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THE DERAILMENT OF SECTION 13(D) LIABILITY AFTER *CSX V. CHILDREN'S INVESTMENT FUND*: AN ARGUMENT FOR MAINTAINING THE BENEFICIAL OWNERSHIP REQUIREMENT FOR SECTION 13(D) DISCLOSURE

Robert T. Law⁺

Innovation on Wall Street has led to the proliferation of sophisticated financial products, the most notable being derivatives.¹ A derivative, in the financial product context, is a two-party transaction with “a contract that either allows or obligates one of the parties (the ‘end-user’) to buy or sell an asset.”² The prominence of derivatives in the current economic climate has heightened concerns about their regulation because derivatives are considered “novel, complex, and opaque.”³ This heightened regulatory concern has centered primarily on one type of derivative known as a “swap.”⁴ In a swap transaction, “one party agrees to provide a sequence of cash flows and in return the other party provides a different sequence of cash flows.”⁵ Despite a seemingly straight-forward definition, financial derivatives are highly complex

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1. Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1458–59 (1993) [hereinafter Hu, *Misunderstood Derivatives*]; see also Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1274 (1991) (“Complex new financial products now allow virtually every manner of fluctuation and cash flow to be hedged against, invested in, and bought and sold.”).

2. Hu, *Misunderstood Derivatives*, *supra* note 1, at 1464; see also *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1275 (S.D. Ohio 1996) (“Derivatives transactions may be based on the value of foreign currency, U.S. Treasury bonds, stock indexes, or interest rates. The values of these underlying financial instruments are determined by market forces, such as movements in interest rates. Within the broad panoply of derivatives transactions are numerous innovative financial instruments whose objectives may include a hedge against market risks, management of assets and liabilities, or lowering of funding costs; derivatives may also be used as speculation for profit.”); BLACK’S LAW DICTIONARY 509 (9th ed. 2009) (defining a “derivative” as “[a] financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity”).

3. Hu, *Misunderstood Derivatives*, *supra* note 1, at 1460.

4. *Id.* at 1459–61.

5. *Id.* at 1467; see also SUSAN ROSS MARKI, *DERIVATIVE FINANCIAL PRODUCTS* 27 (1991).

instruments with possible market impacts that can catch even the most successful investors off guard.

For example, derivatives were directly responsible for shocking the investment world on October 28, 2008, when Volkswagen (VW) briefly surpassed energy giant Exxon Mobil as the world's most valuable company.⁶ On October 26, Porsche, VW's significantly smaller rival, disclosed that it had essentially cornered the market of VW shares through a combination of stock and a type of derivative known as a cash-settled option.⁷ Porsche was able to build its substantial position in VW without raising the awareness of other market participants because derivatives such as cash-settled options do not need to be disclosed to regulators.⁸ Unaware of Porsche's derivative holdings, other investors were short-selling VW shares—essentially betting that the price would go down.⁹ Because demand exceeded supply, VW's stock price soared as short sellers attempted to hedge, or minimize, their losses by buying shares as quickly as possible.¹⁰ According to some market estimates, Porsche stood poised to gain billions of euros from its VW derivatives.¹¹ While investors like Porsche praise derivatives,¹² others call for stricter disclosure rules, arguing that derivatives are secretive and deceptive.¹³ The prominence of sophisticated derivatives in the modern market gives rise to the current legal debate: whether transacting in cash-settled derivatives triggers federal securities law reporting requirements under the Securities Exchange Act of 1934 (1934 Act).

Although numerous provisions may require disclosure of derivatives in one form or another, this Comment will limit its discussion to the requirements under the 1934 Act's section 13(d) beneficial-ownership provision and corresponding Securities and Exchange Commission (SEC) rules. The section

6. Frank Ahrens, *The World's Most Valuable Company*, WASH. POST, Oct. 29, 2008, at D1 (reporting that, for a short period of time, VW's value exceeded \$370 billion, compared to Exxon Mobil's value of \$343 billion).

7. Mike Esterl & Gregory Zucker, *VW Shares To Be Probed After Porsche Disclosures*, WALL ST. J., Oct. 30, 2008, at C1. Porsche disclosed "that it had boosted its VW stake to 42.6% and held so-called cash-settled options linked to another 31.5% of VW's shares." *Id.* Cash-settled options allow the buyer (Porsche) to receive the cash difference between the options' purchase price (or strike price), and the market price of the shares when the options are exercised. *Id.* For example, if Porsche buys a cash-settled option for \$100 and exercises, or cashes in, the option when the market price is \$300, Porsche receives \$200.

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.* Meanwhile, the hedge funds that incorrectly bet on VW's stock price falling lost over \$20 billion. *Id.*

12. *Id.* A Porsche spokesman explained that Porsche is "a very small company buying into a very big company [VW]. That is not something you can afford if everybody is able to read your strategy in the newspaper." *Id.*

13. *Id.* ("DWS, the asset management arm of Deutsche Bank AG, Germany's largest bank, criticized Porsche for a 'lack of transparency' and called on the country's regulators to tighten disclosure rules.").

13(d) disclosure requirements mandate that individuals in a position to alter control of a company disclose such ownership to the SEC and the target corporation.¹⁴ According to the SEC's beneficial-ownership rules, "control" requires either voting or disposition rights over a security.¹⁵ The problem created by derivatives—especially swaps—arises when one party to the swap transaction hedges its exposure by subsequently purchasing actual shares. Under current securities law, such swap transactions do not confer beneficial ownership on the non-hedging party,¹⁶ and therefore, the majority of jurisdictions only require section 13(d) disclosure from the hedging party.¹⁷ However, the Southern District of New York—departing from this established approach—held a non-hedging party bound by the section 13(d) disclosure requirements reasoning that even if the non-hedging party was not a beneficial owner under SEC Rule 13d-3(a), it may nevertheless be deemed a beneficial owner under Rule 13d-3(b).¹⁸ This departure is significant because the Southern District of New York has jurisdiction over Wall Street—the primary location for financial derivatives transactions.

This Comment examines and analyzes the split between the United States Courts of Appeals for the Eleventh and Third Circuits and the Southern District of New York. In Part I, this Comment begins by exploring section 13(d) of the Williams Act, the corresponding SEC rules, and the case-law application of beneficial ownership. All three areas demonstrate that beneficial ownership requires *actual* control over shares. Next, this Comment analyzes the beneficial-ownership evasion and group-formation rules and their role in section 13(d) disclosure. This Comment also develops the substantive issues surrounding the judicial split by examining the uncertainty of modern sophisticated financial instruments. Part II of this Comment addresses the circuit split by critiquing the weakness in the holding of *CSX Corp. v. Children's Investment Fund* and developing strengths of the majority approach. This section argues that the SEC, and not the courts, is in the best position to reform beneficial-ownership application, but concludes that no action is currently needed. In Part III, this Comment further exposes *CSX's*

14. H.R. REP. NO. 90-1711, at 2–4, 8 (1968) [hereinafter H.R. 1711]; *see also* Wellman v. Dickinson, 682 F.2d 355, 365 (2d Cir. 1982) ("Section 13(d) was designed to alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."); LOUIS LOSS & JOEL SELIGMAN, 5 SECURITIES REGULATION 2162 (1990) ("The legislative history thus shows that Congress was intent upon regulating takeover bidders, theretofore operating covertly, in order to protect the shareholders of target companies . . .").

15. *See* discussion *infra* Part I.A.

16. *See infra* notes 102–04 and accompanying text. *Cf.* *CSX Corp. v. Children's Inv. Fund*, 562 F. Supp. 2d 511, 538–48 (S.D.N.Y. 2008) (suggesting, in dicta, that swaps do confer beneficial ownership on the non-hedging party to a swap transaction).

17. *See, e.g.,* *Hemisphere Biopharma, Inc. v. Johannesburg Consol. Invs.*, 553 F.3d 1351, 1363–66 (11th Cir. 2008); *Rosenberg v. XM Ventures*, 274 F.3d 137, 140–48 (3d Cir. 2001).

18. *CSX*, 562 F. Supp. 2d at 552.

weaknesses by examining the unintended consequences of imposing the section 13(d) disclosure requirements on non-beneficial owners. Finally, this Comment concludes by urging the United States Court of Appeals for the Second Circuit to limit *CSX* to its facts; in the alternative, it urges the SEC, in its official interpretative capacity, to reject *CSX*'s departure from the established approach.

I. FEDERAL SECURITIES LAW AND THE WILLIAMS ACT: A FOCUS ON DISCLOSURE

In the 1960s, corporate management was under fire as aggressive investors took advantage of the bullish market and loopholes in disclosure requirements to take over companies.¹⁹ Congress responded to this perceived problem by passing the Williams Act in 1968.²⁰ Utilizing SEC guidance in crafting the legislation,²¹ Congress took "extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bid."²² As a result, Congress amended the 1934 Act with the addition of section 13(d), requiring individuals in a position to alter control of a company to disclose such ownership to the SEC and the target corporation.²³ Accordingly, the goal of section 13(d) was "to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might

19. See JOHN C. COFFEE, JR., JOEL SELIGMAN & HILLARY A. SALE, *SECURITIES REGULATION 717-18* (10th ed. 2003); see also *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) ("The 1960's on Wall Street may best be remembered for the pyrotechnics of corporate takeovers and the phenomenon of conglomeration. . . . [B]efore the enactment of the Williams Act there were no provisions regulating cash tender offers or other techniques of securing corporate control."). Other investors, unaware of these positions, were effectively investing blindly in corporations without the knowledge of potential shifts in corporate control. LOSS & SELIGMAN, *supra* note 14, at 2160 (quoting *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 22 (1977)).

20. See Act of July 29, 1968, Pub. L. No. 90-439, § 2, 82 Stat. 454, 454 (1968). Senator Harrison A. Williams, namesake of the bill, asserted that the gaps in the disclosure requirements of the securities laws needed to be filled to guarantee that:

All will be able to deal in the securities markets knowing that all of the pertinent facts are available. This is the premise under which our securities markets are supposed to work. Following this premise they have thrived and prospered over the years. Now is the time to eliminate the last remaining areas where full disclosure is necessary but not yet available.

Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking and Currency, 90th Cong. 3 (1967) (statement of Sen. Williams, Chairman, S. Subcomm. on Sec.).

21. See LOSS & SELIGMAN, *supra* note 14, at 2158-63 (reviewing the Williams Act's legislative history).

22. 113 CONG. REC. 24,664 (1967) (statement of Sen. Williams); see also H.R. 1711, *supra* note 14, at 4; S. REP. NO. 550, at 3 (1967) (Conf. Rep.) [hereinafter S.R. 550].

