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## Lessons Learned from *CSX Corp. v. Children's Investment Fund Management* and Proposals for Reform

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**LESSONS LEARNED FROM *CSX CORP. V.*  
*CHILDREN'S INVESTMENT FUND*  
*MANAGEMENT AND PROPOSALS FOR*  
**REFORM****

*Sean M. Donahue\**

*The federal securities laws governing beneficial ownership do not capture ownership positions in equity swaps or other similar instruments. In the majority of situations these owners do not possess voting or investment power as defined in Rule 13d-3(a) of the Securities and Exchange Act, and thus, they do not have a disclosure obligation. Such persons, however, do have the ability to significantly influence the voting or disposition of the securities of a company. In fact, because their ownership positions remain hidden, these persons can gain an unfair advantage in a proxy contest or engage in a stealth takeover.*

*Issues related to hidden ownership were litigated in the case of CSX Corp. v. Children's Investment Fund Management, where a hedge fund acquired long positions in equity swaps giving it the same economic interests as stock ownership, and then, with the help of another hedge fund, launched a proxy contest. An analysis of the facts in this case and the holdings of the court offer great insight into the decoupling of economic interests from voting rights and investment power.*

*This Article examines CSX and concludes that Rule 13d-3(a) should be amended to require disclosure by beneficial owners of equity swaps and other similar instruments. It further provides a specific disclosure recommendation for the amendment of that Rule. This Article also explores Rule 13d-3(b), reasoning that this Rule should be construed in a manner analogous to the safe harbors contained in Rule 144A and Regulation S, and, therefore, only apply when a person is also a beneficial owner under Rule 13d-3(a). Lastly, this Article demonstrates that sterilization of votes is a necessary remedy under § 13(d) and argues that courts should more frequently enjoin persons who violate this statute from voting at shareholder meetings.*

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## I. INTRODUCTION

The federal securities laws governing beneficial ownership are such that the owner of a long position in an equity swap or similar instrument (Long Party or Long Parties) that has the same economic interest as a holder of common stock does not have to disclose his ownership position because he does not have beneficial ownership of the securities.<sup>1</sup> This person does not have beneficial ownership because he does not possess voting or investment power.<sup>2</sup> The Long Party has an economic interest in the security because he is entitled to any increase in the value of the underlying stock and any dividends; however, he owns a derivative security

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1. 2 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 14.02[2][a] (9th ed. 2008). *But see* CSX Corp. v. Children's Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 517 (S.D.N.Y. 2008), *aff'd*, 292 F. App'x 133 (2d Cir. 2008); ARNOLD S. JACOBS, THE WILLIAMS ACT—TENDER OFFERS AND STOCK ACCUMULATIONS § 2.12 (2009); James P. Smith & Corinne Levy, 'CSX': *Second Circuit Upholds Denial of Injunctive Relief*, N.Y.L.J., Sept. 26, 2008, at 4; Letter from Brian V. Breheny, Deputy Director, Division of Corporation Finance, SEC, to Judge Lewis A. Kaplan, United States District Judge, Southern District of New York (June 4, 2008), *available at* <http://www.gibsondunn.com/publications/Documents/CSX-BrianBrehenyLtrToJudgeKaplan.pdf> [hereinafter Breheny Letter].

Although a long position under an equity swap would generally not be treated as beneficial ownership of the underlying security under Rule 13d-3 under the Exchange Act, as the "long" party would not typically have the right to vote or dispose of the underlying shares, Schedule 13D (but not Schedule 13G) requires the disclosure by a reporting person of contracts involving the relevant shares.

GREENE ET AL., *supra*, § 14.02[2][a] n.26.

Prior to CSX's lawsuit, the prevailing wisdom was that 'masked ownership,' while smacking of gamesmanship, was permissible under the existing proxy rules because a long position in a cash-settled swap, standing alone, constitutes neither actual nor beneficial ownership of the referenced shares. (Section 13(d) requires disclosure only by 'beneficial owners.')

Smith & Levy, *supra*.

[A] person who is a party to a cash-settled swap does not beneficially own the securities subject to the swap if he does not have the right to vote or to sell those securities either pursuant to the swap's contractual terms or pursuant to another understanding or arrangement with the counterparty to the swap. Thus, a party to a cash-settled swap not possessing such voting or dispositive power has no Section 13(d) reporting duty, no matter how large a percent of the stock is the subject of the cash-settled swap.

JACOBS, *supra*, § 2.12.

The Division believes that interpreting an investor's beneficial ownership under Rule 13d-3 to include shares used in a counter-party's hedge, absent unusual circumstances, would be novel and would create significant uncertainties for investors who have used equity swaps in accordance with accepted market practices understood to be based on reasonably well-settled law.

Breheny Letter, *supra*, at 4.

2. Breheny Letter, *supra* note 1, at 2.

rather than physical shares.<sup>3</sup> As such, ownership voting rights and investment power over the security have been decoupled from the economic interest in the security and, rather, are held by the short counterparty (Short Party or Short Parties) to the swap to the extent that the Short Party has hedged by acquiring the securities underlying the swap (Matched Shares).<sup>4</sup> Where the Long Party has economic ownership of securities that are not required to be disclosed under § 13(d) of the Securities and Exchange Act of 1934 (the Exchange Act), he has “hidden ownership” of the securities.<sup>5</sup> If the person also has informal voting power, then he has “hidden morphable ownership.”<sup>6</sup> Additionally, the Long Party can have investment power where the Short Party has no means to hedge other than by acquiring the security underlying the equity swap, acquiring Matched Shares, and then selling the security upon the unwinding of the swap.<sup>7</sup>

The phenomenon of hidden ownership was litigated in *CSX Corp. v. Children’s Investment Fund Management*, where a hedge fund, The Children’s Investment Fund Management (UK) L.L.P. (TCI), which owned a long position in a total return equity swap (TRS), was sued by CSX Corporation (CSX), a railroad company, for failing to disclose its beneficial ownership during CSX’s attempt to thwart the hedge fund’s efforts in a

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3. See GREENE ET AL., *supra* note 1, § 14.02[2][a].

An equity swap typically involves an agreement between two parties to exchange a series of payments determined by reference to the change in value of a notional quantity of a single security or group or index of securities (the “reference securities”) over a specified period. In a typical equity swap, one party (the “long party”) will make payments based on the amount of any depreciation in the value of the reference securities during the relevant period, as well as a payment of notional interest based on the notional value of the contract. The other party (the “short party”) will make payments based on the amount of any appreciation in the value of the reference securities during the relevant period, as well as, in some cases, the amount of any dividends or distributions paid with respect to the reference securities during this period.

*Id.*

4. Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816 (2006).

A second approach [to decoupling] employs an equity swap, in which the person with the long equity side (the “equity leg”) of the swap acquires economic ownership of shares (but not voting rights) from the short side (the “interest leg”). The short side often hedges its economic risk by holding shares, thus ending up with votes but no net economic ownership.

*Id.*

5. *Id.* at 825 (“If a person has economic ownership that disclosure rules do not cover (or can reasonably be interpreted by the person as not covering), we call this ‘hidden ownership.’”).

6. *Id.* at 825–26. (“If in practice, this hidden ownership includes informal voting rights, we term this ‘hidden (morphable) ownership.’ These ‘morphable voting rights’ will generally not be verifiable by outsiders, and depend on market customs.”)

7. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 541–43 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

proxy contest.<sup>8</sup> This Article posits that TCI had hidden ownership of the securities because it possessed economic ownership of swaps that did not have to be disclosed under Securities and Exchange Commission (SEC) regulations.<sup>9</sup> CSX argued, and the court found, that TCI had hidden morphable ownership because, in at least some instances, there was evidence it could influence the voting of the securities by the Short Parties, or obtain voting power by engaging in an exchange unwind.<sup>10</sup> The latter occurs where the Long Party unwinds the swap and acquires the shares used by the Short Party to hedge the swap, either from the Short Party or in the open market.<sup>11</sup> CSX also asserted, and the court found, that TCI had investment power because there was no conceivable way for the Short Party to hedge other than acquiring the Matched Shares; once TCI unwound the swap, the Short Party would be forced to sell the shares either to TCI or in the open market.<sup>12</sup> While the court did not reach the question of whether TCI was a beneficial owner of CSX shares, it stated that “there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties.”<sup>13</sup>

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8. *Id.* at 516.

9. While the court decided that TCI had a disclosable position in the swaps because it met the definition of beneficial owner in Rule 13d-3(b), and inferred, while it did not decide the question that TCI quite probably met the definition of beneficial owner in Rule 13d-3(a), this Article concludes that there was no beneficial ownership under Rule 13d-3, and thus no disclosure was required. *See infra* Parts IV.A, IV.B.

10. *CSX Corp.*, 562 F. Supp. 2d at 546 (“[T]here . . . is reason to believe that TCI was in a position to influence the counterparties, especially Deutsche Bank, with respect to the exercise of their voting rights.”).

11. Letter from Professor Bernard S. Black, Professor of Law & Finance, University of Texas Law School, to Brian G. Cartwright, General Counsel, SEC 9 (May 29, 2008), *available at* <http://law.du.edu/images/uploads/corporate-governance/disclosure-csx-children-defendants-reponse.pdf> [hereinafter Black Letter].

When a swap expires, or is terminated early, the dealer, assuming it has hedged, will usually seek to unwind the hedge. If the dealer has hedged with matched shares, it will usually sell most or all of the matched shares. . . .

In some cases, a long equity swap holder will seek to replace that position with full ownership of shares by unwinding the swap and, at the same time or nearly the same time, purchasing shares in the market. I will call this an “exchange unwind.”

*Id.*

12. *CSX Corp.*, 562 F. Supp. 2d at 546.

TCI patently had the power to cause the counterparties to buy CSX. At the very least, it had the power to influence them to do so. And once the counterparties bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions. Certainly the banks had no intention of allowing their swap desks to hold the unhedged long positions that would have resulted from the unwinding of the swaps.

*Id.*

13. *Id.* at 545.

However, the court did reach the question of whether TCI should be deemed a beneficial owner under Rule 13d-3(b) of the Exchange Act.<sup>14</sup> The court held that TCI was a beneficial owner because it purchased the swaps with the purpose and effect of preventing the vesting of beneficial ownership of the securities as part of a plan or scheme to evade the reporting requirements of § 13(d).<sup>15</sup> The court further held that TCI and 3G Fund L.P. (3G), another hedge fund that was a party to the litigation, formed a group for the purposes of § 13(d), and violated § 13(d) because they did not file a Schedule 13D until ten months later.<sup>16</sup> In fashioning a remedy for the group's disclosure violation, the court enjoined the group members from future violations of § 13(d), but chose not to enjoin them from voting in the proxy contest. In the court's view, sterilization was not an appropriate remedy for the disclosure violation because CSX did not show a threat of irreparable harm, especially given that corrective disclosure had already been made.<sup>17</sup>

The court's first conclusion is incorrect because Long Parties' holdings in equity swaps do not have to be reported under § 13(d). The reason is that such parties are not beneficial owners as defined in Rule 13d-3(a) because they do not possess voting or investment power over the securities.<sup>18</sup> While the court's conclusion was incorrect, given the current state of the law, Rule 13d-3(a) should be amended to require disclosure of Long Parties' holdings in equity swaps and this Article provides a recommendation as to how the Rule should be revised to require such disclosure.<sup>19</sup> The court's second holding also was incorrect because TCI did not engage in a plan or scheme to evade the reporting requirements of § 13(d) since it was not a beneficial owner of the securities (as defined in Rule 13d-3(a)).<sup>20</sup> With respect to the formation of a group, the court properly held that TCI and 3G formed a § 13(d) group ten months prior to filing a Schedule 13D in violation of

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14. *Id.* at 548–52.

15. *Id.* at 552.

In sum, the Court finds that TCI created and used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d). Under the plain language of Rule 13d-3(b), it thus is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures created by the TRSs.

*Id.*

16. *Id.* at 554–55 (“In the last analysis, the question comes down to whether this trier of fact . . . is persuaded that TCI and 3G formed a group with respect to CSX securities earlier than they claim. It finds that they did so no later than February 13, 2007.”).

17. *Id.* at 572 (“[T]his Court holds that a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants’ voting rights and that plaintiff has failed to establish such a threat.”).

18. *See infra* Part IV.A.

19. *See infra* Part IV.

20. *See infra* Part IV.B.

§ 13(d).<sup>21</sup> In determining the proper remedy for the group's disclosure violation, however, the court incorrectly held that sterilization was not an appropriate remedy because sterilization was not necessary in order to prevent an unfair director election.<sup>22</sup>

This Article analyzes the *CSX* case, advocates proposals for reform, and adds to the current literature on § 13(d) of the Exchange Act in three important ways. First, it provides a specific disclosure recommendation that the Commission can adopt by amending Rule 13d-3(a) to require disclosure of Long Parties' holdings in equity swaps. While other authors have proposed a recommendation as to how the broad disclosure regime regarding beneficial ownership should be revised,<sup>23</sup> advocated for a judicially imposed solution,<sup>24</sup> or simply argued for Commission action,<sup>25</sup> no other law review article sets forth a specific disclosure recommendation for Rule 13d-3(a). Second, this Article provides an analysis of Rule 13d-3(b), reasoning that it should be construed in a manner analogous to the safe harbors contained in Rule 144A and Regulation S, and thus should apply only when one is a beneficial owner under Rule 13d-3(a).<sup>26</sup> Lastly, it explores the remedy of sterilization of votes in the § 13(d) context by examining the case law and the Commission's positions in this area and concludes that this remedy should be granted more frequently.

Part II of this Article provides an overview of equity swaps, § 13(d), and the decoupling of economic interests from voting rights and investment power. Part III examines the facts and holdings of the *CSX* case. Part IV critiques these rulings and sets forth proposals for reform. Part V concludes the Article.

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21. See *infra* Part III.B.

22. See *CSX Corp.*, 562 F. Supp. 2d at 567–73.

23. See Hu & Black, *supra* note 4, at 875–86.

[T]he ownership disclosure rules can be much simplified and better integrated. Currently, there are five distinct, highly idiosyncratic, complex SEC ownership disclosure regimes. These disclosure regimes apply respectively to large active shareholders (Schedule 13D), large passive shareholders (Schedule 13G), institutional investors generally (Form 13F), insiders and 10% shareholders (Section 16), and mutual funds. Our proposals would significantly simplify this complex scheme, and move toward an integrated system for share ownership disclosure that builds on existing Section 16 and mutual fund disclosure rules.

*Id.* at 820.

24. See Daniel Bertaccini, Note, *To Disclose or Not to Disclose? CSX Corp., Total Return Swaps, and Their Implications for Schedule 13D Filing Purposes*, 31 CARDOZO L. REV. 267, 270 (2009).

25. See Brian T. Sullivan, *CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership*, 87 N.C. L. REV. 1300 (2009).

26. This argument does not seem to have been made in any other article. While the Sullivan note analyzes Rule 13d-3(b), it does not provide a conclusion based on the safe harbors contained in Rule 144A and Regulation S of the Securities Act. See *generally id.*

## II. SWAPS, SECTION 13(D), AND DECOUPLING

### A. EQUITY SWAPS

Usually an equity swap entails two parties making payments to one another where at least one set of payments is determined by the return of a stock or a stock index (the Reference Security or Reference Securities).<sup>27</sup> Typically, the Long Party will make payments based on the amount of any depreciation in the value of the Reference Securities and a payment of notional interest based on the interest that accrues at a negotiated rate on an agreed upon principal amount.<sup>28</sup> This payment of notional interest compensates the Short Party for the cost of financing its position hedging the swap, even if it chooses not to hedge, by giving it an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned the Long Party the notional amount.<sup>29</sup> On the other hand,

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27. See, e.g., GREENE ET AL., *supra* note 1, § 14.02[2][a] (“An equity swap typically involves an agreement between two parties to exchange a series of payments determined by reference to the change in value of a notional quantity of a single security or group or index of securities (the ‘reference securities’) over a specified period.”); Don M. Chance, *Equity Swaps and Equity Investing*, J. ALTERNATIVE INV., Summer 2004, at 75, 75–76.

