

TO DISCLOSE OR NOT TO DISCLOSE? CSX CORP., TOTAL RETURN SWAPS, AND THEIR IMPLICATIONS FOR SCHEDULE 13D FILING PURPOSES

*Daniel Bertaccini**

INTRODUCTION

“Shareholder activism” is a loaded term, capable of conjuring a range of ideas depending on the context of its use. At its most basic and innocuous conception, the term merely refers to shareholders’ taking an interest in the direction of their company by participating in the normal processes that shape the company, such as voting through proxies.¹ At the other extreme lies the notion of a financial coup d’état, seen most strikingly in the popular hedge fund practice of accumulating large enough shareholder positions in public companies to move the companies single-handedly in one direction or another.² Whatever form

* Executive Editor, *Cardozo Law Review*. J.D. Candidate (June 2010), Benjamin N. Cardozo School of Law; B.A., Vassar College, 2004. Many, many, many thanks go out to: Scott Danner, my Notes Editor, for his steadfast guidance throughout the entire writing process; Caroline Boulanger, for her phenomenal editing prowess; everyone else who so generously read a draft and provided such helpful feedback; all members of the *Cardozo Law Review*, for being such great people to work with; and all my family and friends, whose tremendous love and support make me who I am.

¹ Proxy voting is a common method by which shareholders make their voices heard. Since it is a practical impossibility for all shareholders to attend important company meetings, and because their votes are necessary to resolve board member appointments and other concerns relating to their company’s direction, proxies allow shareholders to mail in their votes ahead of the actual meeting. The U.S. Securities and Exchange Commission (SEC) dictates what information needs to be included with proxy statements as well as the proper procedures companies must follow when soliciting proxies. For a complete list of rules governing the solicitation of proxies, see SEC Regulation 14A on Solicitation of Proxies, 17 C.F.R. §§ 240.14a-1 to 14b-2 (2009).

² When a hedge fund legally acquires a block of shares in a company, it usually obtains the right to vote each share that it owns, in accordance with the traditional “one share, one vote” standard. See Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1013-14 (2006). This voting power alone may provide the hedge fund with enough clout to pressure a company’s directors into following a course of action sought by the hedge fund; after all, the threat of soliciting proxies to replace members of the company’s board of directors can be quite persuasive. Specifically, if the company’s management opposes the called-for changes, the hedge fund will often utilize proxies to substitute current executives with new ones willing to implement

the so-called “activist” practice may take, it is clear that the term refers to attempts by shareholders to use whatever powers they have as owners to influence their company’s behavior.³

Of course, not all shareholders are created equal. Some own miniscule percentages of their companies—through mutual funds, for example—while others maintain significant stakes. Yet regardless of their percentage ownerships, most long-term shareholders invest in a company because they share a similar belief: optimism about the company’s business prospects, particularly its ability to generate profits.⁴ In order to ensure that shareholders with long-term investment goals for their company are not blindsided by activist investors seeking to replace the company’s management, Section 13(d) of the Williams Act⁵ requires investors to disclose publicly their intentions in a Schedule 13D form whenever they accumulate more than five percent of the stock of a public company.⁶

There are good reasons why some parties want to avoid such disclosure. For example, a party looking to wage a takeover battle may not want its intent to be known until it decides that the time is right.

its plans. Frequently, the hedge fund’s significant voting power can predetermine the outcome of the proxies, especially when multiple hedge funds team up to form “wolf-packs.” See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007) (“[Hedge funds] target companies, take large positions in their stock, criticize their business plans and governance practices, and confront their managers, demanding action that enhances shareholder value. When one hedge fund announces a 5% or 10% position in a company, others follow, forming a ‘wolf pack’ that sometimes has the voting power to force management to address its demands.”). Cf. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1274-81 (2008) (discussing the historical transition of influence on corporate activities from a company’s management to its shareholders, particularly through the advent of activist hedge funds).