23. See *Wellman v. Dickinson*, 682 F.2d 355, 365 (2d Cir. 1982) ("Section 13(d) was designed to alert investors in securities markets to potential changes in corporate control and provide them with an opportunity to evaluate these potential changes.").

represent a potential shift in corporate control.”²⁴ Thus, Congress intended Section 13(d) to function as a shield for investors rather than as a sword for management.²⁵

A. Defining Beneficial Ownership

1. Section 13(d)

Section 13(d) requires any person who, directly or indirectly, acquires “beneficial ownership” of more than five percent of specified “equity securit[ies]” to disclose such holdings.²⁶ Section 13(d)(3) further provides that “[w]hen two or more persons act . . . for the purpose of acquiring, holding, or disposing of securities of an issuer, such . . . group shall be deemed a ‘person’ for the purposes of this subsection.”²⁷ Disclosure is required at five percent because it “serves . . . as an objective indicator of a potential takeover.”²⁸ Although beneficial ownership is the mechanism with which the Williams Act

24. *GAF Corp.*, 453 F.2d at 717; see also Comment, *Section 13(d) and Disclosure of Corporate Equity Ownership*, 119 U. PA. L. REV. 853, 854–55, 858, 865 (1971).

25. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975) (holding that in enacting section 13(d), “Congress expressly disclaimed an intention to provide a weapon for management to . . . prevent large accumulations of stock . . .”). Critics reject the idea that the Williams Act is an evenhanded statute, and instead argue that management is the beneficiary of the statute. See generally Jonathan R. Macey & Jeffrey M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L.Q. 131 (1987). However, others argue that disclosure erodes away the gains for the bidder. See generally Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989).

26. 15 U.S.C. § 78m(d)(1) (2006); 17 C.F.R. § 240.13d-1(a) (2006). The extensive amount of information that the beneficial owner must disclose includes: (1) the identity and background of the person who acquired the shares “and all other persons by whom or on whose behalf the purchases have been or are to be effected”; (2) “the source and amount of the funds . . . used or to be used in making the purchases”; (3) “if the purpose of the purchases . . . is to acquire control of the business . . . any plans or proposals . . . to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure”; (4) the total shares owned and the number of shares the person has “a right to acquire, directly or indirectly,” including those “by each associate of such person, giving the background, identity, residence, and citizenship of each such associate”; and (5) “information as to any contracts, arrangements, or understandings with any person” regarding the securities, “naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.” 15 U.S.C. § 78m(d)(1)(A)–(E). The beneficial owner must provide all this information in a Schedule 13D to the issuer of the stock and to the SEC within ten days of the acquisition. 15 U.S.C. § 78m(d)(1); 17 C.F.R. § 240.13d-101.

27. 15 U.S.C. § 78m(d)(3). A “person” for securities law purposes is “a natural person, company, government, or political subdivision, agency, or instrumentality of a government.” 15 U.S.C. § 78c(9).

28. Mark L. Berman, Note, *SEC Takeover Regulation under the Williams Act*, 62 N.Y.U. L. REV. 580, 586 n.40 (1987).

pursues the goal of marketplace transparency, Congress left it up to the SEC to define the term.²⁹

2. SEC Rule 13d-3(a)

The 1934 Act grants general rulemaking authority to the SEC to formulate “rules and regulations as may be necessary or appropriate to implement the provisions of [the 1934 Act].”³⁰ The SEC, through Rule 13d-3(a), defined beneficial ownership as the “power to vote, or to direct the voting of, [a] security; and/or [i]nvestment power which includes the power to dispose, or to direct the disposition of, such security.”³¹ The requirement of control for beneficial ownership is entitled to the level of deference discussed by the United States Supreme Court in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*³² because Congress granted the SEC rulemaking authority for the implementation of section 13(d).³³ The purpose of the SEC’s beneficial-ownership rule was to “provide more objective standards for the application of [section 13(d) reporting] requirement[s].”³⁴ Therefore, the inquiry into beneficial ownership goes beyond determining who has legal title to the security.

3. Beneficial Ownership Jurisprudence: Requirement of Control

In *Wellman v. Dickinson*, the United States Court of Appeals for the Second Circuit considered whether an investment banker who provided account

29. See Disclosure of Corporate Ownership, 40 Fed. Reg. 42,212–13 (Sept. 11, 1975) [hereinafter 1975 Release].

30. 15 U.S.C. § 78w(a).

31. 17 C.F.R. § 240.13d-3(a)(1)–(2) (2006). Under federal securities law, the power to direct means the power to control. See *Levy v. Southbrook Int’l Invs. Ltd.*, 263 F.3d 10, 15–16 (2d Cir. 2001) (finding that section 13(d) requires “disclosure of shareholder control”); see also 17 C.F.R. § 240.12b-2 (“[C]ontrol’ . . . means . . . the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”). Rules 12b-2 and 13d-3 are meant to be construed together. See 17 C.F.R. § 240.12b-1 (stating that the rules “govern all registration statements pursuant to section 12(b) . . . and all reports filed pursuant to section[] 13”).

32. *Chevron U.S.A., Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837, 843–44 (1984) (“If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”); see also *SEC v. McNaulty*, 137 F.3d 732, 741 (2d Cir. 1998) (ruling that the SEC’s “interpretations of §13 and of its own regulations thereunder are entitled to deference”).

33. See 1975 Release, *supra* note 29.

34. Beneficial Ownership Disclosure Requirements, 42 Fed. Reg. 12,342 (Mar. 3, 1977) [hereinafter 1977 Release]. The SEC’s interpretation is entitled to deference because Congress did not define “beneficial ownership.” The SEC’s rule only needs to be “reasonably related to the purposes of the enabling legislation” in order to be sustained. *Mourning v. Family Pub. Serv.*, 411 U.S. 356, 369 (1973). However, the SEC cannot create regulations that fail to implement Congressional objectives. *Ernst & Ernst v. Hoehfelder*, 425 U.S. 185, 212–14 (1976).

management and advice was the beneficial owner of the shares he supervised.³⁵ In that case, Dickinson conspired with the company's investment banking firm, Eberstadt, to sell a block of the company's shares to a corporation interested in waging a proxy war.³⁶ The Second Circuit held that Eberstadt, and Dickinson as its agent, was the beneficial owner of shares held in the accounts that the firm managed, as well as those held by the investment funds it advised, because it actually controlled the disposition of the shares.³⁷ The court found Dickinson's argument that beneficial ownership requires control over present voting power unpersuasive.³⁸ Instead, the court reasoned that "[t]he power to dispose of a block of securities represents a means for effecting changes in corporate control in addition to the possession of voting control."³⁹ Under *Wellman*, the ability to exert actual control over stock, regardless of the form of control, is essential for beneficial ownership.⁴⁰

However, in a separate opinion, Judge Van Graafeiland expressed concern over the lack of clarity in the Williams Act and the accompanying SEC rules.⁴¹

35. *Wellman v. Dickinson*, 682 F.2d 355, 357–58 (2d Cir. 1982). The court also addressed whether Dickinson formed a group for purposes of beneficial ownership disclosure. *See infra* Part I.C.

36. *Wellman*, 682 F.2d at 358. Dickinson was removed as chairman of the board of directors after losing an internal power struggle with the new management. *Id.* Interestingly, Dickinson was the son of one of the company's founders. *Id.* The trial court aptly observed that "[t]he background and governing facts in this complex drama embrace personality conflicts, animosity, distrust, and corporate politics, as well as a display of ingenuity and sophistication by brokers, investment bankers and corporate counsel." *Wellman v. Dickinson*, 475 F. Supp. 783, 797–98 (S.D.N.Y. 1979).

37. *Wellman*, 682 F.2d at 366–67. The court deemed Dickinson, through his investment banking firm, Eberstadt, the beneficial owner of the discretionary accounts because the firm "controlled the disposition of the . . . shares held in th[o]se accounts." *Id.* at 366. Further, the court found that the firm was "always in a position to direct the disposition of the [Funds'] 443,200 shares" because the Funds' directors followed the investment firm's recommendations "as a matter of course." *Id.*; *see also* *Jacobs v. Pabst Brewing Co.*, 549 F. Supp. 1050, 1064–66 (D. Del. 1982) (finding that the investment advisor was the beneficial owner of shares held by its clients, and therefore section 13(d) filing was required because of the ability to direct the votes in a proxy contest).

38. *Wellman*, 682 F.2d at 365 ("Although voting control is alone sufficient to support a finding of beneficial ownership, it need not be the only indicium."). The *Wellman* decision predates the application of Rule 13d-3, but the Rule's subsequent implementation further emphasizes the fallacy of Dickinson's argument for calculating beneficial ownership. *Id.* at 365 n.12 ("The SEC adopted Rule 13d-3 in February, 1977 but postponed its effective date until April 30, 1978, subsequent to the events involved in this case. Although Rule 13d-3 is not controlling, it serves as further evidence that the Commission had not intended beneficial ownership to be defined solely as present voting power.").

39. *Id.* at 365.

40. *Id.*

41. *Id.* at 368 (Van Graafeiland, J., concurring in part and dissenting in part) ("When reputable and honest businessmen, advised by able and ethical lawyers, are held to have violated a federal statute, the likelihood is that there is something faulty in the statute, the manner in which it is administered, or both. In this case, I believe the fault lies with both.").

According to Judge Van Graafeiland, the flaw in Congress's and the SEC's efforts stemmed from an attempt to "regulate both purchases and sales of stock with the same set of rules and with an inadequate definition of terms."⁴² Judge Van Graafeiland's concerns would prove accurate with the growing prevalence of sophisticated derivatives in the modern market.⁴³

In *Calvary Holdings, Inc. v. Chandler*, the United States Court of Appeals for the First Circuit held that the legal titleholder of a security who only votes shares at the direction of a third party is not a beneficial owner under section 13(d).⁴⁴ In *Calvary Holdings*, Chandler did not file a Schedule 13D after becoming the record owner of more than five percent of the outstanding shares in Diceon Electronics, Inc.⁴⁵ The transaction included a nominee⁴⁶ agreement that limited the "rights, powers and obligations" of Chandler with respect to the shares.⁴⁷ *Calvary Holdings*, which was involved in a proxy fight with Diceon, sued Chandler on the theory that beneficial ownership encompasses all nominees, even if a third party controls the vote.⁴⁸ Relying on legislative history⁴⁹ and SEC No-Action letters,⁵⁰ the court concluded that nominees with only ministerial duties are not required to file a Schedule 13D.⁵¹ Therefore, although Chandler was the record owner, he did not beneficially own the stock because he lacked the control to vote.⁵²

42. *Id.*

43. *See infra* Parts I.D.–E.

44. *Calvary Holdings, Inc. v. Chandler*, 948 F.2d 59, 60 (1st Cir. 1991).

45. *Id.* at 60–61. A corporation that had previously held the stock as nominee for two directors of Diceon transferred the shares to Chandler. *Id.*

46. BLACK'S LAW DICTIONARY 1149 (9th ed. 2009) (defining a "nominee" as "[a] person designated to act in place of another, usu[ally] in a very limited way" or as "[a] party who holds bare legal title for the benefit of others or who receives and distributes funds for the benefit of others").

47. *Calvary Holdings*, 948 F.2d at 61. The undisputed facts established that the nominee agreement permitted Chandler to vote or dispose of the stock only at the direction of the third parties. *Id.* at 62.

