely to succeed in proving that the defendants violated Section 14(a).

The plaintiffs also claimed that the defendants violated Sections 13(e), 14(e) and 10(b) of the Securities Exchange Act by failing to file a tender offer statement before soliciting preferred shareholders to enter into TRS transactions.[22] Plaintiffs' Section 13(e) and 14(e) claims fall under the Williams Act, and were added to "insure that public shareholders facing a tender offer or the acquisition by a third party of large

block shares possibly involving a contest for control be armed with adequate information about the qualifications and intentions of the party marking the offer or acquiring the shares."[23]

However, neither the Seventh Circuit, the Williams Act, nor Securities Exchange Commission regulation define "tender offer."[24] To resolve this issue, the court turned to Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), for an eight-factor test for determining what constitutes a tender offer.[25] The eight factors are:

(1) active and widespread solicitation of public shareholders for the shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subjected to pressure to sell his stock; and (8) whether the public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company's securities.[26]

The court in Corre found that the defendants' use of TRS transactions met only the second factor. Defendants sought to purchase a substantial percentage of the preferred stock, approaching shareholders holding more than 70 percent of the preferred stock, and successfully acquired 59.9 percent of the outstanding shares of the preferred stock through TRS transactions.[27]

Among other things, Emmis did not engage in active and widespread solicitation. Rather it only approached a small number of shareholders. Also the terms of the offer were negotiable, and the defendants agreed to an outright purchase with one of the five selling preferred shareholders who would not consent to structuring the transaction as a TRS.[28]

Although the defendants' TRS were not "typical" TRS transactions, the defendants classified them as such as the transactions were not a complete exchange of the entire bundle of rights of ownership.[29] The court found that, on plaintiffs' motion, they were unlikely to succeed on the merits for their claims that the defendants violated federal securities laws and Indiana state law. Thus, while investors should be aware of increased scrutiny over TRS transactions, courts have ruled that their amorphous nature is not always subject to all aspects of federal securities laws.

TRS have also been the subject of Financial Industry Regulatory Authority findings. Recently, Deutsche Bank Securities Inc. (CRD #2525, New York, New York) submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined $275,000 in connection with TRS. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to establish and enforce adequate written supervisory procedures regarding dividend-related yield enhancement on total return swap transactions that involved U.S. equities.

FINRA's findings elaborate on Deutsche Bank's shortcomings, and provide guidance on procedures that investors involved in TRS transactions should cultivate and maintain. FINRA's findings explain that Deutsche Bank did not maintain any written procedures for how to supervise or document decisions that impacted dividend uplift on swap trades referencing U.S. dividend-paying securities.[30]

Specifically, Deutsche Bank issued guidelines regarding the TRS program in the form of a memorandum; however having provided this advice, it did not take any steps to establish written procedures for the members of the swaps desk who were in a position to implement the guidance provided in the memo.[31]

Deutsche Bank did not identify who was responsible for enforcing firm policies in this area, or provide an adequate process for enforcing and documenting supervision of these policies.[32] FINRA's findings also stated that Deutsche Bank issued additional guidance regarding the TRS program, but it did not establish

adequate procedures describing how its staff would or should monitor cross-trades, market-on-close pricing or customer trading patterns, or how staff should assess and document customers' requests for exceptions to the guidelines.[33]

FINRA's findings included a conclusion that Deutsche Bank's memo and guidelines permitted certain TRS transactions that were exceptions to the aforementioned guidance under particular circumstances.[34] However, Deutsche Bank did not keep adequate records of decisions to allow exceptions, and after-the-fact reviews of such decisions were not adequately documented.[35]

FINRA found that Deutsche Bank developed a document so that overall client trading patterns could be monitored and potential red flags regarding the use of TRS could be identified by desk personnel, but the document and Deutsche Bank's review of it were insufficient in that the document was based on data that did not facilitate adequate monitoring.[36]

Deutsche Bank was aware that it needed to improve its record keeping regarding swaps so as to better manage risks associated with yield enhancement on TRS.[37] Deutsche Bank did not put in place systems to retrieve sufficient data from managers' review of executions the desk staff made.[38] Deutsche Bank's records regarding market-on-close pricing or cross-trades were not adequate, such that it made it difficult for the firm to supervise desk staff's compliance with the guidelines regarding such pricing.[39]

As these cases demonstrate, TRS has been the focus of some litigation in the past. As investigations and regulatory scrutiny in the financial industry continues, TRS may become the subject of further litigation and scrutiny.

—By Stacey Slaughter and Shane St. Hill, Robins Kaplan Miller & Ciresi LLP

Stacey Slaughter is a partner in Robins Kaplan's Minneapolis and New York offices. Shane St. Hill is an associate in the New York office. They are both trial attorneys who represent businesses, organizations, individuals, shareholders, brokers, pension funds, unions and institutional investors that face significant commercial disputes and complex business problems.

[1] CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (2008).

[2] Id. at 538.

[3] The Williams Act, 15 U.S.C. § 78m(d) (1971).

[4] CSX Corp., 562 F. Supp. 2d at 540.

[5] Id. at 545.

[6] Id. at 543.

[7] Id. at 546.

[8] Miles Weiss, Einhorn's Swaps Boosting Marvell Bet Exposed by Buyback, Bloomberg (Apr. 19, 2013), www.bloomberg.com/news/print/2013-04-19/einhorn-s-swaps-boosting-marvell-bet-exposed-by-buyback.html.

[9] The court noted that “the transaction defendants call total return swaps are not typical TRS transactions.” Corre Opportunities Fund LP v. Emmis Comms. Corp., 892 F. Supp. 2d 1079, 1089 (S.D. Ind. 2012).

[10] 892 F. Supp. 2d 1079 (S.D. Ind. 2012).

[11] Id. at 1079.

[12] Id. at 1081.

[13] Id.

[14] Id. at 1082.

[15] Id. at 1083.

[16] Id. at 1084.

[17] Id.

[18] Id. at 1090.

[19] Id.

[20] Id. (quoting 17 C.F.R. § 240.14a-2(a)(2).

[21] Id.

[22] Id. at 1092.

[23] Id. (quoting Ind. Nat. Corp. v. Rich, 712 F.2d 1180, 1183 (7th Cir. 1983)).

[24] Id.

[25] Id.

[26] Id. (quoting Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979)).

[27] Id. at 1093.

[28] Id.

[29] Id. at 1089.

[30] Id.

[31] Id.

[32] Id.

[33] Id.

[34] Id.

[35] Id.

[36] Id.

[37] Id.

[38] Id.

[39] Id.