³ European Corporate Governance Institute Topic Page on Shareholder Activism, <http://www.ecgi.org/activism/> (last visited Sept. 2, 2009). The European Corporate Governance Institute discusses other forms of shareholder activism:

Activism covers a broad spectrum of activities. Activism includes “voting with ones feet” (exit), private discussion or public communication with corporate boards and management, press campaigns, blogging and other e-ways of public “naming and shaming”, [sic] openly talking to other shareholders, putting forward shareholder resolutions, calling shareholder meetings and—ultimately—seeking to replace individual directors or the entire board.

Id. See generally Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) (describing how shareholder activism takes on various forms depending on the type of institutional investor engaging in it and focusing in particular on hedge fund activism).

⁴ There are, of course, other types of investors (e.g., day-traders) who focus more on a company’s potential to generate immediate returns. These typically institutional investors do not usually employ activist tactics, primarily because their short-term investment decisions are not based on a commitment to the company’s prospects for long-term growth.

⁵ 15 U.S.C. § 78m(d) (2006); SEC Regulation 13D-G, 17 C.F.R. §§ 240.13d-1 to -102 (2009).

⁶ See *infra* Part I.A (discussing the history and purposes of Section 13(d), as well as the requisites for filing a Schedule 13D).

Leaking indications of a plan to move a company in a certain direction creates the risk of the company's learning of the attempted takeover, thereby providing the company with more of an opportunity to organize efforts aimed at blocking the maneuver.⁷ At the same time, the party hoping to gain control of the company must be able to count on having a sizeable number of voting shares in its corner prior to launching the takeover bid; otherwise, it will have no assurance of being successful. The increasing popularity of hedge fund participation in takeover bids has produced clever schemes to allow for the relatively silent accumulation of shareholder power. Some of these techniques test the limits of U.S. securities laws, skirting the line between what constitutes clearly illegal activity and what simply takes advantage of favorable statutory language that may be incapable of adapting to today's nuanced market activities.

One technique hedge funds appear to be using with increased frequency involves entering into total return swaps (TRSs) with investment banks.⁸ TRSs give hedge funds all the incidents of control over shares of stock, yet the investment banks purportedly retain "beneficial ownership" of the shares.⁹ For Section 13(d) purposes, beneficial ownership is defined as maintaining either voting or investment power over shares of stock.¹⁰ Since Section 13(d) is triggered only when beneficial ownership exceeds five percent, investors interested in changing the direction of a public company can use TRSs to acquire powerful, real stakes in the company without necessarily having to disclose under Section 13(d) should their swap contracts put them above the five percent reporting threshold.

This Note argues that a characterization of TRSs that treats the

⁷ There are additional concerns that motivate a hedge fund to act secretly when making a move on a company. If the market prematurely discovers the attempted takeover, the price of the company's stock will likely increase because the public knows that the stock is highly valued by a "big bidder." Such market awareness threatens to make the hedge fund's takeover bid much more expensive and, perhaps in the extreme, not worth the fight. It also risks tipping off other potential bidders who can use such knowledge to make their own tender offers more attractive to the target company's shareholders.

⁸ To be sure, hedge funds and investment banks are not the only types of investors that enter into TRS arrangements. Insurance companies, credit card lenders, mutual funds, pension funds, partnerships, and trusts all participate in the TRS market when they deem the swap contracts to be the best way of achieving their particular investment goals. See Financial-edu.com, Total Return Swap (TRS), <http://www.financial-edu.com/total-return-swap-trs.php> (last visited Sept. 2, 2009). For the purposes of this Note, however, I will use hedge funds and investment banks as the two representatives of the counterparties to a TRS transaction. See *infra* Part I.B, for a discussion of the counterparties' differing roles in executing a TRS.

⁹ See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 516 (S.D.N.Y.) (noting that TRSs are "a type of derivative that [confer] . . . substantially all of the indicia of stock ownership save the formal legal right to vote the shares"), *aff'd in part*, 292 F. App'x 133 (2d Cir. 2008).

