Torys on Mergers and Acquisitions

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Use of Derivatives by Shareholder Activists

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In recent years, hedge funds and other activist investors have relied on equity derivatives strategies to accumulate economic interests in potential takeover or proxy contest targets. So-called stealth accumulations have seemingly increased in both Europe and North America. In Europe, LMVH amassed more than a 20% holding in Hermes, largely through the use of equity derivatives, and in the United States, hedge funds acquired significant economic positions in this manner in Fortune Brands and J.C. Penney, allegedly with a view to exerting control or influence. Such transactions have brought these strategies to the forefront of attention of both activist investors and securities regulators in 2011. In the United States, the Securities and Exchange Commission is actively studying modernizing its reporting requirements to take into account the use of equity derivatives strategies in connection with takeover bids; we understand that the Canadian securities regulators are also considering this.

Typically, these equity derivatives strategies involve cash-settled total return equity swaps or similar vehicles, including, as they are known in Europe, "contracts for differences" (CFDs). In these contracts, while no actual purchase or sale of underlying securities occurs between the purchaser of the swap (the "long" party) and the counterparty, the counterparty will typically hedge its risk by purchasing the underlying securities. The long party will not receive the power to vote the underlying securities or to compel the counterparty to dispose of them. As a practical matter, however, the swap may be "closed out" and "converted" into a direct holding by the long party by cash-settling the swap and using the proceeds to acquire the securities from the counterparty.

Under Canadian and U.S. securities laws, the prevailing view of cash-settled total return swaps has historically been that, absent specific evidence to the contrary, these swaps do not provide the long party with actual or beneficial ownership of, or control or direction over, the underlying securities. Therefore, a party acquiring an economic interest in an issuer under an equity swap of more than 10% of the outstanding equity or voting securities of a class of a Canadian issuer has not typically filed an early warning report or an insider report relating to that interest (although a party that is already an insider as a result of beneficial ownership of such securities would be required to disclose its acquisition of an economic interest under an equity swap on an insider report under National Instrument 55-104, *Insider Reporting Requirements and Exemptions*). On its face, a party can, in this manner, accumulate an economic interest of virtually any size (including actual beneficial ownership of up to 9.9% of the issuer's securities) in an issuer without making disclosure. A party that is already an insider can increase its economic interest using an equity swap without filing an early warning report or being subject to the associated purchase moratorium on the underlying securities; rather it can simply disclose the position on an insider report filed five days after the transaction (and that report is not required to contain any statement about the party's intentions). In the United States, similarly, a long party

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would not typically file a report under Section 13(d) of the *Securities Exchange Act of 1934* (the 1934 Act) after acquiring an economic interest under a total return swap in 5% of the common stock of an issuer.

In 2006, the Ontario Securities Commission considered the use of equity derivatives and reporting requirements in the Sears Canada transaction. Although the OSC was unable to conclude on the evidence that cash-settled equity swaps gave a hedge fund beneficial ownership or control or direction over the subject Sears Canada shares, the OSC indicated that the use of swaps to deliberately "park" securities and avoid reporting obligations in the context of a takeover bid could constitute abusive conduct. Subsequently, in 2008, in the proxy contest for CSX, the United States District Court for the Southern District of New York (affirmed on appeal) found that two hedge funds used cash-settled total return swaps and other arrangements to obtain significant economic power over CSX, without disclosure, before launching a proxy contest for seats on the CSX board of directors. Although the Court declined to go so far as to say that a typical cash-settled total return swap creates beneficial ownership, the Court found that, in the circumstances, the conduct of the hedge funds was sufficient to have deemed them to have acquired beneficial ownership; the hedge funds had, according to the Court, entered into these arrangements for the purpose of avoiding their disclosure obligations.

In an effort to protect themselves from stealth acquisitions, some U.S. issuers have included derivative-based long positions in the definition of "beneficial ownership" in their shareholder rights ("poison pill") plans. In both the United States and Canada, however, these efforts are largely chilled by the position of influential proxy advisory firms. For example, the 2011 voting guidelines of ISS recommend voting against approval of a plan that refers to derivatives contracts in the definition of "beneficial ownership."

The use of equity swaps to acquire economic toeholds or positions of influence has attracted regulatory scrutiny and recent reform outside North America. In the United Kingdom, the Financial Services Authority implemented new rules in June 2009, which contemplate a general disclosure regime requiring aggregation of physical share and long CFD holdings. In Australia, the Australian Takeovers Panel issued an Equity Derivatives Guidance Note that requires disclosure of positions taken in equity derivatives when there is, or can be expected to be, a "control transaction" by purchasers who have a combined long and actual physical position exceeding 5% of the underlying stock. Hong Kong has enacted similar rules to require disclosure of positions taken by way of cash-settled equity derivatives. Germany is expected to enact similar rules in 2011.

Perhaps not surprisingly, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) in the United States did not ignore this issue. It will add Section 13(o) to the 1934 Act to provide that beneficial ownership of a security will be deemed to have been acquired on the basis of the purchase or sale of a security-based swap to the extent that the SEC deems it to do so by rule. With the July 2011 enactment of this section looming, the SEC is being encouraged to amend the concept of beneficial ownership for purposes of Section 13(d). For example, Wachtell, Lipton, Rosen & Katz formally petitioned the SEC on March 7, 2011 to reformulate the definition of "beneficial ownership" for this purpose to encompass ownership of any derivative instrument that includes the "opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of a subject security" (a formulation similar to "economic interest in a security" found in Canadian securities legislation). On March 17, 2011, in Release No. 34-64087, the SEC reaffirmed that where a security-based swap is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan to avoid the beneficial ownership requirements, the party concerned may be deemed to have beneficial ownership of the subject securities; the SEC also announced that its staff is engaged in a project to modernize reporting under Section 13(d).

In Canada, the Canadian Securities Administrators, through a consultation paper published in November 2010, commenced a project intended to create sweeping transformational regulation of the Canadian OTC derivatives market; that consultation paper, however, did not address this issue. In Ontario, the December 2010 amendments to the *Securities Act* did expressly extend the prohibition on insider trading with material undisclosed information to related derivatives (including cash-settled derivatives). No amendments have yet been proposed, however, to the early warning reporting rules, but this issue is understood to be under study.

Taken together, these developments are expected to prompt further regulatory scrutiny of the use of equity swaps in contests for corporate control. Canadian securities regulators might be expected to revisit the early warning rules in this context.