48. *Id.* *Calvary Holdings* based its argument on Delaware law, which only entitles record owners to vote. *Id.*

49. *See* H.R. 1711, *supra* note 14, at 2–3 (noting that the Williams Act requires disclosure by those in a position to alter control of a company).

50. *See* Rio Grande Industries, Inc., SEC No-Action Letter, [1989–1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,318, at 79,174 (Apr. 5, 1989) (asserting that trustees of pension fund were exempted from filing requirements because participants directed the trustees' voting); Depository Trust Co., SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,192, at 82,243 (Feb. 23, 1989) (asserting that clearinghouses were exempt from filing requirements); Overseas Shipbuilding Group, Inc., SEC No-Action Letter, [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,374, at 88,768 (Sept. 30, 1977) (asserting that minority partners were excused from filing requirements because majority partners had all the power to decide the voting of partnership stock).

51. *Calvary Holdings*, 948 F.2d at 62.

52. *Id.* at 64 ("In no way could Chandler, although the record owner of the stock, effectuate any control over . . . management.").

B. Rule 13d-3(b): A Fine Line between Lawfully Structuring around Disclosure and Unlawfully Evading the Reporting Requirements

To prevent evasion of beneficial-ownership disclosure, Rule 13d-3(b) provides that

any person who creates or uses a . . . contract, arrangement, or device with the purpose o[r] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) . . . shall be deemed to be the beneficial owner of such security.⁵³

According to the SEC, an example of a Rule 13d-3(b) violation is a transaction where a party enters into a “scheme to evade” the reporting requirements to “avoid[] disclosure of *his beneficial ownership*.”⁵⁴ The SEC Release accompanying the rule seems to indicate that beneficial ownership is a prerequisite for Rule 13d-3(b) liability. However, the dearth of Rule 13d-3(b) jurisprudence makes it necessary to consider the legality of structuring contracts to avoid or mitigate disclosure requirements.

1. Conversion Caps

In *Levy v. Southbrook International Investments, Ltd.*, the Second Circuit addressed whether a “conversion cap” that prevents an investor from acquiring more than five percent of an underlying security violates Rule 13d-3(b).⁵⁵ Although *Levy* is primarily a section 16(b) case,⁵⁶ *Levy* argued in the alternative that the conversion cap was void as an evasion of beneficial-ownership disclosure under Rule 13d-3(b).⁵⁷ *Levy* based this argument on the theory that the conversion cap was a “sham transaction.”⁵⁸ Facially, both a section 16(b) and a section 13(d) argument are relevant because Rule 16a-1 incorporates the Rule 13d-3(a) definition of beneficial ownership.⁵⁹ The court

53. 17 C.F.R. § 240.13d-3(b) (2006).

54. See 1977 Release, *supra* note 34, at 12,347 (emphasis added).

55. *Levy v. Southbrook Int’l Inv., Ltd.*, 263 F.3d 10, 12 (2d Cir. 2001). The conversion cap provided that “Southbrook may not convert shares to the extent that such conversion would result in Southbrook owning more than 4.9% of ImmunoGen’s outstanding common stock.” *Id.*

56. *Id.* at 13–14 (“[T]he issue presented is whether Southbrook, despite the existence of the 4.9% conversion cap, is a more than 10% beneficial owner of ImmunoGen’s common stock.”); see 15 U.S.C. § 78p(b) (2006); see also *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998) (“[L]iability under section 16(b) does not attach unless the plaintiff proves that there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any one class of the issuer’s securities (4) within a six month period.”).

57. *Levy*, 263 F.3d at 12.

58. *Id.* at 17.

59. See 17 C.F.R. § 240.16a-1(a)(1) (“[F]or [the] purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities . . . the term ‘beneficial owner’ shall mean any person who is deemed a beneficial owner pursuant to section

held that the conversion cap did not amount to Rule 13d-3(b) evasion and based its holding on interpretive guidance from the SEC.⁶⁰ *Levy*, therefore, stands for two propositions: (1) structuring an investment contract to prevent exceeding the beneficial-ownership threshold does not amount to an evasion of the reporting requirements,⁶¹ and (2) SEC interpretations are entitled to deference.⁶²

2. "Parking" Schemes

In *SEC v. Drexel Burnham Lambert, Inc.*, the legal titleholder of stock was found not to be the beneficial owner because he obtained the shares through a "parking" scheme.⁶³ In *Drexel Burnham*, co-conspirators, attempting to acquire control of a company, solicited an investor to purchase and hold shares

13(d) of the Act and the rules thereunder.") *But cf.* *Egghead.com, Inc. v. Brookhaven Capital Mgmt. Co.*, 340 F.3d 79, 83 (2d Cir. 2003) ("Beneficial ownership' under SEC rules is defined differently for different purposes."). In *Egghead.com*, the court determined that a broad definition of beneficial ownership comports with the Williams Act's purpose of "alert[ing] the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." *Id.* at 84 (quoting *Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 122–23 (2d Cir. 2001)). Therefore, the court found that "[n]o serious adverse consequences flow to the holder or owner of such securities as the result of the broadly inclusive definition of beneficial ownership." *Id.* at 84 (noting that "[s]ection 16(b), in contrast, has [the] far more drastic consequence[] of strict liability). Although section 16(b) adopts section 13(d)'s definition of beneficial ownership, the court determined that it applies in a narrower context. *Id.* ("The rules for determining beneficial ownership under § 16 are less inclusive than those governing determination of beneficial ownership for purposes of § 13.").

60. *Levy*, 263 F.3d at 14 (noting that the court "requested and received an amicus curiae brief from the [SEC] which provided support for [Southbrook's] position"). A regulation interpretation by the SEC receives substantial deference. *Chevron U.S.A., Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837, 843–44 (1984); *see also* *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000) (noting that the court is "bound by the SEC's interpretations of its regulations in its amicus briefs, unless they are plainly erroneous or inconsistent with the regulation[s]"). In *Levy*, the Second Circuit reasoned that "[b]ecause the SEC's position is neither plainly erroneous nor inconsistent with the regulations and comports with our interpretation, we adopt it." *Levy*, 263 F.3d at 16.

61. *Levy*, 263 F.3d at 16–18.

62. *Id.* at 14, 16.

63. *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 590–91 (S.D.N.Y. 1993). According to the Second Circuit,

"[s]ecurities parking" essentially involves a purported transfer of ownership in securities combined with a secret agreement providing the "seller" with the right to repurchase them at a later date. The "seller" receives the tax benefits of a loss realized by the "sale"; the "buyer" is compensated for the "cost of carrying" the securities. Since the agreement to resell ensures that the "seller" never loses control of the securities, the government considers "parking" a form of tax and securities fraud.

United States v. Jones, 900 F.2d 512, 515 (2d Cir. 1990); *see also* *Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 869 (2006) ("Parking involves an understanding that the client will buy the stock back at a later date and protect its counterparty against loss.").

of the target company without economic risk until the group was ready to acquire the stock from him.⁶⁴ Thus, the court deemed the co-conspirators beneficial owners of the stock because the agreement between the investor and the group conferred “a significant ability to affect how voting power or investment power will be exercised.”⁶⁵ *Drexel Burnham* implies that parking is an unlawful evasion of the beneficial ownership reporting requirements; therefore, the initiators of the parking scheme are subject to Section 13(d) disclosure.⁶⁶

Likewise, in *United States v. Bilzerian*, Paul Bilzerian was convicted of numerous securities law violations, including parking stock at a brokerage firm in an attempt to create a false appearance of stock ownership.⁶⁷ Specifically, Bilzerian entered into agreements with broker-dealer Jeffries & Company to park 58,000 shares of H.H. Robertson Company stock⁶⁸ and 306,600 shares of Armco Steel.⁶⁹ Jeffries then purchased additional shares of Armco for its own account, and promised to aggregate those shares with the original 306,600 shares.⁷⁰

3. Structuring to Avoid Legal Requirements Is Not Per Se Illegal

The various exemptions available in federal securities and tax law are instructive in the analysis of reporting requirement evasion under Rule 13d-3(b). In *SEC v. Softpoint*, the Southern District of New York considered

64. *Drexel Burnham*, 837 F. Supp. at 591 (“[The investor] reasonably understood that he was being sought to do a ‘parking’ job at [the group’s] request, and that if he took a position in [the target company,] he would be ‘stopped out’, i.e., that he would be ‘made whole’ if the stock went down before it was delivered to the source from which the parking had occurred.”). The group initiated the parking scheme because a “Standstill Agreement” prevented the group from holding more than 24.9% of the target company’s shares. *Id.* at 590. The Standstill Agreement functioned like the conversion cap discussed in *Levy*. See *supra* Part I.B.1. The court aptly observed that “[t]o carry out the plan, it was necessary to enlist others in the conspiracy who would be willing to acquire more than 10% of [the target company’s] outstanding voting stock.” *Drexel Burnham*, 837 F. Supp. at 590. However, the stock price dropped substantially by the time the group was ready to purchase the solicited investor’s shares; thus, the group “sought to set a price which would not be too high in relation to the market price ‘so as to avoid making the transaction seem ridiculous.’” *Id.* at 592.

65. *Id.* at 607.

66. *Id.* at 609.

67. *United States v. Bilzerian*, 926 F.2d 1285, 1289–90 (2d Cir. 1991). Bilzerian’s convictions were based primarily on misrepresentations on Schedule 13D filings. *Id.* at 1297 (1934 Act section 10(b) conviction); *id.* at 1299 (18 U.S.C. § 1001 conviction).

68. *Id.* at 1289–90. Bilzerian promised Jeffries that he would repurchase the stock after 30 days, a textbook parking scheme promise of no market risk for the broker-dealer. *Id.* However, due to the substantial price drop during the parking period, Bilzerian refused to repurchase the stock. *Id.* This refusal generated a \$250,000 loss for Jeffries, which Bilzerian compensated by generating broker commissions. *Id.* at 1290.

69. *Id.* at 1289–91.

70. *Id.* at 1291. In total, Bilzerian purchased 818,900 Armco shares and netted a profit of \$575,000 from the parking and accumulation agreements. *Id.*

whether a stock liquidation scheme qualified for a Regulation S exemption.⁷¹ The court held that bona fide transactions are exempt under Regulation S, and that the disclosure “that Softpoint’s domestic stock liquidation plan predated its foreign distributions [revealed] . . . a preconceived artifice—designed to cloak the sale of unregistered securities.”⁷² Likewise, in *SEC v. Corporate Relations Group, Inc.*, a Florida federal district court held that the defendants’ scheme was not exempt under Regulation S because it was “a calculated albeit failed attempt to evade” section 5 of the 1934 Act.⁷³ The courts in *Softpoint* and *Corporate Relations Group* asserted that securities exemptions are waivable only if the predominant motivation behind the structuring agreement suggests bad faith.⁷⁴ Therefore, at a minimum, courts arguably cannot invalidate a disclosure exemption without a motive balancing test.