¹⁰ See *infra* Part I.A (detailing the specifics of beneficial ownership and Section 13(d)'s reporting requirements).

investment bank as the sole “beneficial owner” of the underlying stock is contrary to the transparency objectives¹¹ of the Williams Act. Instead, a holding that both parties to a TRS contract presumptively qualify as the beneficial owners of the stock in question under Section 13(d) will best promote the fundamental goals of the statute. The burden on a hedge fund resulting from such a presumption would be far outweighed by the protection disclosure offers to other shareholders, and this protection is exactly what the statute aims to promote in the first place. Until courts adopt such a policy, hedge funds will continue to circumvent the disclosure requirements of the statute through the use of swaps, thereby threatening to defraud large groups of public shareholders.¹²

Part I of this Note first discusses the concept of beneficial ownership—which lies at the heart of Section 13(d)—and then explains the structure of TRSs and how defendants in a recent S.D.N.Y. decision, *CSX Corp. v. Children’s Investment Fund Management (UK) LLP.*, used them to avoid Section 13(d) disclosure.¹³ Parts II.A and II.B analyze the judicial treatment of swaps in *CSX Corp.* and critique the court’s endorsement of conducting case-by-case inquiries aimed at determining whether an individual purposefully acted to evade the reporting requirements of Section 13(d). Parts II.C and II.D argue why courts should presumptively treat the long counterparty to a TRS as the beneficial owner of the underlying security and rebut the arguments raised by proponents of maintaining the status quo. Finally, Part III suggests a judicial framework that presumes beneficial ownership in the

¹¹ See *infra* notes 14, 16 and accompanying text.

¹² Section 13(d) has been minimally litigated since Congress enacted the Williams Act. In those rare instances where Section 13(d) is litigated, the parties involved are usually embroiled in a heated takeover battle. Since courts have consistently held that permanent injunctions on future Section 13(d) violations may be the only remedy available, the potential returns from litigation are slight indeed. As the litigation process almost always uncovers the existence of hidden swap agreements for the benefit of the public, and given that the purpose of the Williams Act is to ensure that shareholders will be informed of their companies’ dealings, courts are wary to issue any additional relief. See, e.g., *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d 559 (S.D.N.Y. 2007); see also *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975) (noting that, in enacting the Williams Act, “Congress expressly disclaimed an intention to provide a weapon for management to discourage takeover bids or prevent large accumulations of stock which would create the potential for such attempts”); *infra* note 91. However, the dearth of significant litigation in this area should not suggest that Section 13(d) is an unimportant statute. To the contrary, Section 13(d) serves an instrumental role in protecting the average shareholder, and, if hedge funds are permitted to continue blindsiding the public using TRSs, the day is not too far off when shareholders will be terribly cheated under the guise of a statute that aims to protect them.

¹³ 562 F. Supp. 2d 511 (S.D.N.Y.), *aff’d in part*, 292 F. App’x 133 (2d Cir. 2008). The issue of the proper construction of TRSs for Section 13(d) filing purposes was one of first impression in the Southern District of New York, and a review of relevant case law suggests that no other courts have specifically addressed the issue. The Second Circuit issued a summary order affirming the limited question of whether Judge Kaplan was correct in not ordering the sterilization of the shares acquired by TCI via the swap contracts. See *infra* note 91. As such, it does not appear that the Second Circuit will soon be discussing the question either.

hedge fund.