[A]n equity swap is a transaction between two parties in which each party agrees to make a series of payments to the other, with at least one set of payments determined by the return on a stock or stock index. The return is calculated based on a given notional principal and may or may not include dividends. The payments occur on regularly scheduled dates over a specified period of time.

Chance, *supra*, at 76.

28. GREENE ET AL., *supra* note 1, § 14.02[2][a]; see also *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 520 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

Counterparty A—the “short” party—agrees to pay Counterparty B—the “long” party—cash flows based on the performance of a defined underlying asset in exchange for payments by the long party based on the interest that accrues at a negotiated rate on an agreed principal amount (the “notional amount”). . . . Counterparty A, referred to as the “total return payer” or “beneficiary,” is entitled to receive from Counterparty B (1) an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned Counterparty A the notional amount, and (2) any decrease in the market value of the referenced asset.

*CSX Corp.*, 562 F. Supp. 2d at 520.

The notional amount typically is the value of the referenced asset at the time the transaction is agreed and may be recalculated periodically. The difference between the reference rate and the negotiated interest rate of the swap depends on (1) the creditworthiness of the two parties, (2) characteristics of the underlying asset, (3) the total return payer’s cost of financing, risk, and desired profit, and (4) market competition.

*Id.* at 520 n.13 (internal citation omitted).

29. See GREENE ET AL., *supra* note 1, § 14.02[2][a]. The court in *CSX* explained:

[The Short Party] is entitled to have the long party place it in the same economic position it would have occupied had it advanced the long party an amount equal to the

the Short Party will make payments based on the amount of any appreciation in the value of the Reference Securities, as well as the amount of any dividends or distributions paid with respect to the Reference Securities.<sup>30</sup> Because equity swaps result in payments based on the return on a stock or stock index, they provide cash flows to the Long Party that mimic equity returns.<sup>31</sup> Therefore, equity swaps can be used as substitutes for direct transactions in equity.<sup>32</sup> These instruments give the Long Party exactly the same economic interest it would have if it actually purchased the stock or stock index.<sup>33</sup>

### B. SECTION 13(D)

Section 13(d) was enacted as part of the Williams Act.<sup>34</sup> This Act was passed in 1968 to close a gap in the securities laws by requiring disclosure of pertinent information where persons sought to gain corporate control of a company by a tender offer and through open market or privately negotiated purchases.<sup>35</sup> Section 13(d) of the Act was enacted to “alert the marketplace

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market value of the referenced security. But there are at least two salient distinctions, from the short party’s perspective, between a TRS and a loan. First, the short party does not actually advance the notional amount to the long party. Second, it is subject to the risk that the referenced asset will appreciate during the term of the TRS.

*See CSX Corp.*, 562 F. Supp. 2d at 521.

30. *See CSX Corp.*, 562 F. Supp. 2d at 520.

Counterparty B, which may be referred to as the “total return receiver” or “guarantor” is entitled to receive from Counterparty A the sum of (1) any cash distributions, such as interest or dividends, that it would have received had it held the referenced asset, and (2) either (i) an amount equal to the market appreciation in the value of the referenced asset over the term of the swap (if the TRS is cash-settled) or, what is economically the same thing, (ii) the referenced asset in exchange for its value on the last refixing date prior to the winding up of the transaction (if the TRS is settled in kind).

*Id.*

31. *Id.* at 521; *see also* Chance, *supra* note 27, at 78 (providing an example of “[a]n [e]quity [s]wap with the [e]quity [r]eturn [p]aid [a]gainst [a]nother [e]quity [r]eturn”).

In practical economic terms, a TRS referenced to stock places the long party in substantially the same economic position that it would occupy if it owned the referenced stock or security. There are two notable exceptions. First, since it does not have record ownership of the referenced shares, it does not have the right to vote them. Second, the long party looks to the short party, rather than to the issuer of the referenced security for distributions and the marketplace for any appreciation in value.

*CSX Corp.*, 562 F. Supp. 2d at 521.

32. *See CSX Corp.*, 562 F. Supp. 2d at 521; *see also* Chance, *supra* note 27, at 78.

33. *See CSX Corp.*, 562 F. Supp. 2d at 521; *see also* Chance, *supra* note 27, at 78.

34. Adoption of Beneficial Ownership Disclosure Requirements, Securities Act Release No. 5808, Exchange Act Release No. 13,291, 42 Fed. Reg. 12,342, at 12,343 (Mar. 3, 1977) [hereinafter Beneficial Ownership Disclosure Requirements Release].

35. *See Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearing on S. 510 Before the Subcomm. on Securities of the Comm. on Banking and Currency, 90th Cong. 1 (1967) (statement of Sen. Williams, Chairman, S. Subcomm. on Securities).*

to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control.”<sup>36</sup> The disclosure required by § 13(d) is aimed to help investors make informed investment decisions based on market prices that reflect an awareness of the required information.<sup>37</sup> Section 13(d)(1) provides in pertinent part that:

(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78l of this title . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing [certain information].<sup>38</sup>

Further, Rule 13(d)-1(a), which was promulgated by the Commission in 1978 as a regulation under § 13(d),<sup>39</sup> requires any person who acquires, either directly or indirectly, beneficial ownership of greater than 5% of a § 12 registered equity voting security to file and disclose certain information.<sup>40</sup> As such, the disclosure mandated by § 13(d) is only required when a person has beneficial ownership of the security. As stated by former Commission Chairman Manuel F. Cohen, “beneficial ownership is the test.

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At present, however, some areas remain where full disclosure is necessary for investor protection but not required. The legislation before the subcommittee today will close what I consider to be a significant gap in these last remaining areas. It requires the disclosure of pertinent information to stockholders where persons seek to obtain control of a corporation by: (1) a cash tender offer and (2) through open market or privately negotiated purchases of securities. Disclosure would also be required when corporations purchase their own stock in the open market.

*Id.*

36. *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

37. *Id.*

38. Securities Exchange Act of 1934, § 13(d)(1), 15 U.S.C. § 78m(d)(1) (2006).

39. Filing and Disclosure Requirements Relating to Beneficial Ownership, Securities Act Release No. 5925, Exchange Act Release No. 14,692, Investment Company Act Release No. 10,212, 43 Fed. Reg. 18,484, at 18,484 (Apr. 28, 1978).

40. See 17 C.F.R. § 240.13d-1 (2009).

(a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D.

*Id.*

[The acquiring entity] might try to get around it, and that would be a violation of law, but the legal requirement is beneficial ownership.”<sup>41</sup>

The Commission has defined beneficial ownership in Rule 13d-3(a) to include any ownership where the person has voting or investment power over the securities.<sup>42</sup> The Rule provides that:

(a) 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.<sup>43</sup>

The Commission intended Rule 13d-3(a) to be a “broad definition” that would “obtain disclosure from all those persons who have the ability to change or influence control.”<sup>44</sup> In this regard, the determination of beneficial ownership requires “[a]n analysis of all relevant facts and circumstances in a particular situation . . . in order to identify each person possessing the requisite voting power or investment power.”<sup>45</sup> More than one person can have beneficial ownership of a security and may possess such ownership directly or indirectly.<sup>46</sup> For example, if X owns 74% of Y Corporation and Y Corporation purchases 9% of Z Corporation, X is the indirect owner of the 9% interest in Z Corporation, while Y Corporation is the direct owner of the 9% interest.<sup>47</sup>

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41. See *Full Disclosure of Corporate Equity Ownership and Corporate Takeover Bids: Hearing on H.R. 14475 and S. 510 Before the Subcomm. on Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 40–41 (1968) (statement of Manuel F. Cohen, Chairman, SEC).

42. See 17 C.F.R. § 240.13d-3(a)(1)–(2) (2009).

43. *Id.*

44. Filing and Disclosure Requirements Relating to Beneficial Ownership, Securities Act Release No. 5925, Exchange Act Release No. 14,692, Investment Company Act Release No. 10,212, 43 Fed. Reg. 18,484, at 18,484 (Apr. 28, 1978).

45. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,344.

46. See § 240.13d-3.

47. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,346.

*Example 1. Rule 13d-3(a), indirect ownership; Rule 13d-3(d)(i), option to acquire.* X, an individual, beneficially owns sixty-eight percent of Y Corporation. Y Corporation purchases four percent of a class of securities of Z Corporation and also an option, exercisable within thirty days of the date of purchase, to purchase an additional two percent of the outstanding shares of the same class of Z corporation.

*Question.* Does X have a filing obligation and, if so, how may it be satisfied?

*Interpretative Response.* Yes, X has an obligation to file under Rule 13d-1 since under Rule 13d-3 he is the indirect beneficial owner of the Z shares held by Y Corporation due to his power to direct their voting or disposition. It should be noted

Beneficial ownership may arise through any contract, arrangement, understanding, relationship, or other means, and “does not require formal documentation of arrangements.”<sup>48</sup> Essentially, a person is a beneficial owner if he has or shares voting rights or investment power.<sup>49</sup> In order to “have” that power, the person must have such authority at the present time without the consent of another party and without another person having that power.<sup>50</sup> A person shares such power if he and at least one other person can make decisions regarding the voting or disposition of the securities.<sup>51</sup> With respect to voting power, it should be restricted to the ability to vote or to direct the vote.<sup>52</sup> The power to vote means the person can vote himself, while the power to direct the vote means the person can instruct others how to vote.<sup>53</sup> Investment power includes the power to dispose of, or to direct

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that the operation of Rule 13d-3(d)(1)(i) puts X above the five percent threshold inasmuch as the shares subject to the option will be aggregated with those purchased. X’s reporting obligation may be satisfied with a filing by X disclosing his indirect ownership and the intermediaries involved; alternatively, since Y Corporation also would be subject to a separate filing requirement with respect to the same securities, X may file jointly with Y disclosing the control position and other information required with respect to X pursuant to Instruction C to Schedule 13D.

*Id.*

48. SEC v. First City Fin. Corp., 688 F. Supp. 705, 721 (D.D.C. 1988), *aff’d*, 890 F.2d 1215 (D.C. Cir. 1989).

49. § 240.13d-3.

50. See JACOBS, *supra* note 1.

“Has” connotes the present power without the consent of another party and without another person also having that power. Thus, having the power subject to another’s consent is equivalent to not having the power at all. Having the power in the future is not having the present power, but beneficial ownership may exist under Rule 13d-3(d)(1)(i).

*Id.*

51. *Id.*

“Shares” the power means that the person in question and at least one other person can make the decision. Thus, each of three trustees of a trust “shares” the power over securities in the trust’s corpus, even though two of them can outvote the third. On the other hand, if one person has the legal power to vote (since he is the record holder) but another instructs him how to vote, the record holder does not share the power. Rather, the other person “has” the sole power. Thus, sharing the power means the person has a meaningful role (although not necessarily a decisive one) in exercising the power to vote or dispose of the security. “Shares” also connotes a present ability; one who in the future will share the power is not the beneficial owner under Rule 13d-3(a), although he may be a beneficial owner pursuant to Rule 13d-3(d)(1)(i).

*Id.*

52. *Id.* (“The voting power clause [states] ‘voting power which *includes* the power to vote, or to direct the voting.’ ‘Includes’ should be construed as ‘means.’ Accordingly, voting power should be restricted to ‘the power to vote or to direct the vote.’”) *But see* CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 539–48 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008) (using the plain language of the statute to set forth a standard whereby it is sufficient that the party has the ability to influence the voting or disposition of the securities).

53. See JACOBS, *supra* note 1.

the disposition of a security, and it is properly restricted to the words of the statute.<sup>54</sup>

The other way in which a person can have beneficial ownership is under Rule 13(d)-3(b).<sup>55</sup> This Rule provides that:

(b) Any person who, directly or indirectly, [1] creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device [2] with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership [3] 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.<sup>56</sup>

In adopting the Rule, the Commission gave an example of a transaction that would violate § 13(d) involving stock parking,<sup>57</sup> an arrangement which, according to one court, is “a concealment of stock ownership achieved by placing the stock in an account in the name of a third party.”<sup>58</sup> The Commission provided the following example:

In order to acquire a substantial position in the voting securities of Z Corporation prior to the election of directors which will take place in the near future, X causes ten institutions to each acquire three percent of the outstanding shares of Z Corporation. None of the institutions are aware of the purchases by the other institutions or of X’s control objective. As an attempted means of avoiding disclosure of his beneficial ownership of the Z shares until a short time before the election, X, simultaneously with the purchase of the Z shares, gives an irrevocable proxy to A, which proxy will lapse according to its terms . . . . A is a beneficial owner of the Z shares subject to the proxy due to his power to vote them and therefore he must report such ownership pursuant to Rule 13d-1, as well as information about X under Item 6 of Schedule 13D. In addition, as indicated in Rule 13d-3(b), X is also deemed a beneficial owner of the same Z shares for the period of the proxy as well as thereafter, and therefore must file a Schedule 13D.<sup>59</sup>

Aside from stock parking, Commission pronouncements and court decisions have not focused on Rule 13(d)-3(b) until the *CSX* decision.<sup>60</sup>

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54. *Id.*

55. *See* 17 C.F.R. § 240.13d-3(b) (2009).

56. *Id.*

57. *See* Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,348.

58. *SEC v. First City Fin. Corp.*, 688 F. Supp. 705, 720 (D.D.C. 1988), *aff’d*, 890 F.2d 1215 (D.C. Cir. 1989).

59. *See* Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,348.

60. *See* *JACOBS*, *supra* note 1, § 2:13.

This provision has received little notice from the cases and SEC pronouncements. Some cases and a series of SEC releases do no more in substance than merely acknowledge its existence. Another case stated that deliberate efforts to conceal legal ownership do not affect the determination of beneficial ownership . . .

### C. DECOUPLING AND HIDDEN MORPHABLE OWNERSHIP

Decoupling occurs when the voting rights of a security or the investment power over the security are separated from the economic interest in the security.<sup>61</sup> While there are a number of ways to decouple voting rights and investment power from economic ownership,<sup>62</sup> this Article focuses on the use of equity swaps whereby a person with a long position in the swap acquires economic ownership of the shares while the Short Party retains the voting rights and investment power over the securities (assuming that the Short Party has hedged with Matched Shares).<sup>63</sup> The ownership of the shares is “hidden” in that the Long Party does not have to disclose his economic interest under § 13(d).<sup>64</sup> In this regard, practitioners and the SECs Division of Corporation Finance agree that a Long Party does not have beneficial ownership under Rule 13(d)-3(a) unless he has the power to vote or to sell the securities, either pursuant to the swap’s contractual terms or pursuant to another understanding or arrangement with the Short Party.<sup>65</sup> Consequently, a party to a cash-settled swap that has no § 13(d) reporting obligation may acquire a substantial long position in the security without having to file a Schedule 13D.<sup>66</sup> However, if the person beneficially owns physical shares in excess of 5%, he becomes subject to § 13(d) reporting and disclosure issues regarding the swap under

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. . . [The Rule] is a good failsafe but is not an important weapon in a plaintiff’s arsenal.