Exemptions from tax structuring laws can also be illustrative.⁷⁵ In *Gregory v. Helvering*, the United States Supreme Court considered whether a taxpayer’s motivation of tax avoidance affected the legality of how business transactions were structured.⁷⁶ The Court asserted that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid

71. *SEC v. Softpoint*, 958 F. Supp. 846, 861 (S.D.N.Y. 1997); see also 17 C.F.R. § 230.901 (2006) (discussing rules for overseas sales). Regulation S only shelters bona fide transactions and is “not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the [Securities Act of 1933.]” 17 C.F.R. § 230.901 n.2.

72. *Softpoint*, 958 F. Supp. at 861. The court also determined that the stock liquidation scheme “fail[ed] to qualify for the safe harbor exemption under Regulation S.” *Id.*

73. *SEC v. Corp. Rel. Group, Inc.*, No. 6:99CV12220RL28KRS, 2003 WL 25570113, at *16–17 (M.D. Fla. Mar. 28, 2003).

74. *Id.* at *14; *Softpoint*, 958 F. Supp. at 861; see also *Zimmerman v. Chi. Bd. of Trade*, 360 F.3d 612, 624 (7th Cir. 2004) (“In order to constitute bad faith, the plaintiffs must show that ‘self-interest or other ulterior motive unrelated to proper regulatory concerns is alleged to constitute the sole or the dominant reason for the exchange action.’” (quoting *Sam Wong & Son, Inc. v. N.Y. Mercantile Exch.*, 735 F.2d 653, 677 (2d Cir. 1984))).

75. See, e.g., ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 130–31 (10th ed. 2007). To avoid the phenomenon of “double taxation” an eligible corporation may elect to become an “S Corporation” for tax purposes and receive the “pass-through taxation that is typical of [partnerships].” *Id.*

76. *Gregory v. Helvering*, 293 U.S. 465, 468–69 (1935). Evelyn Gregory, a taxpayer, was the sole stockholder of United Mortgage Corporation (United), whose assets included 1000 shares of the Monitor Securities Corporation (Monitor). *Id.* at 467. On September 18, 1928, Gregory organized the Averill Corporation (Averill), in which she was the sole stockholder. *Id.* Soon thereafter, United transferred the 1000 Monitor shares to Averill. *Id.* Less than a week after being organized, Averill “was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to [Gregory].” *Id.* Gregory sold the shares for \$133,333.33, but reported as taxable the capital net gain of \$76,007.88 (calculated as the selling price less the apportioned cost of \$57,325.45). *Id.* The Commissioner of Internal Revenue initiated the action, assessing Gregory’s tax liability at the selling price because it was essentially a dividend paid out by United. *Id.*

them, by means which the law permits, cannot be doubted.”⁷⁷ Instead of looking to motive, the Court examined whether the transaction “was the thing which the statute intended.”⁷⁸ Under *Gregory*, taking advantage of exemptions to avoid paying more taxes is valid, regardless of motive, so long as the legislation permits it.⁷⁹

C. Section 13(d) Group: Friends with Beneficial Ownership

Section 13(d)(3) provides that “[w]hen two or more persons act . . . for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ for the purposes of this subsection.”⁸⁰ Under SEC Rule 13d-5, a group is formed “[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing” of securities.⁸¹ This rule does not function to dissuade consultation between shareholders,⁸² but rather the test for group formation is “whether there is sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [members]’ for the purpose of

77. *Id.* at 469.

78. *Id.* Under these facts the Court determined:

The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excluded from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute.

Id. at 470; *see also* *Knetsch v. United States*, 364 U.S. 361, 365–66 (1960); *Int’l Trading Co. v. Comm’r*, 484 F.2d 707, 711 (7th Cir. 1973) (“[A] taxpayer may achieve benefits under one section of the Code when what might seem to be the same benefits are denied under another section.”).

79. *Gregory*, 293 U.S. at 468–69.

80. 15 U.S.C. § 78m(d)(3) (2006); *see also* *Wellman v. Dickinson*, 682 F.2d 355, 362 (2d Cir. 1982) (commenting that section 13(d) “requires a group that has acquired, directly or indirectly, beneficial ownership of more than 5% of a class of a registered equity security, to file a statement with the SEC disclosing, among other things, the identity of its members and the purpose of its acquisition” (footnote omitted)); S.R. 550, *supra* note 22, at 8. Section 13(d)(3) would prevent a group of persons who seek to pool their voting or other interests in the securities of any issuer from evading the provisions of the statute because no one individual owns more than 10 percent of the securities. The group would be deemed to have become the beneficial owner, directly or indirectly, of more than 10 percent of a class of securities at the time they agreed to act in concert. Consequently, the group would be required to file the information called for in section 13(d)(1) within 10 days after they agree to act together, whether or not any member of the group had acquired any securities at that time.

H.R. 1711, *supra* note 14, at 8–9. As of December 22, 1970, section 13(d)(1) was amended to require filing after the acquisition of five percent. Pub. L. No. 91-567, § 1, 84 Stat. 1497.

81. 17 C.F.R. § 240.13d-5(b)(1) (2006).

82. *Pantry Pride, Inc. v. Rooney*, 598 F. Supp. 891, 899–900 (S.D.N.Y. 1984). The court observed that “[s]ection 13(d) allows individuals broad freedom to discuss the possibilities of future agreements without filing under securities laws.” *Id.* at 900.

acquiring, holding, or disposing of securities.”⁸³ Evidence of business and personal relationships and the parties’ parallel action alone is insufficient;⁸⁴ instead, “the [group] members [must be] combined in furtherance of a common objective.”⁸⁵ However, courts may also consider factors such as trading patterns and past dealings when determining the existence of a group.⁸⁶

In *GAF Corp. v. Milstein*, the Second Circuit considered whether a group linked by a desire to seek control in a company must report such intentions under section 13(d).⁸⁷ The group caused a company under its control to substantially reduce its GAF purchases when it became apparent that the group’s effort to gain a senior management position in GAF was unsuccessful.⁸⁸ The court held that an attempted takeover through the pooling

83. *Hallwood Realty Partners v. Gotham Partners*, 286 F.3d 613, 617 (2d Cir. 2002) (quoting *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982)). The implication of this test is that a plaintiff can establish the existence of a group without a formal writing from the parties. *Id.*; see also *Wellman*, 682 F.2d at 363 (finding that direct and circumstantial evidence supported the determination that defendant reached an understanding with others to create a group). The Second Circuit has acknowledged that it would be rare for a plaintiff to prove group formation without circumstantial evidence. See *Rounseville v. Zahl*, 13 F.3d 625, 632 (2d Cir. 1994) (“[C]onspiracies are by their very nature secretive operations that can hardly ever be proven by direct evidence.”). The court also considered an allegation that persons acted as a group to be “analogous to a charge of conspiracy” because “both assert that two or more persons reached an understanding, explicit or tacit, to act in concert to achieve a common goal.” *Hallwood Realty Partners v. Gotham Partners*, 95 F. Supp. 2d 169, 176 (S.D.N.Y. 2000), *aff’d*, 286 F.3d 613 (2d Cir. 2002).

84. See *Log On Am., Inc. v. Promethean Asset Mgmt. L.L.C.*, 223 F. Supp. 2d 435, 449 (S.D.N.Y. 2001) (holding that general allegations of institutional investors’ parallel investments did not establish a section 13(d) group); see also *Trans World Corp. v. Odyssey Partners*, 561 F. Supp. 1315, 1323 (S.D.N.Y. 1983) (“[T]he unadorned allegation that defendants are acting as a group is not adequate to sustain a Section 13(d) claim.” (citing *Segal v. Gordon*, 467 F.2d 602, 608 (2d Cir. 1972))). Indeed, “[a] close consulting relationship, even when combined with a possible future acquisition of stock, is insufficient to bring a defendant within the ambit of Rule 13d-3.” *Morales v. New Valley Corp.*, 999 F. Supp. 470, 474–75 (S.D.N.Y. 1998); see also *K-N Energy, Inc. v. Gulf Interstate Co.*, 607 F. Supp. 756, 767 (D. Colo. 1983) (determining that information sharing, without more, fails to establish group formation).

85. *Wellman*, 682 F.2d at 363; see also 146 CONG. REC. 27,176 (2000) (statement of Sen. Gramm) (“The SEC is directed to focus on the wrong doers rather than provide new paperwork burden [sic] and regulatory costs on the law abiding [sic] investors and financial services providers.”).

86. *Hallwood Realty Partners v. Gotham Partners*, 286 F.3d 613, 618 (2d Cir. 2002).

87. *GAF Corp. v. Milstein*, 453 F.2d 709, 713 (2d Cir. 1971). The group consisted of Milstein, his two sons, and his daughter. *Id.* at 712. The court lamented that it was “not confronted with the relatively simple concept of legal title, but rather with the amorphous and occasionally obfuscated concepts of indirect and beneficial ownership which pervade the securities acts.” *Id.* at 715.

88. *Id.* at 713. The group’s involvement in GAF stemmed from receiving approximately 10.25% convertible preferred stock when a company in which they invested merged into GAF. *Id.* Preferred stock—as compared to common stock—is usually non-voting; however, it receives preference by the payment of dividends. HAMILTON & MACEY, *supra* note 75, at 316–17. However, in *GAF*, “[t]he convertible preferred stock vote[d] share-for-share with the common

of holdings triggered the section 13(d) reporting requirements because it threatened “the stability of the corporate structure.”⁸⁹ Under *GAF*, a section 13(d) group is formed where the members combine to potentially exert changes in corporate control.⁹⁰

Likewise, in *Wellman v. Dickinson*, the Second Circuit found that Dickinson and “friends” formed a group to shift the corporate control of Becton.⁹¹ After Becton’s board of directors relieved Dickinson of his position as chairman, Dickinson and the others agreed to sell their blocks of shares in Becton to a corporation interested in purchasing a substantial holding in Becton.⁹² The court found that the selling group “reached an understanding to act in concert in disposing of their shares” because Dickinson and friends held themselves out as a group to potential buyers.⁹³ Under *Dickinson*, a court will deem friends to be the beneficial group owners of cumulative stock if they are linked by a common objective and make representations that the cumulative stock is available.⁹⁴

Conversely, in *Hallwood Realty Partners v. Gotham Partners*, the Second Circuit declined to find that the institutional investors formed a section 13(d) group.⁹⁵ In *Hallwood*, the defendants bought company shares during the early-to mid-1990s.⁹⁶ Despite evidence that the defendants discussed Hallwood in

stock. Each share of preferred [was] co[n]vertible into 1.25 shares of common stock.” *GAF*, 453 F.2d at 716 n.13.

89. *GAF*, 453 F.2d at 717–18 (“A shift in the *loci* of corporate power and influence is hardly dependent on an actual transfer of legal title to shares . . .”).

90. *Id.* at 718. *But cf.* *Bath Indus., Inc. v. Blot*, 427 F.2d 97, 109 (7th Cir. 1970) (finding that section 13(d) disclosure requirements are triggered only if the group agrees to acquire additional shares to further its goal of corporate control).

91. *Wellman v. Dickinson*, 682 F.2d 355, 365 (2d Cir. 1982) (finding that Dickinson and the others formed a group to achieve the common objective of “profit[ing] from a shift in the corporate control of Becton”).

