

**SEC PROPOSES TO READOPT BENEFICIAL OWNERSHIP RULES
TO CLARIFY TREATMENT OF SECURITY-BASED SWAPS
UNDER THE DODD-FRANK ACT**

On March 17, 2011, the United States Securities and Exchange Commission (the “Commission”) proposed to readopt portions of Rules 13d-3 and 16a-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) solely for the purpose of preserving the current treatment of security-based swap agreements under Sections 13(d), 13(g) and 16 of the Exchange Act.¹ This technical rule amendment would avoid an unintended consequence of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)² and would give the Commission more time to reconsider the circumstances under which security-based swap agreements should confer beneficial ownership under those provisions. Comments on the proposal may be submitted to the Commission on or before April 15, 2011.

Rule 13d-3 under the Exchange Act defines beneficial ownership for purposes of the reporting rules under Sections 13(d) and 13(g) of the Exchange Act, which generally require beneficial owners of more than 5% of a class of voting equity security registered under the Exchange Act to report their ownership on Schedule 13D or Schedule 13G. Rule 16a-1(a)(1) under the Exchange Act defines beneficial ownership for purposes of determining whether a person is a “10% beneficial owner” subject to the disclosure, short-swing-profit and short-sale-prohibition provisions of Section 16 of the Exchange Act. The beneficial ownership definition under Rule 16a-1(a)(1) is based directly on the definition of that term under Rule 13d-3.

Currently, most security-based swap agreements do not confer beneficial ownership of their reference securities on the party that is “long” those securities through the swap. These agreements generally provide that the swaps are to be settled only in cash, do not confer voting or investment rights with respect to the reference securities, and do not require that the “short” counterparty hedge its position by holding the reference securities. However, it is clear under current law that a security-based swap *will* confer beneficial ownership of its reference securities where the swap confers or otherwise provides voting or investment power with respect to the reference securities,³ where the swap confers the right to acquire beneficial ownership within 60 days,⁴ or where the swap is used with the purpose or effect of divesting or preventing the vesting

¹ Securities and Exchange Commission Release No. 34-64087; File No. S7-10-11, March 17, 2011.

² Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³ Rule 13d-3(a).

⁴ Rule 13d-3(d)(1)(i). If, however, the swap is acquired with the purpose or effect of changing or influencing control of the issuer of the reference securities or in connection with or as a participant in any transaction having that purpose or effect, then the swap will confer beneficial ownership immediately, without regard to the 60-day timeframe. *Id.*

of beneficial ownership as part of a plan or scheme to evade the reporting requirements of Section 13(d) or 13(g) of the Exchange Act.⁵

The problem sought to be addressed by the Commission with this proposal is that Section 766 of the Dodd-Frank Act, while granting the Commission broad authority to determine when security-based swaps confer beneficial ownership, provided that, effective July 16, 2011, such swaps do not confer beneficial ownership except to the extent that the Commission affirmatively adopts rules providing otherwise. The unintended effect of Section 766, without Commission action, would be to reverse current law in those circumstances where swaps would now be deemed to confer beneficial ownership of their reference securities. By proposing to readopt these rules, the Commission simply intends to preserve the *status quo* pending completion of a separate project being undertaken by its staff to develop proposals for modernizing Section 13(d) and 13(g) reporting.

In recent years, the treatment of securities-based swap agreements under the securities laws has been controversial. For example, in advance of conducting a 2008 proxy contest for seats on the CSX Corporation board of directors, two hedge funds acquired beneficial ownership of more than 5% of the company's shares. A decision in the ensuing litigation conducted an in-depth analysis of total return equity swaps and came close to deciding that these security-based swaps inherently confer beneficial ownership based, largely, on the practical necessity of the "short" swap counterparty to hedge its position by acquiring physical shares and the practical power of the "long" counterparty to cause those physical shares to be sold by unwinding the swap.⁶ That conclusion was left up in the air because the court ultimately decided that the hedge funds beneficially owned CSX shares by virtue of the anti-evasion provision of Rule 13d-3(b) as applied to the specific facts of that case.

The larger context of this proposal — modernization of the reporting rules under Sections 13(d) and 13(g) of the Exchange Act — will entail significant focus on the treatment of security-based swap agreements. Another central matter to be reconsidered is the ten-day window between crossing the 5% beneficial ownership threshold and the obligation to make a filing.⁷ And lurking in the background is likely to be the question of "empty voting," where a stockholder of record for a particular vote may have completely divested itself of an economic interest in the vote's outcome (or may have an interest adverse to stockholders generally) and yet retain full voting rights. As suggested in the Commission's Concept Release on the U.S. Proxy System,⁸ changes to disclosure requirements, including Schedules 13D and 13G, may be part of the federal law effort to ameliorate the "empty voting" conundrum.

⁵ Rule 13d-3(b).

⁶ *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 562 F. Supp. 2d 511 (S.D.N.Y. June 11, 2008), affirmed without opinion by *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, et al.*, 292 Fed. Appx. 133 (2d Cir. 2008).

⁷ Until adoption of Section 929R of the Dodd-Frank Act, the ten-day window was embedded in Section 13(d) of the Exchange Act and could not be changed by rule of the Commission.

⁸ Securities and Exchange Commission Release No. 34-62495; File No. S7-14-10, July 14, 2010.

* * * * *

If you have any questions regarding this memorandum, please contact Gregory B. Astrachan (212-728-8608, gastrachan@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, N.W., Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

March 21, 2011

Copyright © 2011 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.