*Id.* The only case other than *CSX* to even discuss the Rule in any detail is *Levy v. Southbrook Int’l. Invs., Ltd.*, 263 F.3d 10, 14–18 (2d Cir. 2001). In that case, “the Second Circuit held that a cap on the right to convert a derivative security to, say, 4.9% of the outstanding stock, is not a sham and will be respected.” JACOBS, *supra* note 1, § 2:13; *see also Levy*, 263 F.3d at 18.

61. *See Hu & Black, supra* note 4, at 811. (“[T]he derivatives revolution and other capital markets developments now allow both outside investors and insiders to readily decouple economic ownership of shares from voting rights.”).

62. *Id.* at 816.

One method relies on the share lending market, which lets one investor “borrow” shares from another. Under standard lending arrangements, the borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights. . . . Other decoupling strategies are also possible, such as relying on put and call options or, where they exist, single-stock futures.

*Id.*

63. *Id.* at 816.

64. *Id.* at 816, 825 & 868.

65. *See GREENE ET AL., supra* note 1, § 8.02[1].

66. *Id.*

several Items of Schedule 13D.<sup>67</sup> Specifically, Item 6 requires the disclosure of equity swap contracts.<sup>68</sup>

A person who avoids § 13(d) disclosure by holding long positions in equity swaps has hidden morphable ownership if such ownership includes the power to direct the voting of the shares by the Short Party, or the ability to conduct an exchange unwind and acquire the Matched Shares.<sup>69</sup> While Long Parties typically do not have the power to direct the voting of the shares, and do not give explicit direction to Short Parties because such instructions would likely trigger disclosure under § 13(d),<sup>70</sup> the Long Party can choose to enter into an equity swap with a dealer whom it believes will vote the shares in the way it desires. For example, a person may enter into an equity swap with a dealer that owns a hedge fund with a large investment in the company subject to the swap and, therefore, has similar investment objectives as the Long Party. Also, dealers have significant economic incentives to vote the shares in the manner the Long Party desires because they want to obtain the client's business, including potentially receiving large prime brokerage fees.<sup>71</sup> However, the market practice is that dealers make their own voting decisions without consulting the swap counterparties.<sup>72</sup>

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67. See generally 17 C.F.R. § 240.13d-101 (2009) (for example, he would face Item 3—Source and Amount of Funds or Other Consideration; Item 4—Purpose of Transaction; Item 5—Interest in Securities of the Issuer; Item 6—Contracts, Arrangements, Understandings or Relationships with Respect to Securities of the Issuer; and Item 7—Material to be Filed Exhibits); see also GREENE ET AL., *supra* note 1, § 8.02[1] (discussing disclosure).

68. § 240.13d-101. Item 6 requires the person to:

Describe any contracts, arrangements, understandings or relationships (legal or otherwise) among the persons named in Item 2 and between such persons and any person with respect to any securities of the issuer, including but not limited to transfer or voting of any of the securities, finder's fees, joint ventures, loan or option arrangements, puts or calls, guarantees of profits, division of profits or loss, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into. Include such information for any of the securities that are pledged or otherwise subject to a contingency the occurrence of which would give another person voting power or investment power over such securities except that disclosure of standard default and similar provisions contained in loan agreements need not be included.

*Id.*

69. See Hu & Black, *supra* note 4, at 826 (“These ‘morphable voting rights’ will generally not be verifiable by outsiders, and depend on market customs.”).

70. See Black Letter, *supra* note 11, at 8 (“Market practice for U.S. companies, which has developed in part because of § 13(d) rules, is for the dealer to make its own voting decisions, without consulting its swap counterparties.”).

71. See Hu & Black, *supra* note 4, at 815.

72. See Black Letter, *supra* note 11, at 8.

I am not aware of a market practice with respect to whether it is appropriate for a swap counterparty to contact a dealer and attempt to persuade it to vote in a particular way. Such efforts may exist, especially for non-U.S. companies, but they are not the norm for U.S. companies and did not occur in this case. If such attempts were made, they

For example, dealers simply may vote in proportion to what they understand others' votes to be or follow the recommendations of RiskMetrics, a proxy advisory firm.<sup>73</sup> Others may aggregate and "net-off" share positions among multiple trading desks such that the dealer actually has a net short position and thus no voting rights.<sup>74</sup> Further, some dealers may have a policy of not voting the shares, at least in contested situations, or they may be unable to do so because they have lent the shares to third parties under an agreement that transfers the voting rights to the borrower.<sup>75</sup> Thus, even though there are circumstances where the Long Party can influence the voting of the Short Party, in the majority of situations, this is not the case.

A Long Party may have voting power because of its ability to conduct an exchange unwind. This can occur when the Short Party hedges its exposure by acquiring the underlying shares.<sup>76</sup> A derivatives dealer who acts as the Short Party for equity swaps often hedges its positions by purchasing shares in the open market.<sup>77</sup> This is especially the case where the swap involves a large number of shares of a thinly-traded company where alternative hedging strategies may be limited.<sup>78</sup> However, there is no guarantee that the Short Party will hedge in this manner, as hedging strategies vary among dealers.<sup>79</sup> In fact, swap dealers' hedging practices are

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may fail because there is no direct contact between the dealer's swaps desk and the persons who make voting decisions, or because the dealer has a policy against responding to such efforts. It is possible that such an effort may backfire by causing the dealer to abstain from voting.

*Id.*

73. Brief of Amici Curiae International Swaps and Derivatives Association, Inc. and Securities Industry and Financial Markets Association at 21–25, *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) L.L.P.* (2d Cir. July 18, 2008) (No. 08-2899) [hereinafter ISDA Brief].

74. *Id.* at 24–25.

75. See generally SIFMA, Master Securities Loan Agreement (2000), [http://www.sifma.org/services/stdforms/pdf/master\\_securities\\_loan\\_agreement\\_2000\\_version.pdf](http://www.sifma.org/services/stdforms/pdf/master_securities_loan_agreement_2000_version.pdf).

76. See Hu & Black, *supra* note 4, at 838 ("Holding matched shares to hedge an equity swap may be a preferred strategy when the client is concerned with governance, precisely because doing so lends itself to vote morphing.").

77. *Id.* But derivatives dealers may hedge their positions by other means. See generally FINANCIAL SERVICES AUTHORITY, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: CONSULTATION AND DRAFT HANDBOOK TEXT, 2007, CP07/20, [http://www.fsa.gov.uk/pubs/cp/cp07\\_20.pdf](http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf).

78. Hu & Black, *supra* note 4, at 837.

79. See ISDA Brief, *supra* note 73, at 11.

In most cases, the derivatives dealer will hedge its short equity swap position. When hedging occurs, it often (but not always) involves the purchasing of "matched shares." For example, a dealer might take the short side of an equity swap referencing 1,000,000 shares of CSX, and at or very close to the same time, purchase 1,000,000 CSX shares in the market. If the dealer is fully hedged and CSX shares then rise (fall), the dealer will lose (gain) on the swap exactly the same amount it gains (loses) on matched shares.

Other forms of hedging include acquiring a long position in single stock futures, acquiring a (long call option, short put option) position, and acquiring a long position in

far from uniform and many dealers hedge their exposure on a portfolio basis, rather than swap-by-swap.<sup>80</sup> Further, while some dealers may be willing to sell the shares to the party via an exchange unwind, some have a policy of not doing so, and, in any case, they are not obligated to do so.<sup>81</sup> In addition, the International Swaps and Derivatives Association's equity swap documentation and any dealer-specific supplements, which are used for nearly all swaps, do not give the Long Party any power to direct the actions of the dealer with respect to whether the dealer will hedge with Matched Shares. Furthermore, if the dealer does decide to hedge, no guidance is provided concerning how the dealer will vote or dispose of the Matched Shares.<sup>82</sup> Thus, while there are circumstances where the Long

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another equity swap referencing the same company's shares. The dealer will choose whichever hedging method is most economically attractive. Under current market conditions, for sizeable equity swaps, the cheapest means of hedging is usually to acquire matched shares. Smaller positions may be hedge in other ways or left unhedged, and hedges of large positions may be incomplete.

Black Letter, *supra* note 11, at 7–8.

80. ROBERT L. TORTORIELLO & PAUL E. GLOTZER, GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES § II(E)(3)(c) (14th ed. 2009) (summarizing interpretive letters from the Office of the Comptroller of the Currency describing various hedging practices, including hedging on a portfolio basis).

81. See Black Letter, *supra* note 11, at 9.

Dealers' practices with respect to exchange unwinds differ. Some dealers, if they have hedged with matched shares, are willing to sell the shares directly to their investor, if the investor requests this. Other dealers, as a matter of policy, will refuse to sell matched shares directly to the swap counterparty.

Investor preferences with respect to exchange unwinds also differ. Some investors may ask their dealer whether the dealer holds matched shares and is interested in selling the shares to the investor. Others may prefer not to even make such an inquiry, partly to limit market knowledge of their positions, and partly to avoid any inference that they had a prior agreement with the dealer with respect to the possible unwind.

*Id.* Moreover,

[m]arket expectation that a dealer will unwind a swap is not a guarantee, as illustrated by a 2006 buyout offer by Sears Holdings for the minority shares in its Sears Canada subsidiary. A hedge fund had previously acquired equity swaps in Sears Canada from Scotiabank. Scotiabank later became the dealer-manager for Sears Holdings' buyout offer. The offer required approval by a majority of the Sears Canada minority shareholders. Sears Canada's independent directors opposed the bid; so did many Sears Canada shareholders. The hedge fund asked Scotiabank to unwind the swap so it could vote against the offer. Scotiabank not only refused, but also committed to vote its Sears Canada shares *for* the offer. Scotiabank thus became an empty voter; perhaps with negative economic interest because it was an agent for Sears Holdings. The hedge fund complained about Scotiabank's failure to observe swap market conventions and said it was "looking forward to regulatory and legal scrutiny of this transaction."

Hu & Black, *supra* note 4, at 839 (internal citations omitted).

82. See Black Letter, *supra* note 11, at 8.

The ISDA equity swap documentation and any dealer-specific supplements do not give a long equity swap holder any power to direct: (i) whether the derivatives dealer will

Party to an equity swap can acquire the underlying shares and obtain voting power, there are situations where this is not the case.

The Long Party may have investment power where the Short Party has no other means to hedge, because by entering into the swap, the Long Party is essentially directing the Short Party to hedge by purchasing the underlying shares.<sup>83</sup> By unwinding the swap, the Long Party essentially has the power to direct the Short Party to sell the shares, as Short Parties typically sell their hedged shares when the Long Party unwinds the swap.<sup>84</sup> The Long Party may have the ability to acquire the physical shares upon the unwinding of the swap, as the dealer may be willing to sell the shares to the Long Party or the Long Party may simply purchase the shares in the open market.<sup>85</sup> Under circumstances where the Short Party has no means to hedge other than by buying the underlying shares, and such party plans to sell those shares upon the unwinding of the swap, the Long Party essentially has investment power over the security. However, market realities are such that the Short Party does not always purchase the underlying shares to hedge its position in the swap and does not always sell the underlying shares when the Long Party unwinds the swap.<sup>86</sup> Further, even dealers that hedge with Matched Shares may sell them prior to the unwinding of the equity swap or may hold on to them after the swap is unwound.<sup>87</sup> Thus, even though there are circumstances where the Long

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hedge; (ii) if the dealer hedges, how it does so, with matched shares or in another way; (iii) if the dealer hedges by acquiring matched shares, whether the counterparty will hold those shares on the record date for a shareholder meeting, or will instead lend the shares to others on that date[;] (iv) if the dealer hedges with matched shares and holds them on a record date, whether the counterparty will vote the shares at the shareholder meeting; or (v) if the counterparty hedges with shares, holds those shares on the record date, and votes the shares, how the counterparty will vote. The dealer-specific addendum will sometimes specifically state that some or all of these matters are in the sole discretion of the dealer.

*Id.*

83. See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 546 (S.D.N.Y. 2008), *aff'd*, 292 F. App'x 133 (2d Cir. 2008).

84. *Id.* at 542 (“With very minor exceptions, whenever TCI terminated a swap, the counterparty sold the same number of physical shares that were referenced in the unwound swap and it did so on the same day that the swap was terminated.”). However, “[m]arket expectation that a dealer will unwind a swap is not a guarantee.” See *Hu & Black*, *supra* note 4, at 839.

85. See *Black Letter*, *supra* note 11, at 9.

86. See *supra* notes 78–82 and accompanying text.

87. See *ISDA Brief*, *supra* note 73, at 23. Examples of where this might occur include:

[1] Where a swap dealer has offsetting swaps, it may simply dispose of the initially established hedges (to the extent they set off), in order to reduce transaction costs

[2] Where traders decide to take a market “view” on particular shares, market segments or the market in general, they may adjust share holdings that were initially acquired as a hedge, thereby taking on, rather than hedging, exposure.

Party has the power to influence the disposition of the security, there are situations where this is not the case.

### III. *CSX CORP. V. CHILDREN'S INVESTMENT FUND* *MANAGEMENT*

#### A. FACTS OF THE CASE

TCI is an activist<sup>88</sup> hedge fund that buys large enough stakes in companies to bring about changes in the direction of the companies.<sup>89</sup> Likewise, in October 2006, TCI began acquiring long positions in total return equity swaps in CSX because it thought that if it could influence the company to make certain changes, the value of its positions would increase.<sup>90</sup> By the end of 2006, TCI had acquired 8.8% of CSX.<sup>91</sup> Beginning in December 2006, TCI explored the possibility of a leveraged buyout.<sup>92</sup> In February 2007, CSX announced a plan to repurchase some of its stock in an effort to defend itself against a potential takeover.<sup>93</sup> Accordingly, TCI began contacting other hedge funds, attempting to influence them to acquire shares in CSX in order to build support for whatever course of action TCI would decide to take with respect to its ownership in the company.<sup>94</sup> In accordance with this plan, 3G, one of the funds contacted by TCI, began purchasing shares in CSX.<sup>95</sup> As of March 29, 2007, TCI owned equity swaps referencing nearly 14% of CSX stock, but had yet to purchase any of the company's shares directly.<sup>96</sup>

In March and April of 2007, TCI began to acquire physical shares of CSX.<sup>97</sup> At this point, a leveraged buyout was becoming a less likely

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[3] Where traders "cross-hedge" using one security, or an index of securities, as a surrogate for another, or hedge positions in multiple securities with a single listed or unlisted derivative on an index of securities.

*Id.*

88. See Dieter G. Kaiser, *Activists*, in *ENCYCLOPEDIA OF ALTERNATIVE INVESTMENTS* 5 (Greg N. Gregoriou ed., 2009). "The investment process of an activist begins with fundamental analysis to identify companies [that are undervalued]." *Id.* The activist will then engage in either a friendly or a hostile strategy. *Id.* A fund using a friendly strategy will have private communications with management in an effort to effect change in the company that will increase shareholder value. *Id.* Alternatively, or after friendly tactics are unsuccessful, the activist may use a hostile strategy, such as waging a proxy contest or threatening and/or engaging in a change in control transaction. *Id.* at 5–6.

89. See *CSX Corp.*, 562 F. Supp. 2d at 533.

90. *Id.* at 523.

91. *Id.* at 524.

92. *Id.*

93. *Id.* at 553.