92. *Id.* at 358. The defendants found a buyer in Sun Company, Inc. (Sun) and informed Sun’s board that their fifteen percent block of Becton shares was available. *Id.* at 360. Further, the defendants indicated that an additional ten to twenty percent of Becton’s outstanding shares could be “readily acquired.” *Id.* Sun executives were aware that the block of shares represented the group’s cumulative holdings. *Id.*

93. *Id.* at 363 (finding that the selling group had beneficial ownership of approximately thirteen percent of Becton’s outstanding shares). The court gave substantial weight to the testimony of William LaPorte, chairman of the board of directors of a company approached with the takeover proposal. *Id.* LaPorte testified that a friend of Dickinson indicated that he “controlled 500,000 shares of Becton and that the shares controlled by Dickinson and [another friend] were available and would ‘go with [the] deal.’” *Id.* (second alteration in original).

94. *Id.* at 365–66.

95. *Hallwood Realty Partners v. Gotham Partners*, 286 F.3d 613, 615 (2d Cir. 2002).

96. *Id.* at 616. Each defendant, except for EFO, independently filed a Schedule 13D when it acquired more than five percent of the outstanding shares. *Id.* Defendant PMG actually filed a Schedule 13G, which is similar to a Schedule 13D, but it may only be filed by a purchaser that has “no intent to change or influence the issuer or to act in concert with others” who have such an intent. *Id.* at 616 n.4.

meetings between 1994 and 2000, the district court held that Hallwood failed to prove that the defendants formed a section 13(d) group.⁹⁷ The court reasoned that the institutional investors did not form a group because each “made an independent decision to purchase units, based on due diligence and a common understanding among knowledgeable investors that Hallwood units were undervalued.”⁹⁸ Thus, a group is not formed if friends independently reach the same investment decision and subsequently discuss investment strategy.⁹⁹

D. Commodity Futures Modernization Act: Congress Attempts to Modernize Securities Law

The evolution of the financial industry has “created unprecedented opportunity and complexity for investors, as well as challenges for capital markets regulators.”¹⁰⁰ Cognizant of the regulatory uncertainty created by sophisticated derivatives, Congress sought to clarify the federal securities reporting requirements through the Commodity Futures Modernization Act of 2000 (CFMA).¹⁰¹ After considering the relationship between “security-based swaps”¹⁰² and the underlying securities, Congress amended the 1934 Act through section 3A to provide that “[t]he definition of ‘security’ [under the 1934 Act] . . . does not include any security-based swap agreement.”¹⁰³

97. *Id.* at 616. The Second Circuit affirmed the district court’s decision. *Id.* at 615.

98. *Id.* at 616–18.

99. *Id.* at 617–18.

100. Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833, 833 (2008).

101. Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763.

102. Gramm-Leach-Bliley Act, Pub. L. No. 106-02, § 206(b), 113 Stat. 1338, 1393–94 (1999) (defining a “security-based swap agreement” as a swap agreement where “a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein”).

103. 15 U.S.C. § 78c-1 (2006); *S. 2697—The Commodity Futures Modernization Act of 2000: Joint Hearing Before the Comm. on Agric., Nutrition and Forestry and the Comm. on Banking, Hous. and Urban Affairs*, 106th Cong. 67–68 (2000) [hereinafter *S. 2697*] (statement of Alan Greenspan, Chairman, Federal Reserve) (testifying that Congress’s goal should be to “focus on insider trading, fraud, manipulation, and make sure that any possibility for those practices to take place is precluded under the regulatory scheme”). Then-Chairman Greenspan rejected broader regulation because the over-the-counter (OTC) derivatives market “is best maintained with a minimum of regulation.” *Id.* Likewise, then-Treasury Secretary Lawrence Summers testified that “[a]s a general matter, we do not believe that swaps should be regulated as securities” because the CFMA’s purpose was “not so as to extend some net of regulation to OTC derivatives in a way that they are not now subject to regulation, but only to assure that the basic protections we provide in our cash markets do not become circumvented through this legislation.” *S. 2697, supra*, at 7, 14 (statement of Lawrence Summers, Secretary of the Treasury); *see also* Annette Nazareth, Director, Division of Market Regulation, Testimony before the Committee on Banking and Financial Services, U.S. House of Representatives, July 19, 2000, *available at* <http://www.sec.gov/news/testimony/ts132000.htm>. (“[T]he [SEC] by and large has taken action

Congress also amended the 1934 Act to limit the SEC's rulemaking authority, forbidding the SEC from imposing reporting requirements on these swaps.¹⁰⁴ Thus, the SEC cannot regulate modern derivatives such as swaps unless Congress repeals the CFMA.

E. The Circuit Divide on the Requirement of Beneficial Ownership for Section 13(d) Violations

1. The Southern District of New York: Beneficial Ownership Is Not a Prerequisite for Section 13(d) Violations

In 2006 and 2007, two hedge funds—The Children's Investment Fund (TCI) and 3G Fund (3G)—executed cash-settled total return equity swaps (TRSs)¹⁰⁵ to invest in a railroad company, CSX.¹⁰⁶ Judge Kaplan described a TRS transaction as follows:

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'). More specifically, 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 before the winding up of the

with respect to swaps only in enforcement cases involving clear instances of fraud.”). Despite the sophistication of swaps, Congress enacted this legislation with an understanding of the relationship between equity swaps and securities trading. *See S. 2697, supra*, at 14 (statement of Lawrence Summers, Secretary of the Treasury) (“[F]unctionally, through a total return swap, one can do something that is the equivalent of purchasing a share of stock.”); *id.* at 32 (testimony of Arthur Levitt, Chairman, Sec. & Exch. Comm’n) (“For example, one could potentially avoid long-established investor and market integrity protections applicable to equity securities by merely documenting an equity transaction as a ‘swap.’”); *see also* 146 CONG. REC. S11,867 (statement of Sen. Gramm, Chairman, S. Banking Comm.) (emphasizing that the definition of “swap agreement” and “security-based swap agreement” has been placed in a “neutral statute[;] . . . that is, legislation that is not specifically a part of a banking, securities or commodities law . . . [that] makes it clear that the SEC is not to impose regulations on such instruments as prophylactic measures”).

104. 15 U.S.C. § 78c-1(b)(3)(A)–(B). The lone exception is the reporting requirements expressly permitted by section 16. *See id.* § 78c-1(b)(3).

105. *CSX Corp. v. Children's Inv. Fund Mgmt.*, 562 F. Supp. 2d 511, 516 (S.D.N.Y. 2008) (determining that TRSs are a sophisticated type of derivative that give the holder “substantially all of the indicia of stock ownership save the formal legal right to vote the shares”).

106. *Id.* at 523–32.

transaction (if the TRS is settled in kind). 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.¹⁰⁷

TRSs were attractive to TCI and 3G because they allow the long party to build an equity interest in a company without premature marketplace disclosure.¹⁰⁸ On the other side, short parties will occasionally purchase shares of the specified underlying security to hedge¹⁰⁹ their exposure.¹¹⁰

Before investing in CSX, TCI and 3G had “a long-standing relationship.”¹¹¹ In March 2007, TCI and 3G met to discuss their CSX holdings; the two funds, along with other individuals, subsequently filed a Schedule 13D on December 19, 2007—which indicated the formation of a section 13(d) group.¹¹² However, “[b]oth disclaimed beneficial ownership of the underlying shares referenced by their TRSs.”¹¹³ As a result, CSX filed suit alleging, among other things, violations of section 13(d).¹¹⁴

In *CSX v. Children’s Investment Fund*, the issue before the court was “whether the holder of a cash-settled equity TRS beneficially owns the referenced stock held by the short counterparty.”¹¹⁵ As an initial matter, the

107. *Id.* at 520.

108. *Id.*

109. *See* Oppold, *supra* note 100, at 834 (“In general, a hedge involves taking a position in one security and an offsetting position in another security. . . . Using derivative instruments to take hedged positions allows investors ideally to limit their downside risk while making a directional bet that a security will move up or down, or even simply experience volatility.”).

110. *See* FIN. SERVS. AUTH., DISCLOSURE OF CONTRACTS FOR DIFFERENCE annex 4, at 3 (2007), http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf. Although hedging is an option, the survey found that “[m]ost [market] participants . . . do not necessarily hedge their . . . positions by buying the underlying shares . . .” *Id.*

111. *CSX*, 562 F. Supp. 2d at 532. The court found that the two funds were familiar with each other because “Synergy, a fund under the 3G umbrella, has been an investor in TCI since its beginning.” *Id.* at 532–33.

112. *Id.* at 534–35. The Schedule 13D disclosed that the funds had “entered into an agreement to coordinate certain of their efforts with regard [sic] (i) the purchase and sale of [various shares and instruments] and (ii) the proposal of certain actions and/or transactions to [CSX].” *Id.* at 535 (alterations in original). The group further disclosed its cumulative ownership of actual shares—8.3%—as well as its economic exposure in CSX through swaps. TCI’s exposure was approximately 11% while 3G’s was less than 1%. *Id.*

113. *Id.*

114. *Id.* at 518.

115. *Id.* at 517. The court interpreted the legislative history of the Williams Act as requiring a broad construction of the definition of beneficial ownership. *Id.* at 539. The court concluded that the SEC intended to apply a broad construction in formulating Rule 13d-3a. *Id.* at 540 (“By stating that a beneficial owner ‘includes’ rather than ‘means’ any person who comes within the criteria that follow, it made plain that the language that follows does not exhaust the circumstances in which one might come within the term.”). Moreover, the court concluded that

court found that the TRSs did not confer any voting or disposition rights on TCI, nor did the swaps require the counterparties to hedge their exposure with actual CSX shares.¹¹⁶ After significant analysis,¹¹⁷ the court declined to answer the question whether TCI's swaps conferred beneficial ownership.¹¹⁸ However, the test for determining beneficial ownership of swaps, found in the court's dicta, would expand Rule 13d-3(a) beyond a requirement of actual control.¹¹⁹ The court proposed a two-part test for triggering section 13(d) disclosure: (1) whether the swaps considered that the counterparties would hedge their positions with actual shares, and (2) whether the counterparty had "a significant ability to affect" the shares' voting or investment power.¹²⁰

To ensure compliance with section 13(d), Rule 13d-3(b) attributes beneficial ownership to a person who employs a "plan or scheme" to avoid the reporting requirement.¹²¹ Instead of determining whether TCI's TRSs conferred beneficial ownership on their own, the court held 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)."¹²² After reviewing the language of Rule 13d-3(b), the court found the evidence "overwhelming" that TCI used TRSs to avoid section 13(d) disclosure.¹²³

In reaching this holding, the court rejected the views expressed by the SEC's Division of Corporation Finance (Division), which concluded that "as a general matter, 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."¹²⁴ The court found the Division's interpretation unpersuasive

the SEC's broad interpretation is furthered by Rule 13d-3b because it was implemented so that Rule 13d-3(a) "cannot be circumvented by an arrangement to divest a person of beneficial ownership or to prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d)." *Id.* (quoting 1977 Release, *supra* note 34, at 12,344).