I. BENEFICIAL OWNERSHIP, TOTAL RETURN SWAPS, AND THE FACTS OF
CSX CORP.

A. *Defining “Beneficial Ownership” for Section 13(d) Purposes*

The Williams Act of 1968¹⁴ amended certain provisions of the Securities and Exchange Act of 1934 (Exchange Act)¹⁵ with the intention of promoting transparency in public stock ownership by alerting shareholders to potential shifts in control of their companies.¹⁶ The Williams Act’s amendment of Section 13(d) of the Exchange Act requires any entity that accumulates more than five percent of a security’s publicly traded stock to file a Schedule 13D form¹⁷ with the

¹⁴ See 15 U.S.C. §§ 781-78n (2006). One of the Williams Act’s main areas of focus is the regulation of tender offers; the Act sets mandatory disclosure requirements for parties utilizing this method to quickly accumulate a large number of shares. See Schedule TO (Tender Offer Statement under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934), 17 C.F.R. § 240.14d-100 (2009), for the minimum information required to be disclosed when making a tender offer. The purpose behind requiring parties to file a Schedule TO whenever making a tender offer is to apprise all the shareholders of the targeted company that a takeover bid is being made, thereby giving each shareholder a fair chance to sell his or her shares with the knowledge that the company’s management may very soon be changing hands. This concern for the ordinary investor is the same sort of motivation that drives the Section 13(d) reporting requirements.

¹⁵ See 15 U.S.C. §§ 78a-78oo (2006).

¹⁶ The House Report for the 90th Congress discussing the proposals of the Williams Act notes in the heading “Protection of Investors” that the underlying goal of the Act’s securities regulations is “full and fair disclosure for the benefit of investors.” H.R. REP. NO. 90-1711, at 3 (1968), *reprinted in* 1968 U.S.C.A.N. 2811, 2813. The report also explains that “[t]he purpose of [S]ection 13(d) is to require disclosure of information by persons who have acquired a substantial interest, or increased their interest in the equity securities of a company by a substantial amount, within a relatively short period of time.” *Id.* at 8; *see also CSX Corp.*, 562 F. Supp. 2d at 538 (“Section 13(d) in particular was adopted ‘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.’” (quoting *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971))); *Filing and Disclosure Requirements Relating to Beneficial Ownership*, Securities Act Release No. 5925, Exchange Act Release No. 14,692, Investment Company Act Release No. 10,212, 14 SEC Docket 862, 1978 WL 170898, at *2 (Apr. 21, 1978) (“The legislative history of [Section 13(d)] indicates that it was intended to provide information to the public and the affected issuer about rapid accumulations of its equity securities in the hands of persons who would then have the potential to change or influence control of the issuer.”).

¹⁷ See Schedule 13D, 17 C.F.R. § 240.13d-101 (2009), for the standard form. If they meet specific criteria, certain institutional investors are excused from filing a Schedule 13D when they acquire more than five percent of a company’s shares; instead, they are permitted to file the more abbreviated Schedule 13G. *See* SEC Regulation 13D-G, 17 C.F.R. § 240.13d-1(b)(1) (2009) (describing the conditions required for a party to file a Schedule 13G). In addition to being either a registered broker, bank, insurance company, etc., the entity must have “acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect” 17 C.F.R. § 240.13d-1(b)(1)(i).

SEC,¹⁸ essentially disclosing the purchase as well as any intentions the party may have to influence the company via its percentage ownership. The purpose of the reporting requirement is to inform investors.¹⁹ In particular, a Schedule 13D may alert existing shareholders to a potential shift in a company's direction when one or more shareholders increase their voting power by accumulating a large number of shares.²⁰

Acquiring an excess of five percent of common stock, however, is insufficient in itself to trigger Section 13(d). The key determination that invokes the Schedule 13D filing requirement is whether the person²¹ is deemed the "beneficial owner" of the acquired stock.²² The regulations promulgated pursuant to Section 13(d) include two sections that discuss alternative means of determining beneficial ownership. Rule 13d-3(a)²³ establishes that any person who obtains either voting power or investment power in a security is the beneficial owner of such security.²⁴ The second ground for establishing beneficial ownership is outlined in Rule 13d-3(b),²⁵ which states that if a person is found to have purposefully evaded the reporting requirements by entering into any arrangement with the express intention of preventing beneficial ownership from vesting, that person will be deemed the beneficial

¹⁸ The onus is on the purchasing party to file a Schedule 13D with the SEC; the SEC then publishes the disclosure for the benefit of the public. See 17 C.F.R. § 240.13d-101.