94. *Id.*

95. *Id.*

96. *Id.* at 526.

97. *Id.* at 527.

alternative because CSX had shown little interest in it.<sup>98</sup> Consequently, TCI explored the possibility of a proxy fight as a means to effect the changes in CSX that it desired.<sup>99</sup> By holding the actual shares as opposed to swaps, TCI had the ability to vote the shares.<sup>100</sup> In August 2007, TCI met with a proxy solicitation firm to discuss the mechanics of a proxy contest,<sup>101</sup> and in October 2007, TCI began to identify potential director nominees.<sup>102</sup> In November 2007, TCI began unwinding its swap positions with six of its eight counterparties and shifted its positions to Citigroup and Deutsche Bank in part because it believed that such firms may vote the same way as TCI in a proxy contest.<sup>103</sup> In this regard, Deutsche Bank owned a hedge fund, Austin Friars Capital, which had a proprietary position in CSX.<sup>104</sup> Austin Friars Capital consulted with TCI on multiple occasions about the direction that CSX should take to maximize shareholder value.<sup>105</sup>

As noted, 3G began purchasing CSX stock in February 2007.<sup>106</sup> By October 2007, 3G owned a combination of physical shares and positions in swaps amounting to 4.2% of CSX.<sup>107</sup> The economic exposure of 3G to CSX never exceeded 4.9% of CSX stock.<sup>108</sup> In anticipation of a proxy fight, 3G began searching for potential nominees to the board of CSX, and two nominees were secured by December 2007.<sup>109</sup> On December 10, 2007, TCI, 3G, and their director nominees (collectively, the Group) filed a Schedule 13D disclosing that they were going to engage in a proxy solicitation.<sup>110</sup> The Group then filed a notice of intent to nominate a minority slate of five directors to the board of CSX, which was comprised of twelve directors.<sup>111</sup> The Group supplemented its notice to include a bylaw that would allow shareholders owning 15% of CSX stock to call a special meeting.<sup>112</sup> CSX filed a preliminary proxy statement in February 2008 and the group filed its proxy statement on March 10, 2008.<sup>113</sup>

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98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 528.

102. *Id.* at 535.

103. *Id.* at 529–30.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.* at 532.

108. *Id.*

109. *Id.* at 535.

110. *Id.*

111. *Id.* at 536.

112. *Id.* at 537.

113. *Id.*

**B. RULINGS IN THE CASE**

CSX filed suit on March 17, 2008 alleging that TCI violated § 13(d) by failing to timely disclose its beneficial ownership of the shares of CSX stock referenced in the total return swaps and claiming that TCI was a beneficial owner of such shares under Rules 13d-3(a) and 13d-3(b).<sup>114</sup> CSX also alleged that TCI and 3G had formed a § 13(d) group ten months prior to filing a Schedule 13D.<sup>115</sup>

The court did not decide the question of whether the ownership of the swaps by TCI constituted beneficial ownership under the definition in Rule 13d-3(a), but did offer its view that such a position likely did.<sup>116</sup> It found that “[i]n the last analysis there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties.”<sup>117</sup>

With respect to whether TCI had voting power under Rule 13d-3(a), the court found that “[i]n the last analysis, the question whether there was an agreement-explicit or implicit-between Deutsche Bank and TCI with respect to the voting of the shares is a close one.”<sup>118</sup> However, the court explained that “there nevertheless is reason to believe that TCI was in a position to influence the counterparties, especially Deutsche Bank, with respect to the exercise of their voting rights.”<sup>119</sup> The court reasoned that TCI moved its shares to Deutsche Bank because it believed it could influence the voting of the Matched Shares.<sup>120</sup> This belief was based in part on the fact that Austin Friars Capital was owned by Deutsche Bank, held a proprietary position in CSX, and, as of March 2007, shared a common interest in taking the railroad private.<sup>121</sup> The court also speculated that Deutsche Bank may have recalled loans of shares around the record date so that it would be entitled to vote them in a manner favorable to TCI, evidenced by the reloaning of the shares immediately after the record date.<sup>122</sup> The court also found that TCI potentially had the power to influence how the counterparties voted the shares by selecting banks with certain voting policies.<sup>123</sup> While there may not have been an explicit agreement or understanding between TCI and the banks with respect to the voting of the shares, the court found that there was enough evidence, especially with

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114. *Id.* at 538.

115. *Id.* at 538–39.

116. *Id.* at 545–48.

117. *Id.* at 545.

118. *Id.*

119. *Id.* at 546.

120. *Id.*

121. *Id.* at 544.

122. *Id.*

123. *Id.* at 544.

respect to Deutsche Bank, that TCI had the power to influence the voting of the securities, although it did not decide this question.<sup>124</sup>

With respect to whether TCI had investment power, the court found that TCI contemplated and intended that the counterparties would hedge the swaps by purchasing shares in CSX and that it was inevitable that the counterparties would hedge in this manner.<sup>125</sup> It further reasoned 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.”<sup>126</sup> The court reasoned that “once the counterparties bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions.”<sup>127</sup> Thus, while TCI did not explicitly direct the banks to purchase or sell the hedged shares, the court found that TCI had investment power, although it technically did not decide this question.<sup>128</sup>

The court, however, did decide the question of whether TCI was a beneficial owner under Rule 13d-3(b),<sup>129</sup> holding that “TCI created and used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d).”<sup>130</sup> The court found that “[u]nder the plain language of Rule 13d-3(b), [TCI] is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures created by the TRSs.”<sup>131</sup> The court reasoned that TCI purposely remained below the 5% disclosure requirement for its ownership of physical shares and made certain that its counterparties stayed below 5% in order to avoid the filing of a Schedule 13D on behalf of itself or its counterparties.<sup>132</sup> The court explained that TCI acted in such a manner to avoid paying a higher price for CSX shares.<sup>133</sup> It further found that avoiding disclosure allowed

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124. *Id.* at 542.

125. *Id.*

126. *Id.* at 543. The court noted that:

[W]hile there theoretically are means of hedging that do not require the purchase of physical shares, in the situation before the Court it is perfectly clear that the purchase of physical shares was the only practical alternative. Indeed, TCI effectively has admitted as much. It did so by spreading its swap transactions among eight counterparties to avoid any one hitting the 5 percent disclosure threshold and thus triggering its own reporting obligation—a concern that was relevant only because TCI knew that the counterparties were hedging by buying shares. And it did so in closing argument, where its counsel said that the banks’ purchases of CSX shares were “the natural consequence” of the swap transactions.

*Id.* at 546.

127. *Id.*

128. *Id.*

129. *Id.* at 552.

130. *Id.*

131. *Id.*

132. *Id.* at 548–49.

133. *Id.*

TCI to exert pressure on CSX without providing the market or the company with complete information.<sup>134</sup>

In interpreting the amicus letter from the SECs Division of Corporation Finance, the court easily found that Rule 13d-3(b) applies “when one enters into a transaction with the intent to create the false appearance that there is no large accumulation of securities that might have . . . potential for shifting corporate control by evading the disclosure requirements of [§] 13(d) or (g) through preventing the vesting of beneficial ownership in the actor.”<sup>135</sup> Further, the court dismissed Professor Bernard Black’s argument that, in order for Rule 13d-3(b) to apply, the underlying evasive activity must constitute beneficial ownership under Rule 13d-3(a).<sup>136</sup> It reasoned that “[a]s Rule 13d-3(b) is reasonably related to the purpose of the statute, it is a perfectly appropriate exercise of the Commission’s authority even where it reaches arrangements that otherwise would not amount to beneficial ownership” and that “[i]f Rule 13d-3(b) reaches only situations that involve beneficial ownership, then it reaches only situations that are reached by Rule 13d-3(a) [which would] render Rule 13d-3(b) superfluous.”<sup>137</sup>

The court also held that TCI and 3G formed a § 13(d) group ten months prior to filing a Schedule 13D.<sup>138</sup> Section 13(d)(3) provides that “[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ . . . .”<sup>139</sup> The court reasoned that “the existing relationship, the admitted exchanges of views and information regarding CSX, 3G’s striking patterns of share purchases immediately following meetings with Hohn and Amin [partners at TCI], and the parallel proxy fight preparations, all suggest that the parties’ activities from at least as early as February 13, 2007, were products of concerted action. . . .”<sup>140</sup> Consequently, the court held that the physical shares acquired by TCI and 3G between February and December 2007 were obtained when the parties should have filed a Schedule 13D, and, thus, the funds were in violation of § 13(d).<sup>141</sup> This Article maintains that this holding was correct based on the overwhelming evidence suggesting that the parties formed a group<sup>142</sup> and, therefore, provides no further analysis of this particular holding.

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134. *Id.*

135. *Id.* at 550.

136. See Black Letter, *supra* note 11, at 5.

137. *CSX Corp.*, 562 F. Supp. 2d at 552.

138. *Id.* at 558.

139. 15 U.S.C. § 78m(d)(3) (2006).

140. See *CSX Corp.*, 562 F. Supp. 2d at 554.

141. *Id.* at 552–54. The court noted that “[d]efendants most recently held 8.3 percent of CSX’s shares. Of that total, 1.9 percent were acquired by 3G before its disclosure obligation arose upon the expiration of 10 days following the formation of a group with TCI no later than February 13, 2007.” *Id.* at 568 n.314.

142. *Id.* at 553. This evidence includes that:

As relief, among other requested remedies, CSX sought an injunction prohibiting TCI and 3G from voting any CSX shares at the 2008 annual meeting, including those shares obtained when in violation of § 13(d), which amounted to approximately 6.4% of CSX's outstanding shares.<sup>143</sup> To obtain an injunction, a moving party such as CSX has to show success on the merits and irreparable harm if the relief is not granted.<sup>144</sup> Furthermore, according to the Supreme Court in *Rondeau v. Mosinee Article Corp.*, for § 13(d) actions the irreparable harm must be caused to those interests that the Section seeks to protect, such as alerting investors to potential changes in corporate control.<sup>145</sup> CSX showed success on the merits because the court found that, among other things, "TCI and 3G failed to file the required disclosure within [ten] days of forming a group."<sup>146</sup> Thus, the critical issue was whether CSX could show irreparable harm.

In attempting to show irreparable harm, CSX made two arguments.<sup>147</sup> The first was that TCI and 3G should have been foreclosed from voting the

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TCI and 3G have had a close relationship for years, in part because 3G's Synergy Fund is an investor in TCI.

January 2007—Hohn and Behring discuss TCI's investment in CSX, including its approximate size.

February 2007—3G begins buying CSX shortly after Behring's January conversation with Hohn.

On or about February 13, 2007—Hohn speaks to his "friend Alex" Behring about CSX as a result of market excitement regarding CSX attributable in whole or part to 3G's heavy buying.

At about the same time, Hohn begins tipping other funds to CSX, which continues for some time. This is an effort to steer CSX shares into the hands of like-minded associates.

March 29, 2007—Amin and Behring meet.

March 29, 2007—3G resumes CSX purchases after hiatus.

March 29, 2007 through April 18, 2007—TCI increases its overall (shares plus swaps) position by 5.5 million shares, or 1.2 percent of CSX. 3G increases its position by 11.1 million shares, or 2.5 percent of CSX.

August to September 2007—Hohn becomes concerned about possible reregulation. Both 3G and TCI reduce their CSX exposures, although 3G to a proportionately greater extent than TCI.

Late September—October 2007—TCI tells D.F. King it probably will mount proxy contest. Hohn and Behring meet on September 26, 2007. Both TCI and 3G resume increasing their positions in the wake of the meeting. Both begin looking for director nominees.

*Id.*

143. *Id.* at 568.

144. *Id.* at 567.

145. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975).

146. *CSX Corp.*, 562 F. Supp. 2d at 568.

147. *Id.*

shares they acquired during the period in which they were in violation of § 13(d) because failing to enjoin the votes would result in irreparable injury to shareholders who may have been content with present management.<sup>148</sup> The court found CSX's argument unpersuasive, partly because corrective disclosure had already been made.<sup>149</sup> It also reasoned that while the actions of TCI and 3G altered the corporate electorate, their conduct did no more than increase the funds' likelihood of prevailing in the current contest, and could not be regarded as causing irreparable injury that could be properly remedied by the sterilization of votes.<sup>150</sup>

The second argument made by CSX was that sterilization was required "to avoid permitted defendants [from] retain[ing] the fruits of their violations and to deter future violations."<sup>151</sup> Some courts have suggested that relief beyond corrective disclosure is appropriate to deter violations, and they typically consider "(1) whether a substantial number of shares were purchased after the misleading disclosures and before corrective disclosure, (2) whether the curative disclosure occurred simultaneously with or on the eve of a tender offer, and (3) whether the violation was egregious."<sup>152</sup> The Commission advanced such a position in its amicus brief in *San Francisco Real Estate Investors v. Real Estate Investment Trust of America*, suggesting that "[a]bsent a remedy beyond ordering corrective disclosure, a person will have little incentive to comply with the statute."<sup>153</sup> However, the court in *CSX* did not find such an argument persuasive and ruled that it was foreclosed by *Rondeau*.<sup>154</sup> In doing so, it held that "a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants' voting rights and that plaintiff has failed to establish such a threat."<sup>155</sup>

#### IV. CRITIQUES OF THE RULINGS IN *CSX* AND PROPOSALS FOR REFORM

##### A. LONG PARTIES TO EQUITY SWAPS ARE NOT BENEFICIAL OWNERS UNDER RULE 13D-3(A)

Rule 13d-3 provides that a person beneficially owns a security if he directly or indirectly has or shares voting or investment power through any

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148. *Id.* at 568–69.

149. *Id.* at 569–71.

150. *Id.*

151. *Id.* at 568.

152. *Id.* at 571 (quoting *S.F. Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000, 1009 (1st Cir. 1983)).

153. Brief for the SEC as Amicus Curiae at 36, *S.F. Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000 (1st Cir. 1983) (No. 82-1853) [hereinafter *San Francisco SEC Amicus Brief*]; see also *Gen. Steel Indus., Inc. v. Walco Nat'l Corp.*, SEC Litig. Release No. 9533, 24 SEC Docket 439 (Dec. 21, 1981).

154. *CSX Corp.*, 562 F. Supp. 2d at 571–72.

155. *Id.* at 572.

contract, arrangement, understanding, relationship, or otherwise.<sup>156</sup> A holder of a long position in an equity swap does not have beneficial ownership of the security because he has neither voting nor investment power over the security.<sup>157</sup>

The first reason that Long Parties to equity swaps do not have beneficial ownership over the shares held by the Short Party is because the definition of beneficial ownership does not extend to purely economic interests.<sup>158</sup> According to the Staff of the SEC Division of Corporation Finance (the Staff), “economic or business incentives, in contrast to some contract, arrangement, understanding, or relationship concerning voting power or investment power between the parties to an equity swap, are not sufficient to create beneficial ownership under Rule 13d-3.”<sup>159</sup> Moreover, practitioners share the same view.<sup>160</sup> In this regard, a standard cash-settled swap does not give the Long Party voting or investment power over the Matched Shares, absent a contract, arrangement, understanding, or relationship concerning voting or investment power.<sup>161</sup> The Long Party merely has “an economic interest in the market performance of the referenced security, including any dividends or other distributions associated with it.”<sup>162</sup> Thus, even though the Short Party may have economic or business incentives to vote the shares as the Long Party wishes, or to sell the shares upon the unwinding of the swap, the Long Party does not have actual authority to direct the voting or disposition of the securities.<sup>163</sup> In this regard, the Long Party essentially owns the economic equivalent of nonvoting shares, which are not required to be disclosed under § 13(d).<sup>164</sup> Further, “when the counterparty chooses to act in these areas in circumstances where it is unconstrained by either legal rights held by the other party or by any understanding, arrangement or restricting

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156. See 17 C.F.R. § 240.13d-3 (2009).