116. *Id.* at 541.

117. *Id.* at 539-48 (discussing beneficial ownership generally and applying Rule 13d-3).

118. *Id.* at 548 ("In this case, it is not essential to decide the beneficial ownership question under Rule 13d-3(a).").

119. *Id.* at 540-41.

120. *Id.* at 541 (noting that the first prong must be satisfied before considering the second prong).

121. 17 C.F.R. § 240.13d-3(b) (2006).

122. *CSX*, 562 F. Supp. 2d at 552.

123. *Id.* at 548-49. The following evidence influenced the court's decision: (1) TCI's chief financial officer informed the board that TCI uses swaps because no disclosure is required; (2) "TCI emails discussed the need to make certain that its counterparties stayed below 5 percent physical share ownership . . . to avoid[] triggering a disclosure obligation"; and (3) TCI's admission that it was partly motivated by a desire to avoid an increase in CSX share price in its decision to avoid disclosure. *Id.* at 549.

124. Letter from Brian Breheny, Deputy Director of the Division of Corporation Finance, to Hon. Lewis A. Kaplan, District Judge, Southern District of New York (June 4, 2008) (on file with

because its proposed approach would render Rule 13d-3(b) inoperative.¹²⁵ Likewise, the court found unpersuasive the argument that the SEC lacks the power to find beneficial ownership in situations that fall outside the statutory meaning.¹²⁶ Therefore, the court in *CSX* held that beneficial ownership is not a prerequisite for a Section 13(d) violation.¹²⁷

2. *The Eleventh and Third Circuits: Beneficial Ownership Is a Necessary Prerequisite for Section 13(d) Violations*

a. *The Eleventh Circuit*

In *Hemispherx Biopharma, Inc. v. Johannesburg Consolidated Investments*, the United States Court of Appeals for the Eleventh Circuit decided whether beneficial ownership is required for a section 13(d) violation.¹²⁸ In that case, Hemispherx alleged that the defendants agreed to act as a group to vote and

author). Furthermore, the letter expressed the view that “the long party’s underlying motive for entering into the swap transaction generally is not a basis for determining whether there is ‘a plan or scheme to evade.’” *Id.* The Division opined that the test for determining beneficial ownership under Rule 13d-3(b) for someone who entered into a swap is whether “the person did so with the intent to create the false appearance of non-ownership of a security.” *Id.*

125. *CSX*, 562 F. Supp. 2d at 550 (“An appearance of non-ownership cannot be false unless one in fact is at least a beneficial owner. That beneficial ownership would satisfy Rule 13d-3(a), thus making Rule 13d-3(b) superfluous.”). The Division’s interpretation was not binding on the court and it found the interpretation unpersuasive. *See* *United States v. Mead Corp.*, 533 U.S. 218, 234–35 (2001); *Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC*, 298 F.3d 136, 145 (2d Cir. 2002).

126. Letter from Bernard Black, Professor, University of Texas School of Law, to Brian G. Cartwright, General Counsel, Securities Exchange Commission (May 29, 2008) (on file with author). Professor Black argued that “it must be permissible for an investor to acquire equity swaps, rather than shares, in part—or indeed entirely—because share ownership is disclosable under § 13(d) while equity swaps are not.” *Id.* Professor Black’s argument is based on the premise that “the underlying activity must involve holding a position which is ‘beneficial ownership’ under the statute (Exchange Act § 13(d) or (g)), but would otherwise fall outside the rule—outside the SEC’s effort to define the concept of beneficial ownership elsewhere in Rule 13d-3.” *Id.* However, the *CSX* court found that section 23(a) of the 1934 Act grants the SEC the “power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which [it is] responsible. . . .” *CSX*, 562 F. Supp. 2d at 551 (quoting 15 U.S.C. § 78w(a)(1)). Thus, an SEC rule promulgated under section 23(a) is valid if it is “‘reasonably related to the purposes of the enabling legislation.’” *Mourning v. Family Pub. Serv., Inc.*, 411 U.S. 365, 369 (1973) (quoting *Thorpe v. Hous. Auth. of Durham*, 393 U.S. 268, 280–81 (1969)); *see* *Amendments to Tender Offer Rules: All-Holders and Best-Price*, 51 Fed. Reg. 25,873, 25,875 (July 11, 1986) [hereinafter *Amendments to Tender Offer Rules*]; *see also* *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) (noting that the purpose of section 13(d) is “to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control”).

127. *CSX*, 562 F. Supp. 2d at 548.

128. *Hemispherx Biopharma, Inc. v. Johannesburg Consol. Invs.*, 553 F.3d 1351, 1361 (11th Cir. 2008) (“Whether individuals . . . without a beneficial ownership interest in a company’s securities can nonetheless become members of a ‘group’ within the meaning of section 13(d)(3) of the [1934] Act is an issue of first impression in this circuit.”).

dispose of one defendant's Hemispherx shares.¹²⁹ The defendants countered that beneficial ownership is a prerequisite for being considered a section 13(d)(3) group.¹³⁰ The court observed, however, that "[t]he text of sections 13(d)(1) and 13(d)(3) leaves open the question of whether beneficial ownership of stock is required for group membership within the meaning of paragraph (d)(3)."¹³¹ The court additionally noted that Rule 13d-5 also failed to address the question.¹³²

The Eleventh Circuit applied the principles of statutory construction to decide the issue.¹³³ The court reasoned that "the goal of section 13(d)(3) is to prevent persons who already have attained beneficial ownership of some amount of an issuer's securities from combining to control over five percent of a class of securities, yet ducking the reporting requirements in section 13(d)(1)."¹³⁴ Moreover, the court rejected Hemispherx's position because a Schedule 13D sufficiently accounts for non-beneficial owners with some interest in a security.¹³⁵ Thus, the Eleventh Circuit concluded that "a

129. *Id.* at 1357 ("Hemispherx claims that by virtue of th[e] agreement between Goemaere and the South African defendants, the defendants collectively 'controlled' the voting of Goemaere's shares of Hemispherx and were thus 'beneficial owners' of those shares under section 13(d) of the [1934] Act.").

130. *Id.* at 1363.

131. *Id.*

132. *Id.* ("Rule 13d-5 provides that when two or more persons act as a section 13(d)(3) group, each individual member is deemed to beneficially own the securities owned by all of them. It does not rule out a non-beneficial owner becoming a member of a section 13(d)(3) group and thereby being treated as a beneficial owner of all of the securities owned by any group member. Nor does it compel that result. The regulation simply does not say one way or the other.")

133. *Id.* at 1362. Adhering to the principles of statutory construction, the court restated the question presented as "whether the context of section 13(d)(3) and the congressional purpose behind it show that beneficial ownership of securities is required for group membership." *Id.* at 1363. For a discussion of statutory construction, see *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980), which notes that statutory construction begins with the statute's plain language. However, when the statutory language is unclear, the court "may look beyond the plain language of a statute at extrinsic materials." *CBS, Inc. v. Prime-Time 24 Joint Venture*, 245 F.3d 1217, 1226 (11th Cir. 2001) (internal quotation omitted); see also *United States v. DBB, Inc.*, 180 F.3d 1277, 1282 (11th Cir. 1999) ("[Where] the language of the statute does not clearly answer [the] question . . . [the court] must look beyond the text and determine the legislative intent.").

134. *Hemispherx*, 553 F.3d at 1364 ("That is what section 13(d)(3) is about. That is its purpose.").

135. *Id.* at 1364–65. The court held that "[a] person required to make section 13(d)(1) disclosures must disclose the identity of everyone, including those who are not beneficial owners, who possesses some form of present or future interest in the securities, along with the details of the arrangements or understandings with those non-beneficial owners." *Id.* The court, using the facts of the case, illustrated this principle by noting that "Goemaere controlled thirty percent of Hemispherx's stock and was required to file under section 13(d)(1). Although the other defendants were not required to make a similar filing, Goemaere was obligated to disclose their identities and the details of any arrangement that he had with them regarding the Hemispherx stock." *Id.* at 1365.

beneficial-ownership interest is necessary to become a member of a group within the meaning of section 13(d)(3) of the [1934] Act"; and, therefore, a non-beneficial owner who is a member of a section 13(d) group does not violate the section 13(d) reporting requirements by not filing a Schedule 13D.¹³⁶

b. The Third Circuit

Seven years before *Hemispherx*, the United States Court of Appeals for the Third Circuit, in *Rosenberg v. XM Ventures*, addressed the same issue of whether beneficial ownership is required for disclosure by a section 13(d) group.¹³⁷ After considering the purpose of a section 13(d) group, the Third Circuit noted that "[t]he implication is, of course, that each member of the [section 13(d)(3)] group must have something to 'pool.'"¹³⁸ Accordingly, that something is beneficial ownership.¹³⁹ Therefore, the Third Circuit held that a person cannot become a member of a section 13(d) group without already being a beneficial owner.¹⁴⁰ Although *Rosenberg* goes further than *Hemispherx*, both the Third and Eleventh Circuits require beneficial ownership for a section 13(d) group.¹⁴¹

II. REJECTING CSX: THE MAJORITY APPROACH DEMONSTRATES THAT THE SOUTHERN DISTRICT OF NEW YORK IMPROPERLY JUMPED ABOARD THE REFORM TRAIN

A. CSX: Beneficial Ownership Not Required to Trigger Beneficial-Ownership Disclosure

The issue before the court in *CSX* was "whether . . . TCI's investments in cash-settled TRSs referencing CSX shares conferred beneficial ownership of those shares upon TCI."¹⁴² As a threshold matter, the court found that the TRSs did not confer any direct voting or disposition rights on TCI, nor did the swaps require the counterparties to hedge their exposure with actual CSX

136. *Id.* at 1363.

137. *Rosenberg v. XM Ventures*, 274 F.3d 137, 140 (3d Cir. 2001). Similar to *Levy*, *Rosenberg* addressed an alleged section 16(b) violation. *Id.* at 142; *see also* *Levy v. Southbrook Int'l Inv., Ltd.*, 263 F.3d 10, 11–12 (2d Cir. 2001). This distinction is immaterial because the section 16(b) definition of beneficial ownership incorporates the section 13(d) definition. *See supra* note 59 and accompanying text.

138. *Rosenberg*, 274 F.3d at 145–46.

139. *Id.* at 146; *see* 17 C.F.R. § 240.13d-3(a) (2006).

140. *Rosenberg*, 274 F.3d at 146 ("[T]he legislative history accompanying section 13(d) manifests Congress' intent that an individual must be a beneficial owner of an issuer's securities prior to becoming a member of a section 13(d) 'group.'").

141. *Hemispherx*, 553 F.3d at 1363 ("Rule 13d-5 . . . does not rule out a non-beneficial owner becoming a member of a section 13(d)(3) group and thereby being treated as a beneficial owner of all of the securities owned by any group member.").