¹⁹ See *supra* note 16.

²⁰ See *supra* note 2.

²¹ For Exchange Act purposes, "[t]he term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C. § 78c(a)(9) (2006). Thus, all references to "person" in Section 13(d) carry this connotation. Additionally, "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for [Section 13(d) reporting] purposes . . ." 15 U.S.C. § 78m(d)(3) (2006).

²² See SEC Regulation 13D-G, 17 C.F.R. § 240.13d-1(a) (2009) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D . . .").

In a similar vein, the Exchange Act requires "[a]ny person who, after acquiring directly or indirectly the beneficial ownership of any [security] . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class [to], within ten days after such acquisition" file with the SEC the information that is now required in a Schedule 13D. 15 U.S.C. § 78m(d)(1) (2006).

²³ SEC Regulation 13D-G, 17 C.F.R. § 240.13d-3(a) (2009).

²⁴ Rule 13d-3(a) reads in full:

For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

Id.

²⁵ SEC Regulation 13D-G, 17 C.F.R. § 240.13d-3(b) (2009).

owner of the security.²⁶

Once a beneficial owner of more than five percent of common stock has been established, the owner must file a Schedule 13D with the SEC within ten days of acquiring the triggering stock.²⁷ Should any material change occur in the filing party's position in the security, the statute requires the party to promptly file an amended Schedule 13D.²⁸ The last step in the disclosure chain calls for a copy of any filed Schedule 13D or amendments thereto to be sent to the principal executive office of the issuer of the security, as well to each securities exchange where the security is traded.²⁹

Thus, it is clear that the concept of beneficial ownership lies at the heart of the Williams Act.³⁰ While Rule 13d-3(a) attempts to define the term in light of "voting power" and "investment power," the SEC intended the term to be read broadly in order to encourage disclosure.³¹ Therefore, in order to ensure that the proper party is characterized as the beneficial owner for Section 13(d) purposes, careful attention must be

²⁶ Rule 13d-3(b) reads in full:

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

Id.

²⁷ See 17 C.F.R. § 240.13d-1(a). This ten-day window creates an important, lawful opportunity for activist investors to quietly obtain large stakes in target companies. In the ten days before the five percent position must be disclosed, an investor can acquire as much stock as possible; when the window expires, the investor will simply be required to disclose in its Schedule 13D however large a stake it amassed during the ten-day grace period.

²⁸ SEC Regulation 13D-G, 17 C.F.R. § 240.13d-2(a) (2009). This subsection more fully states:

If any material change occurs in the facts set forth in the Schedule 13D . . . including, but not limited to, any material increase or decrease in the percentage of the class beneficially owned, the person or persons who were required to file the statement shall promptly file or cause to be filed with the Commission an amendment disclosing that change. An acquisition or disposition of beneficial ownership of securities in an amount equal to one percent or more of the class of securities shall be deemed "material" for purposes of this section; acquisitions or dispositions of less than those amounts may be material, depending upon the facts and circumstances.

Id.

²⁹ SEC Regulation 13D-G, 17 C.F.R. § 240.13d-7 (2009).

³⁰ See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 539 (S.D.N.Y.) ("The concept of beneficial ownership is the foundation of the Williams Act and thus critical to the achievement of its goal of providing transparency to the marketplace." (internal quotation marks omitted)), *aff'd in part*, 292 F. App'x 133 (2d Cir. 2008).

³¹ See Filing and Disclosure Requirements Relating to Beneficial Ownership, Securities Act Release No. 5925, Exchange Act Release No. 14,692, Investment Company Act Release No. 10,212, 14 SEC Docket 862, 1978 WL 170898, at *13 (Apr. 21, 1978) ("The Commission is of the view that this broad definition [of beneficial ownership] must be retained in order to obtain disclosure from all those persons who have the ability to change or influence control [of a public company].").

paid to the particular circumstances surrounding any given accumulation of stock that crosses the reporting threshold.³² Given their complicated financial structure, it is difficult to engage in such examinations with TRSs; in fact, the swaps' configurations form a battleground for deciding which party to a TRS transaction should qualify as the beneficial owner of the underlying shares.