157. See generally GREENE ET AL., *supra* note 1. A long position is the “purchase of securities by an investor with the hope there will be an increase in price allowing an investor to recognize a profit from the eventual sale of the securities.” MODERN DICTIONARY FOR THE LEGAL PROFESSION (3d ed. 2001).

158. See Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15,348, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,762 (Nov. 22, 1978). In the adopting release, the Commission declined to include “traditional economic interests in securities, i.e., the right to receive dividends and the right to receive proceeds upon sale” as “criteria for defining beneficial ownership for purposes of Regulation 13D-G.” *Id.*

159. See Breheny Letter, *supra* note 1, at 2.

160. See JACOBS, *supra* note 1, § 2:13.

161. See Breheny Letter, *supra* note 1, at 2.

162. Brief of Amicus Curiae Managed Funds Association in Support of Neither Party 4, CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 292 F. App’x 133 (2d Cir. 2008) (No. 08 Civ. 2764) [hereinafter Managed Funds Association Brief].

163. *Id.*

164. See Black Letter, *supra* note 11, at 17.

relationship with the other party, it is acting independently and in its own economic interests.”<sup>165</sup>

Because the swap agreement between TCI and its counterparties contained no contract, understanding, arrangement, or relationship concerning voting or investment power, TCI is not the beneficial owner of the Matched Shares under Rule 13d-3(a). Further, since the mere presence of economic incentives to vote or dispose of securities does not fall within the definition of beneficial ownership contained in this Rule,<sup>166</sup> TCI did not possess voting or investment power over the securities. As most swap agreements are similar to those entered into by TCI,<sup>167</sup> most Long Parties to equity swaps do not have beneficial ownership under Rule 13d-3(a).

The second reason that a Long Party to an equity swap does not have beneficial ownership over the shares held by the Short Party is because the mere ability to influence another party is insufficient to establish beneficial ownership.<sup>168</sup> In this regard, the court in *CSX* is incorrect in its view that Rule 13d-3(a) extends to persons who can merely influence the voting or disposition of the securities.<sup>169</sup> Beneficial ownership requires control over

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165. Breheny Letter, *supra* note 1, at 2.

166. Managed Funds Association Brief, *supra* note 162.

167. See Black Letter, *supra* note 11, at 7.

Equity swaps are in theory privately negotiated contracts. However, the principal terms of the vast majority of equity swaps are based on documentation published by the International Swap Dealers Association (ISDA). Some dealers use supplements to the standard ISDA equity swaps form, but the principal terms of these supplements are standardized and not individually negotiated with each client.

*Id.* (footnote omitted).

168. ISDA Brief, *supra* note 73.

169. See *CSX Corp.*, 562 F. Supp. 2d at 548–49. ISDA’s amicus brief explained:

In the 1978 Release, the SEC stated that “[t]he legislative history of [§ 13(d)] indicates that it was intended to provide information to the public and the affected issuer about rapid accumulations of its equity securities in the hands of persons who would then have the potential to change or influence *control of the issuer*,” not the potential to ‘influence’ (but not control) the voting of the securities. 1978 Release, 43 Fed. Reg. at 18,484 (emphasis added). Similarly, in the 1977 Release, the SEC used the term “influence” to emphasize that the purpose of determining beneficial ownership under Section 13(d) was to identify the party . . . .

ISDA Brief, *supra* note 73, at 17. The brief further stated:

The district court’s reliance on the 1981 Release was also misplaced. SPA-55, 62. The court cited to a footnote in the release - focused on Section 16(a) - stating that “[w]hile the concepts of beneficial ownership under Section 16(a) and under Rule 13d-3 have much in common, the former stresses the economic benefit to be derived from the securities and the latter emphasizes the ability to control or influence the voting or disposition of shares.” 46 Fed. Reg. at 48,149 n. 17. This passing observation about Section 13 in a release devoted to rules promulgated under Section 16 is not enough to overcome the Rule’s plain language and Congress’ statutory scheme as set forth in Section 13(d), not to mention the clearly contradictory releases [adopted release].

*Id.* at 18 n.5.

the voting or disposition of the shares because “the terms ‘voting power’ and ‘investment power’ as used in the Rule . . . are based on the concept of the *actual authority* to vote or dispose or the authority ‘to direct’ the voting or disposition [of the securities].”<sup>170</sup> Moreover, in adopting the beneficial ownership rules, the Commission chose not to extend the rules to relatives living in the same household because “such a standard was totally inapposite to the voting/investment power approach,”<sup>171</sup> even though such persons may have significant influence over the voting or disposition of the securities by the beneficial owner.<sup>172</sup> Further, the beneficial ownership rules were adopted “to provide *more objective standards*” for the rules defining beneficial owner,<sup>173</sup> and an influence standard is based on subjectivity, which could lead to substantial uncertainty for persons attempting to comply with Rule 13d-3(a).<sup>174</sup> Because the Long Party to an equity swap merely has the ability to influence the voting or disposition of the securities, he does not have voting or investment power as defined in Rule 13d-3(a).<sup>175</sup> Consequently, such person or entity, including TCI, does not have to disclose his long position in an equity swap.

The third reason that holders of long positions in equity swaps do not have beneficial ownership of the Matched Shares is because this judicial interpretation of Rule 13(d)-3(a) incorrectly assumes that the Short Parties always hedge by purchasing the referenced security, and/or that the Long Parties always have the ability to direct the voting and/or disposition of the securities, and such assumptions would lead to substantial uncertainty in applying the Rule. With respect to dispositive power, the argument for beneficial ownership is that the Short Party has to hedge with Matched Shares, and that he will sell the shares when the Long Party unwinds the swap.<sup>176</sup> However, the Short Party does not always purchase the underlying shares to hedge its position in the swap, as hedging practices vary widely among dealers.<sup>177</sup> Further, even where it does hedge with such shares, it may sell them prior to the unwinding of the equity swap or may hold on to them even after the swap is unwound.<sup>178</sup> Consequently, even assuming that there are situations where the Long Party has the ability to direct the disposition of the security by causing the Short Party to purchase the

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170. See Breheny Letter, *supra* note 1, at 2 (emphasis added).

171. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,348.

172. See ISDA Brief, *supra* note 73, at 15–16.

173. *Id.* at 16 (quoting Adoption of Beneficial Ownership Disclosure Requirements, Securities Act Release No. 5808, Exchange Act Release No. 13,291, 42 Fed. Reg. 12,342, at 12,343 (Mar. 3, 1977) (emphasis in original)).

174. *Id.* at 19.

175. See 17 C.F.R. § 240.13d-3(a) (2009).

176. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 541–43 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

177. See TORTORIELLO & GLOTZER, *supra* note 80; see also Black Letter, *supra* note 11, at 7 (“when hedging occurs, it often (but not always) involves purchasing ‘matched shares.’”).

178. See *supra* part II.C.

underlying shares or by causing the Short Party to sell the shares when the Long Party unwinds the swap, there are circumstances where this is not the case. With respect to voting power, the argument for beneficial ownership is that Long Parties can direct or influence the voting of the securities by the Short Parties and/or that they can acquire the Matched Shares upon an exchange unwind and obtain voting rights.<sup>179</sup> However, market realities are such that dealers make their own voting decisions without consulting with the swap counterparties, or may have a policy of not voting their shares.<sup>180</sup> Therefore, while there may be situations where the Long Party has the ability to direct the voting of the shares, or at least has the ability to influence the voting (assuming *arguendo* that influence is the correct standard), there are situations where this is not the case. Further, as explained with respect to dispositive power, because the Short Party does not always purchase Matched Shares—and even when the Short Party purchases the Matched Shares—there is no guarantee that it will sell the shares to the counterparty upon the unwinding of the swap. Thus, there is uncertainty as to whether the Long Party can obtain voting rights.

The uncertainty created by the judicial interpretation of a Rule requiring disclosure of beneficial ownership by Long Parties whose counterparties' hedge with Matched Shares would be difficult for the SEC to administer, since beneficial ownership would be determined solely based upon whether, and in what manner, the Short Party hedged the swap.<sup>181</sup> Further, because “there is no economic difference to an investor between an equity swap hedged by the derivatives dealer with [M]atched [S]hares, and an equity swap hedged in another way, one cannot logically say that the former conveys § 13(d) beneficial ownership and the latter does not.”<sup>182</sup> Moreover, parties could simply contract around the Rule by stating in the swap contract that Short Parties cannot hedge with physically Matched Shares, and thus, the Rule would not capture all long positions in equity swaps.<sup>183</sup> Parties seeking to avoid § 13(d) may simply start to use cash-settled single stock futures that have very similar economic characteristics to equity swaps, but that according to a Commission interpretation, do not confer beneficial ownership.<sup>184</sup>

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179. *CSX Corp.*, 562 F. Supp. 2d at 542–45.

180. See Black Letter, *supra* note 11, at 8.

181. See Sullivan, *supra* note 25, at 1317.

182. See Black Letter, *supra* note 11, at 16.

183. *Id.* at 12.

184. *Id.* at 13. The following interpretation is from an Exchange Act Release:

Q18: Would the equity securities underlying a security future that requires cash settlement be counted for purposes of determining whether the purchaser of the contract is subject to the Regulation 13D beneficial ownership reporting requirements?

A18: No. A purchaser of a cash-settled security future (i.e., a security future that, by its terms, must be settled by a cash payment) would not count the equity securities underlying the contract for purposes of determining whether he or she is subject to the

Because the standard posited by the court depends on specific market practices, it will not lead to uniform results. This will make compliance and administration difficult. For example,

[i]f an investor who holds matched shares is the beneficial owner (in the 13(d) sense) of the matched shares which its dealers holds as a hedge, but the dealer retains the power to hedge in any way it wants, to change the form of its hedge over time, and to potentially not hedge at all, how is the investor to know how many shares it beneficially owns?<sup>185</sup>

In this regard, “it would seem strange to decide *ex post* that equity swaps with dealer 1, which follows one set of practices, count as beneficial ownership of shares; while swaps with dealer 2, which follows a different set of practices, do not.”<sup>186</sup> Such a vague, uncertain, and subjective standard is unworkable. As such, Long Parties should not have to disclose their ownership positions in equity swaps under a judicial interpretation of Rule 13d-3(a).<sup>187</sup> The Commission should amend this rule to capture these ownership positions.

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Regulation 13D reporting requirements, because he or she does not have the right to acquire beneficial ownership of the underlying security.

Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Securities Act Release No. 8107, Exchange Act Release No. 46,101; 67 Fed. Reg. 43,234, at 43,240 (June 27, 2002).

185. See Black Letter, *supra* note 11, at 11. In addition,

among other potential consequences, market participants –

Will face substantial uncertainty as to when their participation in swap transactions may give rise to reporting obligations because they could be said, in retrospect, to have had “influence” over someone else who held securities or been part of a “scheme to evade” reporting requirements.

Will have to design and implement highly sophisticated and extremely expensive monitoring systems, if even possible, to ensure that disclosure obligations are not triggered by securities that they do not own, but over whose owners they may have “influence” or whose “accumulation” may be considered to be part of a “scheme to evade” reporting requirements.

Will face uncertainty as to how standards that largely depend on the “practical realities” of the “real world” will be affected by changes in market practices.

Will constantly have to calibrate on a highly subjective scale how their actions might “influence” another to purchase or sell securities.

ISDA Brief, *supra* note 73, at 25–26.

186. Black Letter, *supra* note 11, at 17.

187. See Sullivan, *supra* note 25, at 1317–19.

**B. RULE 13D-3(A) SHOULD BE AMENDED TO REQUIRE THE  
DISCLOSURE OF LONG POSITIONS IN EQUITY SWAPS**

The Commission is currently “evaluating whether persons using equity derivatives, such as an equity swap, should be subject to the beneficial ownership reporting provisions of the Exchange Act when accumulating substantial share positions in connection with change of control transactions.”<sup>188</sup> The Commission should amend Rule 13d-3(a) to require such persons to be subject to the beneficial ownership rules. Other regulators have already adopted similar reforms,<sup>189</sup> including the Financial Services Authority (FSA), which regulates financial markets in the United Kingdom (U.K.).<sup>190</sup> Similar to the FSA rules for contracts for difference, which are the U.K. equivalent of equity swaps, the Commission should amend Rule 13d-3(a) to require the disclosure of Long Parties’ holdings in equity swaps and other similar instruments. Disclosure should be required regardless of whether the instrument is physically settled in cash or in shares.<sup>191</sup> Just like the U.K. rules, there should be an exemption for dealers that hold long positions in equity swaps as the result of client-servicing transactions (i.e., transactions that are not made on a proprietary basis, such as where a dealer writes a short equity swap for a client, resulting in the dealer holding a long position in the swap).<sup>192</sup> According to the FSA, “[t]he principle behind [such an] exemption is that firms holding a position purely to facilitate a client position, with no interest in the performance of underlying equity, should not need to make a disclosure.”<sup>193</sup>

Rule 13d-3(a) should be expanded to capture economic ownership by using concepts found in the definition of beneficial ownership in § 16 of the Exchange Act.<sup>194</sup> Specifically, Rule 13d-3(a) should be amended to include a new category of beneficial ownership for any “[d]irect or indirect

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188. See *Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (testimony of Mary L. Shapiro, Chairman, SEC), available at <http://www.sec.gov/news/testimony/2009/ts062209mls.htm>.

189. Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PENN. L. REV. 625, 684–86 (2008). Hong Kong and Switzerland have adopted such reforms, and other countries are in the process of considering whether to implement changes to their rules. *Id.* at 684.

190. See generally FINANCIAL SERVICES AUTHORITY, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: FEEDBACK ON CP08/17 AND FINAL RULES, 2009, PS09/3, [http://www.fsa.gov.uk/pubs/policy/ps09\\_03.pdf](http://www.fsa.gov.uk/pubs/policy/ps09_03.pdf) [hereinafter FSA FEEDBACK ON CP08/17]. These rules took effect on June 1, 2009. See Financial Services Authority (FSA), Disclosure and Transparency Rules, §§ 5.1.2, 5.1.3, 5.3.1–5.3.4, 5.7.1, 5.8.2 (2009), available at <http://fsahandbook.info/FSA/html/handbook/DTR/5>.

191. See FSA, Disclosure and Transparency Rules, § 5.3.3.

192. *Id.* § 5.3.1.

193. See FINANCIAL SERVICES AUTHORITY, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: FEEDBACK AND POLICY STATEMENT ON CP07/20, AND FURTHER TECHNICAL CONSULTATION, 2008, PS09/3, § 3.34, available at [http://www.fsa.gov.uk/pubs/cp/cp08\\_17.pdf](http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf).