142. *CSX Corp. v. Children's Inv. Fund Mgmt.*, 562 F. Supp. 2d 511, 539 (S.D.N.Y. 2008).

shares.¹⁴³ The court declined to hold that swaps—on their own—confer beneficial ownership, departing from the actual-control standard and announcing a new test that does not require beneficial ownership to violate section 13(d).¹⁴⁴ The court’s two-part test analyzed: (1) whether the swaps considered that the counterparties would hedge their positions with actual shares, and (2) whether the counterparty had “a significant ability to affect” the exercise of voting or investment power.¹⁴⁵

Although the counterparties had no contractual obligation to hedge, the court found that the first prong of the test was satisfied because TCI knew it was possible that the counterparties could hedge their positions by acquiring actual shares of CSX.¹⁴⁶ Further, the court determined that the second prong was also satisfied through both voting and investment power.¹⁴⁷ The court, in dicta, suggested that the TRSs satisfied both indicia of beneficial ownership due to the fact that TCI had indirect investment power over the counterparties’ CSX shares because the counterparties actually hedged the exposure created by the TRSs.¹⁴⁸ After the transaction was completed, the short party had the ability to unwind the swaps, whereby the long party could gain actual control of the shares.¹⁴⁹ Because the banks—as counterparties—could dispose of their hedged shares, the court found that TCI significantly influenced the investment power of the hedged CSX shares; therefore, TCI beneficially owned those shares.¹⁵⁰ Likewise, the court determined that TCI significantly influenced the voting power of the hedged shares because it focused on swaps in banks likely to vote for TCI’s directors in a proxy battle.¹⁵¹

Instead of determining whether TCI’s TRSs conferred beneficial ownership, the court held 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

143. *Id.* at 541.

144. *Id.* at 541, 548.

145. *Id.* at 541. The first prong of the test must be satisfied before considering the second prong. *Id.*

146. *Id.*

147. *Id.* at 546.

148. *Id.* at 541–42. The evidence showed that the counterparties hedged their exposure on “virtually a share-for-share basis.” *Id.* at 541. The court also determined that the counterparties could only hedge their positions by purchasing actual CSX shares. *Id.* at 542.

149. *Id.* A short party unwinds swaps in kind “by delivery of the shares” to the long party. *Id.*

150. *Id.* at 543. The court observed that TCI’s counterparties sold the hedged shares at the termination of the swap transaction. *Id.* at 542–43.

151. *Id.* at 543 (“Between October and November 2007, TCI moved swaps referencing 28.4 million and 18.0 million shares into Deutsche Bank and Citigroup, respectively, while leaving swaps referencing 1,000 shares with each of its remaining six counterparties.”). The court rejected TCI’s argument that it preferred doing swap transactions with commercial banks, which are government-backed, because they are safer investments. *Id.*; see Carrick Mollenkamp, *HSBC, the Subprime Seer: Sanguine View Isn’t Likely*, WALL ST. J., Nov. 12, 2007, at C1 (“Citigroup, Inc. announced potential write-downs of as much as \$11 billion in the fourth quarter.”).

scheme to evade the reporting requirements of Section 13(d).”¹⁵² After reviewing the language of Rule 13d-3(b), the court found the evidence “overwhelming” that TCI used TRSs to avoid section 13(d) disclosure.¹⁵³

In reaching this holding, the court rejected the views expressed by the Division because the court believed the Division’s reading would render Rule 13d-3(b) inoperative.¹⁵⁴ Also unpersuasive was the argument that the SEC lacks the power to find beneficial ownership in situations that fall outside the statutory meaning.¹⁵⁵ The court concluded that the SEC regulates swaps under Rule 13d-3(b), even when the swaps do not amount to beneficial ownership.¹⁵⁶

B. Majority Approach: Beneficial Ownership Is Necessary to Trigger Section 13(d) Reporting Requirements

In *Hemispherx*, the Eleventh Circuit decided that beneficial ownership is required for a section 13(d) group.¹⁵⁷ This was a novel conclusion because “[t]he text of sections 13(d)(1) and 13(d)(3) leaves open the question of whether beneficial ownership of stock is required for group membership within the meaning of paragraph (d)(3)”; the court also noted that Rule 13d-5 failed to address the question.¹⁵⁸ In light of the congressional purpose behind passage of the Williams Act, the court reasoned that “the goal of section 13(d)(3) is to prevent persons who already have attained beneficial ownership of some amount of an issuer’s securities from combining to control over five percent of a class of securities, yet ducking the reporting requirements in section 13(d)(1).”¹⁵⁹ Similarly, the Third Circuit noted that “[t]he implication is, of course, that each member of the [section 13(d)(3)] group must have something to ‘pool.’”¹⁶⁰ That “something” is beneficial ownership.¹⁶¹ Thus, the objective

152. *CSX*, 562 F. Supp. 2d at 552.

153. *Id.* at 548–49; *see also supra* note 123 (discussing the evidence relied on by the court).

154. *CSX*, 562 F. Supp. 2d at 550 (“An appearance of non-ownership cannot be false unless one in fact is at least a beneficial owner. That ownership would satisfy Rule 13d-3(a), thus making Rule 13d-3(b) superfluous.”).

155. *See also* discussion *supra* note 126.

156. *CSX*, 562 F. Supp. 2d at 552.

157. *Hemispherx Biopharma v. Johannesburg Consol. Invs.*, 553 F.3d 1351, 1362 (11th Cir. 2008). The court observed that “[w]hether individuals . . . without a beneficial ownership interest in a company’s securities can nonetheless become members of a ‘group’ within the meaning of section 13(d)(3) of the [1934] Act is an issue of first impression in this circuit.” *Id.* at 1361.

158. *Id.* at 1363 (“Rule 13d-5 . . . provides that when two or more persons act as a section 13(d)(3) group, each individual is deemed to beneficially own the securities owned by all of them. It does not rule out a non-beneficial owner becoming a member of a section 13(d)(3) group and thereby being treated as a beneficial owner of all of the securities owned by any group member. Nor does it compel that result. The regulation simply does not say one way or the other.”).

159. *Id.* at 1364 (“That is what section 13(d)(3) is about. That is its purpose.”).

160. *Rosenberg v. XM Ventures*, 274 F.3d 137, 146 (3d Cir. 2001).

161. *Id.*; *see also* 17 C.F.R. § 240.13d-3(a) (2006).

requirement of beneficial ownership—actual control—is an essential prerequisite for section 13(d) liability in these circuits.¹⁶²

C. Resolving the Split: The Proper Reformer, the Proper Standard, and the Proper Action

The resolution of this issue requires determining the proper authority for any reform,¹⁶³ the proper standard for beneficial ownership,¹⁶⁴ and what action is currently needed in beneficial-ownership law.¹⁶⁵

1. The Proper Reformer

Although beneficial-ownership law was well settled before *CSX*, the circuit split was arguably foreseeable because section 13(d) is “anything but a model of clarity.”¹⁶⁶ Therefore, the process of statutory interpretation begins with an examination of “the language of the statute” to determine its plain meaning.¹⁶⁷ The inquiry does not stop there; as Judge Learned Hand astutely commented, “it is one of the surest indexes of a mature and developed jurisprudence . . . to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.”¹⁶⁸ Congress enacted section 13(d) through the Williams Act with the purpose of requiring “disclosure of information by persons who have acquired a substantial interest” in a company’s equity securities.¹⁶⁹ However, Congress amended the 1934 Act through the CFMA to remove security-based swap agreements from the definition of security.¹⁷⁰ By specifically excluding swaps from the definition of security, Congress indicated that swaps do not implicate the concerns that the Williams Act was enacted to address.¹⁷¹

Furthermore, through the Williams Act, Congress granted authority over section 13(d) to the SEC.¹⁷² *Chevron* requires courts to give deference to SEC interpretations of section 13(d) because Congress delegated that authority to the SEC.¹⁷³ Thus, courts must accept SEC interpretations that are “reasonably

162. *Hemispherx*, 553 F.3d at 1364; *Rosenberg*, 274 F.3d at 146–47.

163. *See infra* Part II.C.1.

164. *See infra* Part II.C.2.

165. *See infra* Part II.C.3.

166. *GAF Corp. v. Milstein*, 453 F.2d 709, 716 (1971).

167. *See Leocal v. Ashcroft*, 543 U.S. 1, 8 (2004); *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 420 (1968).

168. *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945).

169. S.R. 550, *supra* note 22, at 7; H.R. 1711, *supra* note 14, at 8.

170. 15 U.S.C. § 78c-1(b) (2006).

171. *See supra* notes 19–25 and accompanying text.

172. 1975 Release, *supra* note 29, at 42,212. The 1934 Act grants general rule-making authority to the SEC to formulate “rules and regulations as may be necessary or appropriate to implement the provisions of [the 1934 Act].” 15 U.S.C. § 78w(a).

173. *Chevron U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 843–44 (1984) (“If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority

related” to the goals of the Williams Act.¹⁷⁴ Accordingly, any changes to the well-established beneficial-ownership laws must necessarily come from the SEC and not the courts.

The Third Circuit applied *Chevron* deference to the SEC in determining that the legal titleholder of a security did not beneficially own the shares when he did not control the shares’ vote.¹⁷⁵ Conversely, the Southern District of New York declined to extend *Chevron* deference to an interpretation of Rule 13d-3(b).¹⁷⁶ Neither case is a traditional *Chevron* deference situation because the Third Circuit considered an SEC No-Action Letter¹⁷⁷ and the Southern District of New York considered a staff interpretation.¹⁷⁸

2. The Proper Beneficial-Ownership Standard

In drafting the Williams Act, Congress took “extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids.”¹⁷⁹ To further the congressional intent of an evenhanded statute, disclosure under section 13(d) should only be required in cases of actual beneficial ownership. A requirement for disclosing at a level less than actual beneficial ownership would be overregulation and would amount to providing a sword to corporate management. The expansive definition in *CSX* comes from a misreading of *Drexel Burnham*, which referred to a “significant ability to affect” the exercise of voting or investment power.¹⁸⁰ *Drexel Burnham* never addressed the merits of a significant-influence standard for beneficial ownership because the defendants had actual control over the stock through an express parking scheme.¹⁸¹ In a parking scheme, the legal titleholder is not the beneficial owner of the stock because he does not have control over the shares.¹⁸² Instead, he is holding the stock for someone else—with assurances of being made whole—so that the parker can illegally deceive the market as to his total amount of shares.¹⁸³ Therefore, the *CSX* court’s reliance on *Drexel*

to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”). Specifically, the Supreme Court asserted that *Chevron* deference applies to SEC interpretations of beneficial ownership. *Gen. Dynamics Land Sys., Inc. v. Cline*, 540 U.S. 581, 600 (2004).

174. *Mourning v. Family Pub. Serv.*, 411 U.S. 356, 369 (1973).

175. *Calvary Holdings, Inc. v. Chandler*, 948 F.2d 59, 62–64 (1st Cir. 1991).

176. *CSX Corp. v. Children’s Inv. Fund Mgmt.*, 562 F. Supp. 2d 511, 549–52 (S.D.N.Y. 2008).