B. *The Mechanics of Total Return Swaps*

Total return swaps fit within the larger category of derivatives,³³ a term used to describe financial instruments that derive their value from the price of a reference asset or index.³⁴ Swaps³⁵ essentially involve an exchange of cash flows between two parties; in turn, this cash flow arises out of two different underlying financial instruments.³⁶ One of the underlying instruments is a "reference obligation" or "underlying asset."³⁷ An underlying asset typically takes the form of a security,

³² The SEC once remarked:

An analysis of all relevant facts and circumstances in a particular situation is essential in order to identify each person possessing the requisite voting power or investment power. For example, for the purposes of the rule, the mere possession of the legal right to vote securities under applicable state or other law (i.e., a management proxy committee) may not be determinative of who is a beneficial owner of such securities inasmuch as another person or persons may have the power whether legal, economic, or otherwise, to direct such voting.

Adoption of Beneficial Ownership Disclosure Requirements, Securities Act Release No. 5808, Exchange Act Release No. 13,291, 1977 WL 185650, at *5 (Feb. 24, 1977).

³³ For a general discussion of derivatives, including a detailing of the swap market, see ROBERT W. KOLB & JAMES A. OVERDAHL, FINANCIAL DERIVATIVES (3d ed. 2003). Practically all derivatives, including swaps, are over-the-counter transactions that reflect private negotiations between two parties. *CSX Corp.*, 562 F. Supp. 2d at 523; KOLB & OVERDAHL, *supra*, at 168. Other types of derivatives include forward contracts, futures, and options. KOLB & OVERDAHL, *supra*, at 2. These different types of derivatives can also be combined to form more complex derivatives, sometimes referred to as synthetic instruments. *Id.* at 13. While these different derivatives and synthetics may have their own Section 13(d) implications, the question of whether or not they fall within the rubric of subsection (a) is outside the scope of this Note.

³⁴ See *CSX Corp.*, 562 F. Supp. 2d at 519. Derivatives can be divided into two categories: commodity derivatives and financial derivatives. Commodity derivatives use goods, such as crude oil, or a commodity index as their underlying assets, whereas financial derivatives "cover a diverse spectrum of underlying[] [assets], including stocks, bonds, exchange rates, interests rates, credit characteristics, or stock market indexes." KOLB & OVERDAHL, *supra* note 33, at 1-2. Derivatives can also be based on more than one underlying asset, as in the case where the difference between a domestic index and a foreign index is used as the underlying reference asset. *Id.* at 2.

³⁵ There are five basic types of swaps—equity swaps, commodity swaps, interest rate swaps, currency swaps, and credit swaps—the classification of which depends on the type of underlying asset involved in the transaction. See *id.* at 166. Only equity swaps are considered for the purposes of this Note because they derive their value from stock used as the underlying asset.

³⁶ *CSX Corp.*, 562 F. Supp. 2d at 519.

³⁷ *Id.*

bank loan, or index.³⁸ The second underlying instrument, which this Note refers to as the “loan asset,” is typically a benchmark loan with an interest rate resembling that of a regularly used reference rate, such as LIBOR.³⁹

In essence, the contracts⁴⁰ call for the swapping of different cash flows over a fixed period.⁴¹ In a typical, “plain vanilla” TRS,⁴² the short counterparty⁴³ (represented for this Note’s purposes by the investment bank) will pay the long counterparty⁴⁴ (represented for this Note’s purposes by the hedge fund) money based on the performance of the underlying security. The long counterparty will reciprocate with payments reflecting the interest that is generated from a negotiated principal amount—the “notional amount”⁴⁵—plus the value of any market depreciation of the underlying security.⁴⁶ While the short

³⁸ *Id.*; see also *supra* note 34 (describing the underlying assets commonly used in financial derivatives).