194. See Hu & Black, *supra* note 4, at 882.

pecuniary interest in such security.”<sup>195</sup> “Pecuniary interest” should have the same definition as it does in Rule 16a-1.<sup>196</sup> The definitions of “derivative instrument” and “immediate family” should have the same meaning that they have under this Rule.<sup>197</sup> The definition of “indirect pecuniary interest” should also have the same definition that it has in the Rule; however, the provision regarding derivative securities should be expanded to capture long positions in equity swaps and long ownership positions in similar instruments.<sup>198</sup> To this end, the definition of indirect pecuniary interest should be revised to include, among other things, “[a]ny derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit . . . from the [subject security’s value increasing], including a person’s right to acquire the . . . security through the exercise or conversion of any derivative instrument, whether or not presently exercisable.”<sup>199</sup> In addition, there should be an exemption for dealers holding long positions in equity swaps or similar instruments where these positions were acquired to facilitate client transactions. This exemption would apply to a client-serving intermediary (as defined in the Rule), which “(a) fulfill[s] orders received from clients otherwise than on a proprietary basis; (b) respond[s] to a client’s requests to trade otherwise than on a proprietary basis; or (c) hedge[s] positions arising out of dealings [described] in (a) or (b).”<sup>200</sup>

Amending Rule 13d-3(a) in this manner would require disclosure of persons’ long positions in equity swaps, which would prevent them from using such positions to influence the voting or disposition of a company’s

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195. Memorandum of Theodore N. Mirvis et al., Wachtell, Lipton, Rosen & Katz, Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century 6 (Mar. 3, 2008), <http://www.wlrk.com/webdocs/wlrknew/FirmMemos/WLRK/WLRK.15395.08.pdf> (proposing amendments to Rule 13d-3). The Rule would read as follows with the proposed amendments:

(a) 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; and/or,

(3) Direct or indirect pecuniary interest in such security.

*Id.* (emphasis in original).

196. *Id.* at 13d-3-2. Rule 13d-3(e) should read: “The term pecuniary interest in any security shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject security.” *Id.*

197. *Id.* at 13d-3-3.

198. *Id.* at 13d-3-2 to 13d-3-3.

199. *Id.* at 13d-3-2.

200. Financial Services Authority (FSA), Disclosure and Transparency Rules, § 5.3.1 (2009), available at <http://fsahandbook.info/FSA/html/handbook/DTR/5>.

securities, or engaging in an exchange unwind for the purposes of voting at the annual meeting, conducting a proxy contest, or making a tender offer. Currently, Long Parties have the ability to exert significant influence or control over a company, without public disclosure, in the following ways: First, when a Long Party enters into an equity swap, he, in certain instances, has the ability to influence the disposition of the underlying shares because the Short Party at times has no other effective means to hedge other than purchasing the Matched Shares (e.g., in the case of thinly traded stock).<sup>201</sup> Further, where the Short Party does hedge with Matched Shares, the Long Party has the ability to influence the disposition of the securities through unwinding the swap, regardless of whether he acquires the shares from the Short Party or the shares are sold in the open market.<sup>202</sup> With respect to voting power, the Long Party has the ability to influence the voting of the securities by choosing a counterparty that has a similar voting interest.<sup>203</sup> Additionally, a Long Party may acquire a large amount of a company's securities prior to an annual meeting of shareholders by engaging in an exchange unwind and then vote the newly obtained shares at the meeting. A Long Party could also engage in an exchange unwind and then launch a proxy contest. Moreover, Long Parties may conduct stealth takeovers, several of which have occurred in Switzerland, where the Long Party could acquire a large amount of securities through an equity swap, conduct an exchange unwind, and then launch a tender offer.<sup>204</sup> In addition, equity swaps can be used to conduct a "street sweep" tender offer, where a bidder "can acquire [shares], cross the 5% threshold for 13D disclosure, and . . . before the 13D must be filed, buy up to 9.9% of a target's shares (stopping short of the 10% level that would trigger . . . Exchange Act § 16) and then use decoupling strategies to jump to a much higher level," prior to ever filing a Schedule 13D.<sup>205</sup> Because Long Parties to equity swaps currently can exert significant influence or control over a company without making public disclosure, Rule 13d-3(a) needs to be amended to require these persons to disclose their ownership positions. Such an amendment will alert investors and the marketplace to the accumulation of these large economic positions in a company's stock.

Amending Rule 13d-3(a) would promote investor protection because it would give investors information regarding persons with large economic positions in the securities of a company that have the ability to influence or control the company. It would also preserve market integrity because it assures that a large economic position in a company's stock, the disclosure

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201. See Hu & Black, *supra* note 4, at 837.

202. See *supra* Part II.C.

203. See Hu & Black, *supra* note 4, at 837-38.

204. See Hu & Black, *supra* note 189, at 655-59 (contains examples and the Swiss regulatory response).

205. *Id.* at 736.

of which often results in an increase in the stock price, reaches the marketplace. Regarding the *CSX* opinion, while the court in the case was correct in reasoning that there should be disclosures of long positions in equity swaps, reform should not be made through judicial interpretation because such interpretation leads to substantial uncertainty in the application of the Rule.<sup>206</sup> Moreover, because the Rule was written in the 1970s, before equity swaps or other over-the-counter derivatives existed, it is more appropriate to amend the beneficial ownership rules than try to come up with a meaningful interpretation of an antiquated law.<sup>207</sup> Thus, while the court in *CSX* reached the correct conclusion from a policy standpoint, the optimal way for long positions in equity swaps to be disclosed is to amend Rule 13d-3(a).<sup>208</sup>

Investors are not the only ones who need information about Long Parties' holdings in equity swaps, as this information is also critical to issuers. Presently, companies are engaging in private ordering by adopting second generation advance notice bylaws and poison pills that include a definition of beneficial ownership that encompasses equity swaps and other similar instruments.<sup>209</sup> They are doing so to fill a regulatory gap in the definition of beneficial ownership in Rule 13d-3(a).<sup>210</sup> The private ordering that is occurring in this context can simply be defined as the coming together of non-governmental parties in voluntary arrangements to adopt rules in an area where the government has not yet regulated.<sup>211</sup>

One way that private ordering is occurring is through the insertion of provisions in advance-notice bylaws.<sup>212</sup> Advance-notice bylaws are bylaws "regulating the ability of shareholders to nominate directors or place items on the agenda for consideration at a company's annual or special meeting or by consent."<sup>213</sup> Such bylaws obligate shareholders to provide a specific amount of notice to the company of their proposed directors or agenda items prior to the meeting date.<sup>214</sup> Regarding these bylaws, "[t]ransparency

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206. *Contra* Bertaccini, *supra* note 24 (providing opposing view).

207. *See* Black Letter, *supra* note 11, at 11.

208. Please note that § 13F, which requires disclosure of holdings by institutional money managers, including hedge funds, may need to be amended for the amendment of Rule 13(d)-3(a) to have a sufficient impact on the market.

209. Posting of Charles M. Nathan & Stephen Amdur, Latham & Watkins L.L.P., to The Harvard Law School Forum on Corp. Governance and Financial Regulation (Apr. 22, 2009), [http://www.lw.com/upload/pubContent/\\_pdf/pub2604\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2604_1.pdf).

210. *See id.*

211. *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 327 (2002); *see also* Abram Chayes et al., *Compulsory Terms and Private Ordering*, THE BRIDGE, <http://cyber.law.harvard.edu/bridge/LegalProcess/compulsory.htm> (last visited 1/26/2010).

212. *See* Nathan & Amdur, *supra* note 209, at 1.

213. Marc Weingarten & Erin Magnor, *Second Generation Advance Notification Bylaws*, ACTIVIST INVESTING DEV. (Schulte Roth & Zabel L.L.P., New York, NY), Winter 2009, at 1, 1, [http://www.srz.com/files/News/c13da694-90e5-4080-bc71-0afadf6e832b/Presentation/NewsAttachment/b0dcad4d-4e02-4634-8156-046c2bceada/AIDev\\_Winter09.pdf](http://www.srz.com/files/News/c13da694-90e5-4080-bc71-0afadf6e832b/Presentation/NewsAttachment/b0dcad4d-4e02-4634-8156-046c2bceada/AIDev_Winter09.pdf).

214. *Id.*

and accountability for decoupled equity and voting interests in the context of actual or potential proxy contests was the first problem addressed by private ordering [in the area of decoupling].<sup>215</sup> Right around the time of the CSX decision, companies began to insert provisions in their advance-notice bylaws that define beneficial ownership in a way that captures Long Parties' positions in equity swaps and long ownership positions in other similar instruments.<sup>216</sup>

Another way that private ordering is occurring is through the adoption or renewal of second generation poison pills.<sup>217</sup> These anti-takeover devices are being adopted or renewed to include a definition of beneficial ownership that encompasses long ownership positions in equity swaps and other similar instruments.<sup>218</sup> The rationale for adopting these shareholder rights plans is the ease at which such instruments can be converted to traditional equity by activist investors attempting a proxy contest, or others interested in a change of control transaction.<sup>219</sup>

The private ordering that is occurring in the adoption of advance notice bylaws and poison pills to capture long positions in equity swaps and other similar instruments shows that companies need information about parties' ownership positions in these securities.<sup>220</sup> Companies should not have to fill the regulatory gap in Rule 13d-3(a) by drafting provisions that create a

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215. See Nathan & Amdur, *supra* note 209, at 3.

216. *Id.*

[L]aw firms began recommending that their clients insert requirements in their advance notice bylaws calling for proxy contest proponents to include in their required advance notice of matters they proposed to bring to a shareholder meeting information concerning their decoupled equity and voting interests, whether consisting of synthetic equity without votes, or votes decoupled, in whole or in part, from the economic exposure of traditional equity investment. These provisions have now been inserted in over 550 second generation advance notice bylaws, a number that will likely grow significantly over the next few years.

*Id.*

Such increased disclosure requirements should not be problematic for shareholder proponents, or objectionable. While such disclosures may provide a company with more information than it would have based on SEC filings alone, the overall consequence of companies learning more about the holdings of proponent shareholders should not significantly affect the ability of proponents to nominate directors or propose business for shareholder meetings.

See Weingarten & Magnor, *supra* note 214, at 2. For sample bylaws containing these provisions, see Latham & Watkins L.L.P., Sample Advance Notice & Related Bylaw Provisions (September 2008), [http://www.lw.com/upload/pubContent/\\_pdf/pub2322\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2322_1.pdf).

217. Mark D. Gerstein et al., Latham & Watkins L.L.P., *The Resurgent Rights Plan: Recent Poison Pill Developments and Trends* (2009), [http://www.lw.com/upload/pubContent/\\_pdf/pub2628\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub2628_1.pdf). Approximately 28% of rights plans adopted or renewed in 2008 contained language including derivatives or synthetic equity in the calculation of the beneficial ownership threshold that triggers a rights plan. *Id.*

218. See Nathan & Amdur, *supra* note 209, at 3.

219. See Gerstein et al., *supra* note 217, at 2.

220. See Nathan & Amdur, *supra* note 209, at 2.

definition of beneficial ownership capturing these ownership positions. Rather, such a definition is properly the subject of Commission rulemaking. Consequently, the Commission should amend Rule 13d-3(a) to assure that the definition of beneficial ownership includes Long Parties' holdings in equity swaps and other similar instruments.

**C. PERSONS DO NOT HAVE BENEFICIAL OWNERSHIP UNDER RULE 13D-3(B) UNLESS THEY ARE BENEFICIAL OWNERS UNDER RULE 13D-3(A)**

As previously mentioned, Rule 13d-3(b) provides that any person who (1) uses a contract, (2) with the purpose or effect of preventing the vesting of beneficial ownership of a security, (3) as part of a plan or scheme to evade the reporting requirements of § 13(d) is deemed a beneficial owner of the security.<sup>221</sup> Since equity swaps are contracts and TCI entered into such agreements with the counterparties, the first element is met.<sup>222</sup> Regarding the second element, TCI acted with the purpose and effect of preventing the vesting of beneficial ownership by entering into equity swaps because one of its motives in purchasing the swaps was the avoidance of reporting under § 13(d), and because it monitored its counterparties to assure that they stayed below the 5% ownership threshold that would require disclosure.<sup>223</sup> However, TCI did not violate Rule 13d-3(b) because in order to engage in a plan or scheme to evade the reporting requirements of § 13(d) a person has to be a beneficial owner under Rule 13d-3(a).<sup>224</sup> Since TCI is not a beneficial owner under Rule 13d-3(a),<sup>225</sup> it cannot be deemed a beneficial owner under Rule 13d-3(b).

The first reason that TCI should not have been deemed the beneficial owner of the shares under Rule 13d-3(b) is because the ownership of long positions in equity swaps does not constitute beneficial ownership under § 13(d) or Rule 13d-3(a),<sup>226</sup> and thus, the swaps were not used to create the false appearance of non-ownership of a security. Absent unusual circumstances or an egregious situation, the “plan or scheme to evade” language requires a showing that there was intent to enter into an arrangement that creates a false appearance.<sup>227</sup> While Long Parties to equity swaps, including TCI, often purchase swaps to exert control over a company while avoiding disclosure under § 13(d),<sup>228</sup> this conduct does not comport with the meaning of the terms unusual circumstances, or egregious

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221. 17 C.F.R. § 240.13d-3 (2009).

222. See CSX Corp. v. Children's Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 548–49 (S.D.N.Y. 2008), *aff'd*, 292 F. App'x 133 (2d Cir. 2008).

223. See *id.*

224. See Black Letter, *supra* note 11, at 5.

225. See *supra* Part IV.A.

226. See *id.*

227. See Breheny Letter, *supra* note 1, at 3.

228. See Hu & Black, *supra* note 189, at 630.

situation. Therefore, the issue is whether the arrangement created a false appearance. The term “false appearance” refers to the false appearance of the non-ownership of a security,<sup>229</sup> rather than, as the district court found, the “false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control.”<sup>230</sup> According to the SEC Division of Corporation Finance, for the transaction to fall within the “plan or scheme to evade” language, it must be a sham where the equity swap is being used to create a false appearance or illusion that is contrary to the actual situation (i.e., the person is not actually the owner of the shares).<sup>231</sup> However, it is the contention of this Article that in order to have the intent to enter into an arrangement that creates a false appearance of non-ownership, one must in fact be the beneficial owner of the security in the first place. In this regard, it is impossible to use an equity swap to create the false appearance that the person is not a beneficial owner where the person’s ownership position does not meet the definition of beneficial ownership under Rule 13d-3(a). Simply put, entering into an equity swap to avoid the reporting and disclosure requirements is not necessarily a violation of § 13(d).<sup>232</sup> While acting with such a purpose satisfies the second element of Rule 13d-3(b), it does not attest to whether the person had a plan or scheme to evade the reporting requirements.<sup>233</sup> Thus, a person’s actions do not come within Rule 13d-3(b) when his ownership position does not constitute beneficial ownership under § 13(d) or Rule 13d-3(a).

This conclusion is best explained by reference to the interpretation of a similar safe-harbor rule in Rule 144A of the Securities Act of 1933 (the Securities Act) which reads that “this section is not available with respect to any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the [Securities] Act. In such cases, registration under the [Securities] Act is required.”<sup>234</sup> This safe-harbor, as well as a correlative provision in Regulation S of the Securities Act, was interpreted by the Staff to not apply when a person engages in a sham transaction to create the illusion that the transaction should be exempt from registration

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229. See Breheny Letter, *supra* note 1, at 3.

230. CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 550 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

231. See Breheny Letter, *supra* note 1, at 3.

232. See GREENE ET AL., *supra* note 1, § 8.02[1].

233. Opening Brief of Defendants-Appellees-Cross-Appellants at 41–42, CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 292 Fed. App’x 133 (2d Cir. 2008) (No. 08 Civ. 2899) [hereinafter Opening Brief].