177. *Calvary Holdings*, 948 F.2d at 63–64.

178. *CSX*, 562 F. Supp. 2d at 549–51, 551 n.205.

179. 113 CONG. REC. 24,664 (1967) (statement of Sen. Williams).

180. *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993).

181. *Id.* at 590.

182. *See United States v. Jones*, 900 F.2d 512, 515 (2d Cir. 1990); *Drexel Burnham*, 837 F. Supp. at 590–91.

183. *See Jones*, 900 F.2d at 515; *Drexel Burnham*, 837 F. Supp. at 590–91.

Burnham was misplaced because the defendant was, in fact, the beneficial owner of those shares.¹⁸⁴

3. *The Proper Action*

Recognizing the novelty of swaps, the *CSX* court determined that the SEC had the authority to regulate beneficial ownership in situations that fall outside of its statutory meaning.¹⁸⁵ Although the SEC is entitled to *Chevron* deference in situations where Congress has delegated authority, the court's assessment of the SEC's power is inaccurate because the CFMA explicitly limited the SEC's rulemaking authority.¹⁸⁶ In 2004, in accord with the CFMA, the SEC issued interpretive guidance stating that cash-settled swaps do not implicate beneficial ownership.¹⁸⁷ This interpretation is entitled to *Chevron* deference because it is reasonably related to the Williams Act's goals and is within the authority delegated by Congress.

It appears that populist calls for reform influenced the Southern District of New York when it decided *CSX*.¹⁸⁸ Based on this influence, the court erroneously departed from settled law and rejected the statutory limitation on SEC authority.¹⁸⁹ This finding has inserted ambiguity into a previously settled area of law by holding non-beneficial owners liable under the beneficial-ownership statute and SEC rules. The Second Circuit should reverse *CSX* or explicitly limit the holding to the facts of the case. The Second Circuit must clearly identify an agreement between TCI and one of the banks that represents a stock parking arrangement for TCI to have actual beneficial ownership. Only as a beneficial owner could TCI violate section 13(d) and the corresponding SEC rules.

Any reform to the regulations regarding swaps requires Congress to repeal the CFMA and clearly expand the SEC's power to regulate reporting requirements subject to a *Chevron* deference level of review. If Congress repeals the CFMA and the SEC subsequently takes a position akin to the court

184. *Drexel Burnham*, 837 F. Supp. at 609 (noting that the defendant was a beneficial owner of the shares in question).

185. *CSX Corp. v. Children's Inv. Fund Mgmt.*, 562 F. Supp. 2d 511, 551 (S.D.N.Y. 2008).

186. *See supra* Part I.D.

187. Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, 67 Fed. Reg. 43,240 (June 21, 2002) ("A purchaser of a cash-settled security future . . . would not count the equity securities underlying the contract for purposes of determining whether he . . . is subject to the Regulation 13D reporting requirements, because he . . . does not have the right to acquire beneficial ownership of the underlying security.").

188. *See, e.g., Zachary A. Goldfarb & David Cho, Hedge Funds Making Way For Government Regulation*, WASH. POST, Mar. 14, 2009, at D2 ("The new openness to regulation reflects the desire of investors for a government stamp of approval before they invest their money."); *see also supra* note 13 and accompanying text.

189. *CSX*, 562 F. Supp. 2d at 551–52 (holding that the defendant is a beneficial owner because the SEC has the "power to treat as beneficial ownership a situation that would not fall within the statutory meaning of that term").

in *CSX*, it would be a drastic break from the SEC's longstanding position. If the SEC's authority is reinstated, it should reject populist calls for reform because the beneficial-ownership law currently functions as an evenhanded statute—as it was intended. Imposing a reporting requirement on long parties when the short party hedges its swap position with actual shares will impose exceedingly burdensome disclosure requirements and provide a sword to management instead of protecting investors.¹⁹⁰ Further, the overregulation of swaps will stifle innovation and prevent legitimate, successful market plays by investors.

III. THE UNINTENDED CONSEQUENCES OF FAILING TO OVERTURN *CSX*

The Williams Act and the corresponding SEC Rules sought to define beneficial ownership objectively through an actual control standard.¹⁹¹ Before *CSX*, it was well settled that section 13(d) disclosure is only triggered by beneficial ownership.¹⁹² Imposing the disclosure requirements on non-beneficial owners is subjective, leads to marketplace uncertainty, and does not advance the goals of the Williams Act.

A. Ambiguity with Group Status

The significant-influence standard would have reporting implications for both parties in a swap transaction. *CSX* held that the long party is the beneficial owner of the short party's hedged shares because the long party might significantly influence the short party's voting behavior.¹⁹³ Such a reading implies that the short party creates beneficial ownership in the long party simply by hedging its exposure. Extending the analysis, the counterparties could be deemed a group under Rule 13d-5 because the swaps essentially are an "agree[ment] to act together for the purpose of . . . voting" an issuer's equity securities.¹⁹⁴ As a group, each counterparty would be required to file a Schedule 13D disclosing, among other things, all group members.¹⁹⁵

190. See *infra* Part III.

191. 15 U.S.C. § 78b (2006) ("For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary . . . to insure the maintenance of fair and honest markets in such transactions. . . .").

192. *CSX*, 562 F. Supp. 2d at 548.

193. *Id.* at 545 ("[A] party has voting power over a share under Rule 13d-3(a)(1) if that party has the ability to control or influence the voting . . . of the securities. . . ." (quoting Interpretive Release on Rules Applicable to Insider Reporting and Trading Exchange Act, 46 Fed. Reg. 48,147, 48,149 n.17 (Oct. 1, 1981))).

194. See *supra* Part I.C.

195. 17 C.F.R. § 13d-1(a) (2006) ("Any person who, after acquiring directly or indirectly the beneficial ownership of an equity security . . . shall . . . file . . . a statement containing the information required by Schedule 13D."); *id.* § 13d-1(k)(1)(iii) ("Such statement identifies all such persons, contains the required information with regard to each such person, indicates that

In a situation where one long party enters into swaps with numerous counterparties, each counterparty would be expected to disclose the identity of all other counterparties even if the counterparties do not conduct any business together or are unaware of each other.

Given the extensive amount of information required to be disclosed in a Schedule 13D,¹⁹⁶ and the Williams Act's concern of affecting corporate control,¹⁹⁷ the CSX standard is unduly burdensome and fails to address the statute's purpose. Furthermore, this analysis is counterintuitive as it eliminates the requirement that a group was formed in furtherance of a common goal.¹⁹⁸ The burden of disclosure might prove to be so taxing and time consuming that investors forego the financial advantages of swaps and avoid this type of transaction.¹⁹⁹ This result is not how Congress intended the reporting requirements to function.²⁰⁰

B. *Unintended Disclosure Under Section 16(b)*

The SEC guidance instructs that the long party to a swap does not receive the beneficial ownership necessary to make him an insider under section 16.²⁰¹ Section 16(b) requires, among other things, a ten percent beneficial owner of an equity security to disclose: (1) "the amount of all equity securities of [an] issuer of which the filing person is the beneficial owner," and (2) an indication of any "purchases and sales of the security-based swap agreements."²⁰² Section 16(b) incorporated the section 13(d) definition of beneficial ownership,²⁰³ and the statutory language of section 16(b) indicates that an "equity security" is distinct from security-based swap agreements.²⁰⁴ The former confers beneficial ownership while the latter does not. Unlike section 13(d), Congress explicitly requires disclosure of swaps under certain

such statement is filed on behalf of all such persons, and includes . . . their agreement in writing that such a statement is filed on behalf of each of them.").

196. 15 U.S.C. § 78m(d)(1).

197. *See supra* Part I.A.1.

198. *CSX*, 562 F. Supp. 2d at 552 ("[T]he touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective." (quoting *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982))).

199. *See supra* notes 6–11 and accompanying text for an example of the financial advantages of using swaps.

200. *See* 146 CONG. REC. S11,855, S11,867 (daily ed. Dec. 15, 2000) (statement of Sen. Gramm).

201. *See Ownership Reports and Trading By Officers, Directors and Principal Security Holders*, Exchange Act Release Nos. 34-28,869, 35-25,254, 48 SEC Docket 0236 (Feb. 26, 1991) ("As proposed, the rules adopted today define ten percent holders under section 16 as persons deemed ten percent holders under section 13(d) of the [1934 Act] and the rules thereunder.").

202. 15 U.S.C. § 78p(a)(3) (2006).

203. *See supra* note 59.

204. 17 C.F.R. § 3(a)(11)-1 (2008). The definition of equity security in section 16 is governed by section 3. The term "security-based swap agreements" does not appear in the definition, implying a distinction between the two terms. *Id.*

circumstances in section 16,²⁰⁵ which would suggest that section 13(d) does not require disclosure of swap agreements.²⁰⁶ However, under the significant-influence standard, disclosure of swaps would be required under section 13(d). Thus, a long party would be considered an insider for purposes of section 16 under the *CSX* standard. This expansive standard of section 13(d) disclosure would unnecessarily expose traders to strict liability under section 16, even without actual control over the securities. In other words, the *CSX* approach would make a non-beneficial owner liable under two beneficial-ownership provisions of the 1934 Act, a result that is irreconcilable with either the logic or the purpose of the Williams Act.

IV. CONCLUSION

When analyzing section 13(d) disclosure issues, it is important to keep in mind that the purpose of the Williams Act is investor protection. However, the scope of investor protection is limited to guarding investors from shifts in corporate control without fair notice. Congress specifically requires disclosure of at least five percent beneficial ownership because such a level “serves as an objective indicator of a potential takeover.”²⁰⁷ By removing swaps from the definition of security in the CFMA, Congress recognized that swaps do not trigger the traditional concerns of the Williams Act. Once disclosure is required under section 13(d), the amount of information the beneficial owner must report in a Schedule 13D is extensive.²⁰⁸

Imposing such a burden on a non-beneficial owner, as set forth in *CSX*, is contrary to the purpose of the Williams Act. First, instead of protecting investors, the *CSX* standard would expose investors to personal liability under section 16. Moreover, the overregulation of swaps would function as a sword for management because it gives management investment information asymmetry. The majority approach, requiring beneficial ownership as a prerequisite for section 13(d) disclosure, is the only standard that can provide a shield for investors instead of a sword for management. The Second Circuit should reverse *CSX* or clarify that an agreement existed giving TCI beneficial ownership over the hedged shares. Additionally, the SEC should use its rule-making authority delegated by Congress to state explicitly that beneficial ownership is a prerequisite for the section 13(d) disclosure requirements.

205. See 15 U.S.C. § 78p(a)(1) (noting that directors, officers, and principal stockholders are required to file with the SEC under section 16).

206. See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 537 (1994) (“[I]t is generally presumed that Congress acts intentionally and purposefully when it includes particular language in one section but omits it in another” (quoting *Chicago v. Envtl. Def. Fund*, 511 U.S. 328, 338 (2004))).

207. Berman, *supra* note 28, at 586.

208. 15 U.S.C. § 78m(d)(1).