³⁹ *CSX Corp.*, 562 F. Supp. 2d at 519. LIBOR, which stands for the London Inter-Bank Offered Rate, is a commonly used reference rate for the loan asset; it reflects the interest rate that banks participating in the London money market are currently offering one another on loans. *Id.* Investment banks may also charge a spread above the reference rate, which means that the actual negotiated interest rate might account for: “(1) the creditworthiness of the two parties, (2) characteristics of the underlying asset, (3) the total return payer’s cost of financing, risk, and desired profit, and (4) market competition.” *Id.* at 520 n.13.

⁴⁰ The International Swaps and Derivatives Association (ISDA) created a Master Agreement, which serves as the standard form that parties typically use when entering into swaps. To access this form (albeit for a fee) and to learn more about ISDA’s practices, see ISDA, <http://www.isda.org> (last visited Sept. 2, 2009).

⁴¹ Each counterparty makes its respective payments on certain “refixing dates,” which are delineated in the swap contract and which occur throughout its duration. *CSX Corp.*, 562 F. Supp. 2d at 520 n.14. The counterparties can also agree to terminate, or “unwind,” the swap prior to its maturity, which usually requires one side to pay the other a termination fee. See Arnel Cates, *Swap Financing*, 20 INT’L LAW. 837, 842-43 (1986).

⁴² The term “plain vanilla” refers to highly-standardized swaps that generally involve the basic exchange of cash flows as illustrated *infra* text accompanying notes 48-49. See KOLB & OVERDAHL, *supra* note 33, at 166. “Flavored” swaps contain additional features that can be “customized to meet the particular needs of the swap’s counterparties.” *Id.* Some of the different features that are subject to customization include: whether the notional amount will be amortized, whether a spread will be charged above the loan asset’s interest rate, and other terms relating to the specific credit risks of the counterparties. See *id.* at 166-68, 206-09.

⁴³ The short counterparty is also referred to as the “total return payer” or “beneficiary.” *CSX Corp.*, 562 F. Supp. 2d at 520.

⁴⁴ The long counterparty is also referred to as the “total return receiver” or “guarantor.” *Id.*

⁴⁵ The notional amount usually equals the value of the underlying asset at the time the swap is executed, and may be periodically recalculated during the term of the swap. *Id.* at 520 n.13.

⁴⁶ *Id.* at 520. Judge Kaplan further details the specifics of the swaps:

[T]he “total return receiver” or “guarantor,” is entitled to receive . . . the sum of (1) any cash distributions, such as interest or dividends, that it would have received had it held the referenced asset, and (2) either (i) an amount equal to the market appreciation in the value of the referenced asset over the term of the swap (if the TRS is cash-settled) or, what is economically the same thing, (ii) the referenced asset in exchange for its value on the last refixing date prior to the winding up of the transaction (if the TRS is settled in kind). . . . [T]he “total return payer” or “beneficiary,” is entitled to receive . . . an amount equal to the interest at the negotiated rate that would have been payable had it

counterparty is the entity that actually owns the underlying security, the long counterparty receives payments based on the security's performance, as it would if it owned the asset outright.⁴⁷

A brief illustration of a plain vanilla TRS will help explain how the cash flows move between the counterparties. Assume *ABC* Hedge Fund and *XYZ* Investment Bank enter into a five-year cash-settled TRS.⁴⁸ The underlying asset is 1,000 shares of Google stock, which *XYZ* purchases as the record stockowner, and the loan asset is a \$300,000 notional loan subject to LIBOR. *ABC* would receive cash from *XYZ* equaling the value of any dividends and other distributions payable by Google on the underlying shares, plus any appreciation in the market value of the 1,000 shares that *ABC* would have realized had it outright owned the stock. Meanwhile, *XYZ* would receive cash from *ABC* equaling the value of the interest it would have earned had it actually lent the \$300,000 notional amount to *ABC*, plus any depreciation in the market value of the underlying Google shares.⁴⁹