234. Preliminary Note 3, 17 C.F.R. § 230.144A (2009); *see also* Preliminary Note 1, Regulation S, 17 C.F.R. §§ 230.901–904 (2009) (containing nearly identical language to that quoted above).

under the Securities Act.<sup>235</sup> On the other hand, where the person simply enters into a transaction that is not covered by the Securities Act, the safe harbors are inapplicable.<sup>236</sup> For example, a person conducting a private placement of equity swaps does not engage in a plan or scheme to evade the Securities Act because swaps are not securities under it.<sup>237</sup> Consequently, the person has simply complied with the Securities Act by not issuing securities and the safe harbor is inapplicable.<sup>238</sup> Similarly, the owning of long positions in equity swaps does not constitute beneficial ownership under § 13(d). Moreover, the Exchange Act generally does not apply to equity swaps, but rather to voting shares.<sup>239</sup> The holder of a long position in equity swaps has simply complied with the Exchange Act by entering into a transaction that does not trigger disclosure under § 13(d), and thus, Rule 13d-3(b) and its “plan or scheme to evade” language does not apply. Consequently, “a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements.”<sup>240</sup> In other words, “[o]ne does not evade a statute by complying with it.”<sup>241</sup>

The second reason why long positions in equity swaps do not come within the purview of Rule 13d-3(b) is because the only statement by the Commission regarding violations of this rule is an example of “stock parking,” an activity which includes several elements that differentiate it from hidden ownership through the use of equity swaps.<sup>242</sup> In the Commission Release giving an example of a violation of Rule 13d-3(b), X caused 10 institutions to each purchase 3% of Z Corporation for X and gave A an irrevocable proxy, which will lapse.<sup>243</sup> Under these facts, the Commission concluded that X is deemed a beneficial owner under Rule 13d-3(b).<sup>244</sup> In this example, X had beneficial ownership of the shares, but it was hidden because he “parked” his voting rights with a third party by giving such party an irrevocable proxy.<sup>245</sup> Thus, this example stands for the proposition that a beneficial owner who attempts to conceal his ownership

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235. Letter from Jacob H. Stillman, Solicitor, SEC, to Judge Karon O. Bowdre United States District Judge, Northern District of Alabama 9 (Nov. 28, 2006), available at <http://www.sec.gov/litigation/briefs/2006/healthsouthbrief.pdf>.

236. See Black Letter, *supra* note 11, at 5.

237. *Id.*

238. *Id.*

239. *Id.* at 6.

240. See Breheny Letter, *supra* note 1, at 4.

241. See Black Letter, *supra* note 11, at 5.

242. Stephen Labaton, *Business and the Law: Is ‘Stock Parking’ Like Jaywalking?*, N.Y. TIMES, Mar. 14, 1988, at D2, available at <http://www.nytimes.com/1988/03/14/business/business-and-the-law-is-stock-parking-like-jaywalking.html?pagewanted=1>.

243. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,347; see also SEC v. First City Fin. Corp., 688 F. Supp. 705, 721 (D.D.C. 1988), *aff’d*, 890 F.2d 1215 (D.C. Cir. 1989).

244. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,347.

245. *Id.*

of the shares by transferring voting control to a third party is deemed a beneficial owner under Rule 13d-3(b).<sup>246</sup> Like person X in the stock parking example, a person that purchases a long position in an equity swap may do so to avoid disclosure. Such person has essentially transferred voting control to a third party, provided that the third party has hedged with Matched Shares. More importantly, however, unlike person X, a Long Party to an equity swap is not a beneficial owner attempting to conceal his beneficial ownership, as there have been no purchases of physical shares.<sup>247</sup> Rather, he has engaged in an investment that is not subject to § 13(d).<sup>248</sup> In addition, there are two other material distinctions between shares parked with another party and shares purchased by a Short Party for hedging purposes.<sup>249</sup> In this regard, “[p]arking involves an understanding that the client will buy the stock back at a later date and protect its counterparty against loss.”<sup>250</sup> With an equity swap, there is no such understanding and the dealer must protect itself against loss.<sup>251</sup> Thus, hedging with Matched Shares is distinguishable from conventional stock parking. Consequently, a holder of a long position in an equity swap should not be deemed a beneficial owner under Rule 13d-3(b).

The third reason that Long Parties to equity swaps should not be deemed beneficial owners of the shares held by Short Parties under Rule 13d-3(b) is because the Commission did not intend for the Rule to capture purely economic interests. When the Commission issued the proposing release regarding the beneficial ownership rules, the definition of beneficial ownership included “the right to receive or the power to direct the receipt of dividends from or the proceeds from the sale” of equity securities.<sup>252</sup> These economic interests are nearly identical to those received by the Long Party in an equity swap.<sup>253</sup> The Commission, however, ultimately decided not to include these economic interests in the definition of beneficial ownership.<sup>254</sup> Instead, the Commission decided to include Item 5 of Schedule 13D, which required disclosure by actual beneficial owners of “any other person . . . known to have an economic interest,” such as the right to receive dividends or sale proceeds.<sup>255</sup> Thus, the Commission distinguished beneficial

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246. See Opening Brief, *supra* note 233, at 33–34 (discussing “parking schemes” and beneficial ownership).

247. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,347.

248. See *GREENE ET AL.*, *supra* note 1, § 8.02[1].

249. See *Hu & Black*, *supra* note 4, at 869.

250. *Id.*

251. *Id.*

252. Disclosure of Corporate Ownership: Rules, Schedules, and Reporting and Registration Forms, Securities Act Release No. 5609, Exchange Act Release No. 11,616, Public Utility Holding Company Act No. 19,140, 40 Fed. Reg. 42,212, 42,217 (Sept. 11, 1975); see also ISDA Brief, *supra* note 73, at 7.

253. See ISDA Brief, *supra* note 73, at 7.

254. See Beneficial Ownership Disclosure Requirements Release, *supra* note 34, at 12,348.

255. *Id.* at 12,352 (note this is now Item 6 of Schedule 13D).

ownership from economic ownership by drafting rules where economic only interests do not create beneficial ownership, but requiring that such interests be disclosed by actual beneficial owners.<sup>256</sup> In promulgating Rule 13d-3(b), the Commission surely “did not intend that an arrangement it had expressly concluded should not fall within the definition of beneficial ownership [i.e., arrangements where the party only has economic interests] would result in its participants being ‘deemed’ beneficial owners under the ‘scheme to evade’ provision.”<sup>257</sup> Consequently, Rule 13d-3(b) should not be used to deem holders of long positions in equity swaps beneficial owners of the shares held by Short Parties.

#### **D. THE NEED FOR STERILIZATION AND COURTS WILLING TO ENJOIN THE VOTING OF SHARES**

The court in *CSX* should have sterilized the votes for the shares illegally obtained by TCI and 3G because failing to do so results in irreparable harm to CSX shareholders since the voting of the shares resulted in an unfair director election. In addition, courts should more readily grant this remedy in § 13(d) proceedings. While the court in *CSX* rightly stated that “a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants’ voting rights,”<sup>258</sup> it incorrectly held that CSX did not establish such a threat.<sup>259</sup> Consequently, TCI and 3G should not be able to succeed in a proxy contest by voting shares that they obtained in violation of the securities laws to the detriment of CSX’s other shareholders.

The failure to sterilize votes leads to an unfair election of directors, as demonstrated when TCI and 3G obtained the shares at a reduced price, giving them an ill-gotten voting position in the securities.<sup>260</sup> In this regard, “TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX, which would have been the product of front-running that it expected would occur if its interest in CSX were disclosed to the market generally.”<sup>261</sup> If TCI and 3G had to pay a greater price for the securities, their ownership position would likely have been smaller, and the positions of other CSX shareholders would probably have been more significant. Under these circumstances, TCI and 3G would have had to obtain a larger amount of support to prevail in the proxy contest

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256. See ISDA Brief, *supra* note 73, at 6–8.

257. *Id.*

258. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 572 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

259. *Id.* at 572.

260. Brief for Washington Legal Foundation et al. as Amici Curiae in Support of Plaintiff/Appellant, Urging Reversal at 13, *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 292 F. App’x 133 (2d Cir. 2008) (No. 08-2899) [hereinafter WLF Brief].

261. See *CSX Corp.*, 562 F. Supp. 2d at 549.

than was necessary at the time of the contest.<sup>262</sup> By purchasing these shares at a reduced price, the funds were able to gain an unfair advantage in their efforts to exercise control over CSX.<sup>263</sup> Specifically, they accumulated an economic interest requiring disclosure and failed to disclose such interest, while tipping selective third party funds and encouraging them to acquire CSX.<sup>264</sup> Obtaining the shares at a reduced price increased the voting power of TCI and 3G, allowing them to manipulate the corporate electorate and giving them a significant advantage in the proxy contest.<sup>265</sup> As a result, their votes should have been sterilized to prevent an unfair director election.<sup>266</sup> The court's failure to sterilize votes will lead to an unfair election of directors because it improperly tilts the playing field in favor of activist hedge funds. In drafting the Williams Act, the drafters commented upon the "extreme care" which was taken "to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid."<sup>267</sup> In violating the Williams Act, TCI and 3G changed the composition of CSX's shareholder base to the detriment of those CSX shareholders who may not have shared their vision for the company.<sup>268</sup> Specifically, many activist hedge funds, including TCI and 3G, attempt to maximize the stock price over a short time period and realize quick profits.<sup>269</sup> However, other shareholders are often focused on long-term growth.<sup>270</sup> In this regard, the court should not have allowed TCI and 3G to employ a scheme to avoid disclosure as a means of gaining an unfair advantage over shareholders who do not share their investment goals. By allowing the funds to vote shares in a proxy contest that were obtained when other shareholders did not possess complete information about the

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262. See WLF Brief, *supra* note 260, at 10.

263. *Id.* at 12.

264. *Id.* at 28–29 n.13.

Indeed, TCI's and 3G's efforts to enlist the support of other hedge funds was just one more part of their effort to tilt the playing field in their favor and against the interests of other, longer-term shareholders. Given the Williams Act's well-recognized goal of maintaining a "level playing field" among all participants in contests for corporate control, the tilt caused by TCI's and 3G's resort to a "wolfpack" strategy provides just one more reason why the injunctive relief requested by CSX is essential to restoring a level playing field and preventing CSX's shareholders from suffering irreparable harm.

*Id.* at 29 n.13.

265. *Id.* at 10–11.

266. Further, other persons that violate § 13(d) should be enjoined from voting their shares for the same reason.

267. See *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975) (quoting S. 550, 90th Cong., at 3 (1967); H.R. Rep. No. 1711, 90th Cong., at 4 (1968)); see also *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937, 947 (2d Cir. 1969).

268. See WLF Brief, *supra* note 260, at 8.

269. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006).

270. *Id.*

funds' ownership positions or intentions,<sup>271</sup> the court improperly tilted the playing field in favor of activist hedge funds. Therefore, such entities, including TCI and 3G, should have been enjoined from voting shares obtained when in violation of § 13(d).

The third reason that the failure to sterilize votes results in an unfair election of directors is that corrective disclosure does not cure the harm caused by TCI and 3G. In this regard, the court acknowledged that

[the] actions [of TCI and 3G] may have contributed to creating a corporate electorate that is materially different today than it was before [TCI and 3G] made [their] purchases. Those who are content with present management and unconvinced by [TCI's and 3G's] blandishments may be in a weaker position than they might have occupied had [TCI and 3G] made full and timely disclosure. That all of the facts now have been disclosed does not alter this prospect.<sup>272</sup>

Further, the court expressly acknowledged that the conduct of TCI and 3G increased the funds' likelihood of prevailing in the proxy contest.<sup>273</sup> Yet, one of the court's rationales for not sterilizing the votes was that corrective disclosure had already been made.<sup>274</sup> Corrective disclosure is simply not sufficient to remedy the unfair advantage gained by TCI and 3G in the proxy contest. "An injunction against future violations [and corrective disclosure], without more, not only leaves defendants their ill-gotten gains but also permits them to add to those gains every time they vote their shares."<sup>275</sup> While corrective disclosure gives shareholders the ability to make a decision after reading all the Schedule 13D information, it does not prevent TCI and 3G from voting shares obtained at a reduced price in violation of § 13(d). It also allows activist hedge funds to gain an unfair advantage in contests for corporate control. Consequently, the votes of TCI, 3G, and other violators of § 13(d) should be sterilized.

Fourth, the votes should have been sterilized because, in the actual proxy contest, two of the directors selected by the funds were elected by

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271. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 511 (S.D.N.Y. 2008), *aff'd*, 292 F. App'x 133 (2d Cir. 2008).

272. *Id.* at 569.

273. *See id.*

274. *Id.* at 570.

275. George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 932 (May 1983).

Conceptually, an injunction against voting the shares therefore differs little from an injunction against future violations; sterilization merely forbids voting which, though legal in itself, is made possible by the illegal acquisition. In this respect sterilization resembles many remedies granted in other areas of administrative law. It does not interfere with corporate governance in a way contrary to the intent of Congress.

*Id.*

less than 6.4% of the vote,<sup>276</sup> which is the percentage of shares for which there were disclosure violations.<sup>277</sup> In a very close election contest, CSX announced in July 2008 that “[i]f the Court decides in favor of the CSX position, [two of the TCI directors] will not have the votes needed to be elected to the Board.”<sup>278</sup> After the Second Circuit issued a summary order affirming the decision to not enjoin the voting of the shares,<sup>279</sup> the two TCI directors joined the board of CSX.<sup>280</sup> Thus, two of the directors elected to the Board were elected with shares that were illegally obtained when TCI and 3G were in violation of § 13(d). This outcome shows the impact that the votes of illegally obtained shares can have on director elections and other agenda items at shareholder meetings. Consequently, the votes of TCI, 3G, and other shareholders that violate § 13(d) should be sterilized.

The fifth reason why the votes should have been sterilized and why courts should more readily enjoin votes in future § 13(d) litigation is that, in certain circumstances, the Commission has recognized equitable relief as necessary to remedy intentional violations of § 13(d).<sup>281</sup> In 1981, the Commission stated that a court’s equitable powers to remedy violations of § 13(d) include “the authority to order any relief appropriate under the circumstances.”<sup>282</sup> In this regard, “equitable remedies in addition to corrective disclosure . . . may be necessary or appropriate to remedy violations of the Williams Act, particularly in cases where the defendant deliberately violated Section 13(d).”<sup>283</sup> Absent a sufficient remedy, shareholders could be irreparably harmed and the defendant would be permitted to benefit from his wrongful conduct.<sup>284</sup> Further, where the remedy is limited to corrective disclosure, shareholders are not adequately protected from the harm flowing from the violation.<sup>285</sup> Equity requires that violators of § 13(d) be prevented from taking advantage of the shares obtained while they were in violation of the statute.<sup>286</sup>

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276. Ronald D. Orol’s Blog, [http://ronorol.blogspot.com/2008\\_06\\_01\\_archive.html](http://ronorol.blogspot.com/2008_06_01_archive.html) (June 25, 2008).

277. *See CSX Corp.*, 562 F. Supp. 2d at 568.

278. Press Release, CSX, CSX Announces Final Voting Results for 2008 Annual Meeting of Shareholders (July 31, 2008), [http://www.csx.com/?fuseaction=employees.retirees\\_news-detail&i=49798](http://www.csx.com/?fuseaction=employees.retirees_news-detail&i=49798).

279. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 292 F. App’x. 133, 134 (2d Cir. 2008) (summary order).

280. Press Release, CSX, CSX Board Invites Two New Members to Join Immediately (Sept. 16, 2008), <http://investors.csx.com/phoenix.zhtml?c=92932&p=irol-newsArticle&ID=1197607&highlight>.

281. *Gen. Steel Indus., Inc.*, Litigation Release No. 9533, 24 SEC Docket 439, 440 (Dec. 21, 1981).

282. *Id.*

283. *Id.*

284. *Id.*

285. *See generally* Memorandum of the SEC, Amicus Curiae, *Gen. Steel Indus., Inc. v. Walco Nat’l Corp.*, No. 81-2345, (8th Cir. 1981) [hereinafter *General Steel SEC Amicus Memo*] (discussing equitable relief beyond corrective disclosure).

286. *Id.* at 7.

By allowing TCI and 3G to vote in the proxy contest, the *CSX* court deprived other shareholders of adequate protection against the harm flowing from the violation of § 13(d). In this regard, the group should not have been permitted to take advantage of the shares it obtained while in violation of the statute. TCI and 3G should have been enjoined from voting their shares in the proxy contest. In addition, other courts addressing this issue should not hesitate in sterilizing the shares of parties that violate § 13(d).

The sixth reason why the votes should have been sterilized and why future courts should enjoin violators of § 13(d) from voting at shareholder meetings is that such a remedy is supported by the case law.<sup>287</sup> In *Rondeau*, the Supreme Court held that a showing of irreparable harm is necessary for a private litigant to obtain injunctive relief in a suit under § 13(d).<sup>288</sup> In that case, the purchaser acquired less than 10% of the issuer's stock while unaware of the then recent amendment to § 13(d) lowering the triggering level of disclosure from 10% to 5%.<sup>289</sup> The shareholder subsequently filed a Schedule 13D disclosing all of the required information and chose not to proceed with a tender offer.<sup>290</sup> Further, the Court found that there was no evidence that the shareholder would fail to comply with § 13(d) in the future.<sup>291</sup> Unlike *Rondeau*, where the defendant chose not to proceed with a tender offer, the defendants in *CSX* were attempting to take control of the company by engaging in a proxy contest.<sup>292</sup> The other shareholders were put at a disadvantage in the contest because they did not have adequate information during the period in which TCI and 3G were preparing for the proxy fight. Further, TCI and 3G obtained their shares at a reduced price altering the corporate electorate of shareholders with votes at the meeting. There is also evidence that TCI and 3G may engage in this conduct in the future, as this proposition was the reason the court enjoined them from future violations of § 13(d).<sup>293</sup> The parties' conduct was not a mere technical violation like the shareholder's actions in *Rondeau*, but displayed a willful disregard of the disclosure requirements of § 13(d). TCI and 3G

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287. See *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975).

288. *Id.* at 57.

289. *Id.* at 55.

290. *Id.* at 59.

The short of the matter is that none of the evils to which the Williams Act was directed has occurred or is threatened in this case. Petitioner has not attempted to obtain control of respondent, either by a cash tender offer or any other device. Moreover, he has now filed a proper Schedule 13D. . . .

*Id.*

291. *Id.* (“[T]here has been no suggestion that he will fail to comply with the Act’s requirement of reporting any material changes in the information contained therein.”).

292. See generally *id.*; *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 511 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

293. See *CSX Corp.*, 562 F. Supp. 2d at 572–73.

failed to file a Schedule 13D for ten months in order to acquire the stock at a reduced price and to avoid SEC disclosure requirements.<sup>294</sup> Because the facts in *CSX* are distinguishable from *Rondeau*, the court should have sterilized the shares.

Other district court opinions support a finding that the shares should have been sterilized. For example, in *Champion Parts Rebuilders, Inc v. Cormier Corp.*, several shareholders violated § 13(d) by failing to timely file a Schedule 13D.<sup>295</sup> The violation was for failing to disclose their group formation and/or omitting material facts in the Schedule 13D regarding their control intent.<sup>296</sup> These shareholders had agreed to acquire control of the company through a proxy fight.<sup>297</sup> The court neutralized the shares

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294. *Id.* at 552–55, 573.

295. *See generally* *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F. Supp. 825 (N.D. Ill. 1987).

296. *Id.* at 832, 834, 836–37.

297. *Id.* at 838–39. The reorganization plan was as follows:

*Management Reorganization and Corporate Strategy*

I. Management Reorganization

A. 13-D Holders call for Special Shareholders Meeting

1. Groups calling for special shareholders meeting

- |               |     |
|---------------|-----|
| a. Hodes-Gray | 8%  |
| b. Robinson   | 5%  |
| c. Cormier    | 10% |
| d. Gross      | 12% |

2. Proceed to arrange for meeting

- a. obtain shareholders list
- b. go to court to force meeting if necessary
  1. 13D groups excluding Gross meet to arrange cost sharing if and when a fight breaks out
3. Upon presentation of demand for shareholders meeting, try to get Schwartz to peacefully agree to reorganize management i.e. have directors resign to be replaced by 13D nominees

B. Should Schwartz not immediately agree to a change

1. Initiate proxy fight 13D groups meet to agree on a full slate of directors

C. The Proxy battle

1. Nominees for reorganized board should include following characteristics
  - a. stock ownership in size
  - b. broad range of business disciplines
  - c. automotive experience
2. areas of weakness for 13D groups proxy battle

acquired by these persons in violation of § 13(d) ruling that all such shares had to be voted in proportion to the votes cast by all other shareholders.<sup>298</sup> It reasoned that the “group’s conduct in failing to make proper disclosure [when] they were acquiring control . . . deprived Champion’s present shareholders of the opportunity to make a full range of different decisions as to Champion’s future course . . . [an] injury [that is] both irreparable and cognizable in equity.”<sup>299</sup> The *CSX* court stated that the *Champion* decision “relied on considerations that are inappropriate in light of *Rondeau*.”<sup>300</sup> However, the *Champion* court relied on the fact that the company’s other shareholders suffered irreparable harm, which is precisely the standard for a preliminary injunction set forth in *Rondeau*.<sup>301</sup> Further, *Champion* is distinguishable from *Rondeau* for the same reasons set forth above upon which *CSX* can be distinguished.

In addition, *Champion* is analogous to *CSX* because both cases involved a disclosure violation for failing to timely disclose the formation of a § 13(d) group, and each case related to a proxy contest.<sup>302</sup> Moreover, like the shareholders in *Champion*, *CSX* shareholders were deprived of the opportunity to make informed decisions regarding *CSX* for the ten months during which *TCI* and *3G* were acquiring the stock in violation of § 13(d).<sup>303</sup> Specifically, some of *CSX*’s shareholders may not have shared the hedge funds’ views regarding the future of the company, and, like the shareholders in *Champion*, such shareholders were deprived of the opportunity to make a reasoned investment decision regarding the company’s stock.<sup>304</sup> Similar to the defendants in *Champion*, *TCI* and *3G*

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a. Sheldon Gray-bankruptcy

D. Assuming Victory

1. Board reform so that nominees of 13D groups replace principals of 13D groups
2. the 13D groups agree upon working nominees who will be responsible for implementing a corporate strategy to attain asset value
3. active board – for at least one year after victory have monthly board meetings.

*Id.*

298. *Id.* at 851.

299. *Id.* at 847. The court further reasoned that:

[D]efendants’ blocking position in *Champion*’s shares causes substantial and irreparable adverse effects. *Champion*’s shareholders now face an illiquid market for *Champion*’s shares. *Champion*’s ability to raise equity capital, or to find investment bankers willing to manage placements of its shares, has been substantially impaired.

*Id.* at 847–48 (defendants held 42% of *Champion*’s shares).

300. See *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P.*, 562 F. Supp. 2d 511, 572 n.335 (S.D.N.Y. 2008), *aff’d*, 292 F. App’x 133 (2d Cir. 2008).

301. *Id.* at 571–72; see also *Rondeau*, 422 U.S. at 64–65.

302. See *Champion*, 661 F. Supp. at 832–46; see also *CSX Corp.*, 562 F. Supp. 2d at 511.

303. See *CSX Corp.*, 562 F. Supp. 2d at 511.

304. See *WLF Brief*, *supra* note 260, at 12.

were able to increase their control position by 6.4% during the ten month period without the other CSX shareholders being aware of these parties' acquisitions.<sup>305</sup> As such, the corporate electorate of CSX may have been much different on the record date for the proxy contest had TCI and 3G disclosed their ownership positions. Consequently, the court in *CSX* should have followed the court in *Champion* and sterilized the shares of TCI and 3G.

Another case involving the sterilization of shares in the 13(d) context is *Committee for New Management of Butler Aviation v. Widmark*.<sup>306</sup> In that case, the former CEO of a company initiated a proxy contest and acquired shares in anticipation of the meeting.<sup>307</sup> The court found that he violated § 13(d) by failing to timely file a Schedule 13D.<sup>308</sup> The former CEO, just like the shareholder in *Rondeau*, argued that this was merely a technical violation.<sup>309</sup> The court rejected this argument, reasoning that “[i]f [§] 13(d) means anything, [the former CEO] should not be permitted to gain advantage from a course of action pursued in clear violation of law.”<sup>310</sup>

To put teeth in Section 13(d)(1), the court enjoined the shareholder from voting at the annual meeting all shares purchased during the twelve-month period in question in excess of 2 percent of the outstanding stock—in effect, all shares purchased after the Schedule 13D statement should have been filed with the Commission and sent to the issuer.<sup>311</sup>

In *Water & Wall Associates v. American Consumer Industries*, several shareholders failed to timely disclose their formation of a group in violation of § 13(d).<sup>312</sup> The court, relying on *Butler Aviation*, issued a preliminary

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305. See *CSX Corp.*, 562 F. Supp. 2d at 572.

306. *Comm. for New Mgmt. of Butler Aviation v. Widmark*, 335 F. Supp. 146 (E.D.N.Y. 1971).

307. *Id.* at 149, 154.

308. *Id.* at 154–55.

309. *Id.* at 154.

310. *Id.* at 155.

Here we are not faced with subtle problems which have seemingly resulted in divergent views regarding application of Section 13(d) to group action. Here we are only concerned with admitted statutory violation by a large stockholder, once part of the management of a corporation, who determined on his own to launch a campaign to regain control. In doing so he has clearly plunged the corporation into a costly proxy contest it can ill afford—one which might have been avoided had early disclosure of his plans been made. . . .

. . . At the very least, considerations of equity demand that Dopp be disenfranchised from voting at the December 14th meeting those shares he acquired after January 4, 1971, in excess of the 2% exemption provided by the Williams Act.

*Id.*

311. 3E HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES & FEDERAL CORPORATE LAW* § 25:38 (2d ed. 2009).

312. *Water & Wall Assoc., v. Am. Consumer Indus., Inc.*, No. 103-73, 1973 WL 383, at \*2 (D.N.J. Apr. 19, 1973).

injunction restraining the voting of the shares beneficially owned by such persons.<sup>313</sup>

While both of these cases were decided prior to *Rondeau*, both courts found that the shareholders would suffer irreparable harm if the shares were not sterilized.<sup>314</sup> Just like the courts in *Butler Aviation* and *Water & Wall Associates*, the court in *CSX* should have enjoined TCI and 3G from voting the shares because failing to do so allows these shareholders to benefit from a course of action pursued in violation of § 13(d) to the detriment of the other shareholders of *CSX*. Moreover, based on the precedents in *Rondeau*, *Champion*, *Butler Aviation*, and *Water & Wall Associates*, courts should more frequently sterilize shares for violations of § 13(d) to prevent irreparable harm to shareholders.

Lastly, the votes of TCI and 3G should have been sterilized, and other violators of § 13(d) should be enjoined from voting at shareholder meetings, in order to deter future violations by other parties. While deterrence cannot be an independent basis for an injunction under § 13(d), it is an important factor for courts to consider when determining whether to enjoin the voting of shares.<sup>315</sup> In *Rondeau*, the Court acknowledged that the “usual basis for injunctive relief” is the “danger of recurrent violation” and such relief is designed “to deter, not to punish.”<sup>316</sup> The Court further stated in *Piper v. Chris-Craft Industries, Inc.*, that deterrence may be “a meaningful goal” in fashioning relief for “the most flagrant sort of violations” of the Williams Act.<sup>317</sup> Moreover, according to the Commission

[a]bsent a remedy that deprives the defendant of his wrongfully obtained shares [or the ability to vote such shares], a person will have little incentive to comply with the statute. On the one hand, the potential benefits to be gained from a violation can be quite substantial . . . [o]n the other hand, corrective disclosure is no real deterrent, since it merely requires compliance with the original statutory disclosure obligation and leaves the violator with the profitable fruits of his illegal conduct.<sup>318</sup>

By failing to sterilize votes in cases like *CSX*, hedge funds and others will continue to have an incentive to avoid § 13(d) disclosure obligations to gain an advantage in a proxy contest or to obtain control in a stealth fashion by use of another takeover method. In this regard, the other shareholders of the company are not being afforded the protection of the federal securities laws, as hedge funds and others have the ability to gain an unfair advantage

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313. *Id.* at \*11.

314. See generally *Butler Aviation*, 335 F. Supp. 146; *Water & Wall Assoc.*, 1973 WL 383.

315. *Water & Wall Assoc.*, 1973 WL 383, at \*11. The SEC has endorsed the importance of deterrence in remedying violations of § 13(d). See, e.g., General Steel SEC Amicus Memo, *supra* note 285; San Francisco SEC Amicus Brief, *supra* note 153.

316. See *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 59, 61 (1975).

317. *Id.*

318. See General Steel SEC Amicus Memo, *supra* note 285, at 16–17.

by hiding their ownership positions until they decide to engage in a control contest. Moreover, market integrity is damaged when investors deliberately flout the § 13(d) disclosure requirements, but are still able to vote their shares.<sup>319</sup> Consequently, the shares of TCI and 3G and other violators of § 13(d) should be sterilized to prevent further abuses of the Williams Act.

## V. CONCLUSION

This Article has explained that while holders of long positions in equity swaps have the ability to significantly influence the voting or disposition of the securities of a company, they do not have beneficial ownership under Rule 13d-3(a). It went on to provide a specific recommendation for how Rule 13d-3(a) should be amended to capture Long Parties' holdings in equity swaps and other similar instruments. It showed that Rule 13d-3(b) should be construed in a manner analogous to the safe harbors in Rule 144A and Regulation S, and thus, the Rule should only result in a person being deemed a beneficial owner where the person holds an interest in the security that is considered to constitute beneficial ownership under Rule 13d-3(a). Lastly, the Article demonstrated that sterilization of votes is an appropriate remedy in a § 13(d) action to prevent unfair director elections and that such remedy should be granted more frequently to enjoin violators of § 13(d) from voting at shareholder meetings.

If the Second Circuit decides to write an opinion on the *CSX* case, it should adopt the positions articulated in this Article: that TCI did not have beneficial ownership under Rule 13d-3(a) and that it should not be deemed a beneficial owner under Rule 13d-3(b). Future court rulings on whether votes should be sterilized for violations of § 13(d) should enjoin violators of the statute from voting at shareholder meetings. Furthermore, the Commission should act quickly to require disclosure of Long Parties' holdings in equity swaps and other similar instruments by amending Rule 13d-3(a). More research may be necessary to determine whether a complete overhaul of the beneficial ownership regime is needed, and if so, how such change should be accomplished.<sup>320</sup>

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319. See WLF Brief, *supra* note 260, at 27.

320. See Hu & Black, *supra* note 4. While Hu and Black have already undertaken this inquiry to a certain extent, others could look more deeply into the issue of whether such change is actually needed, and if so, whether their suggested approach is adequate.