While the economic implications for the hedge fund are the same as if it actually owned the referenced security, there are some exceptions that distinguish its position from direct ownership of the security. If the referenced asset is stock—and for most purposes, including this Note, it is—the hedge fund does not have the legal right to vote the shares because it is not the record stockowner.⁵⁰ Also, the hedge fund receives its dividends from the investment bank and not the security's issuer, as would be the case if the hedge fund directly owned the stock.⁵¹

actually loaned [its] [c]ounterparty . . . the notional amount, and (2) any decrease in the market value of the referenced asset.

Id. (footnotes omitted).

⁴⁷ *Id.* at 521 (“In practical economic terms, a TRS referenced to stock places the long party in substantially the same economic position that it would occupy if it owned the referenced stock or security.”).

⁴⁸ TRSs can either be cash-settled or settled-in-kind. A cash-settled swap is terminated when the investment bank pays the hedge fund the sum of any cash distributions (i.e., interest or dividends) and the amount by which the underlying asset appreciated over the term of the swap. *Id.* at 520. A settled-in-kind swap is terminated when the investment bank pays the hedge fund the sum of any cash distributions and sells to the hedge fund the physical shares of the underlying asset (i.e., the stock) in exchange for its value at the last refixing date prior to the termination of the swap. *Id.* Since swaps are privately negotiated contracts, their terms can be altered over the course of their existence if both counterparties agree. *Id.* at 523. This means that, if both parties consent, certain swaps initially calling for a cash settlement may in fact be settled-in-kind when they expire. *Id.* Such flexibility provides hedge funds with a strategic technique for obtaining a position in the underlying asset. See *infra* text accompanying notes 61-63.

⁴⁹ See also *CSX Corp.*, 562 F. Supp. 2d at 520-21 (providing a similar example).

⁵⁰ *Id.* at 521. While the hedge fund may not have the *legal* right to vote the shares, it may very well have a tremendous amount of influence over the way in which its counterparty votes. See *infra* notes 81-83, 115 and accompanying text.

⁵¹ *CSX Corp.*, 562 F. Supp. 2d at 521. Since the hedge fund only receives such payments if its counterparty is trustworthy and remains solvent, TRSs necessarily entail a certain amount of counterparty risk for the hedge fund. The converse is also true, of course. See *infra* note 57 and accompanying text.

From a motivational standpoint, the investment bank and the hedge fund have different objectives for entering into the swap agreement. Generally speaking, the investment bank enjoys the immediate cash flow it receives from the interest payments made by the hedge fund on the notional amount.⁵² While this increased income can be offset by any market appreciation in the referenced security,⁵³ the investment bank may be more willing to accept such risk if it makes its own determination that the security has little chance of appreciating, or if it already maintains a long position in the security that it is seeking to hedge.⁵⁴ More typically, though, the investment bank as a financial institution has no real long-term interest in the underlying stock. Its primary motivation for entering the TRS is economic, as it seeks to gain immediate cash flows through interest payments on the notional amount and through ancillary service fees. Additionally, the investment bank often seeks to cultivate a stable business relationship with its counterparty.⁵⁵

To reduce the risk of the security appreciating, investment banks will almost always hedge their short positions by directly buying a number of shares equal to those referenced in the TRSs.⁵⁶ Hedging allows the investment bank to ensure the swap transactions will be profitable—assuming, of course, that its counterparty follows through on its payment obligations.⁵⁷ When an investment bank properly hedges its short position in the underlying shares referenced in the TRSs, any market appreciation in the underlying stock that would normally threaten the bank's exposed short position is effectively counterbalanced by the identical increase in value of the bank's matching long position.⁵⁸

The potential benefits to the hedge fund in utilizing TRSs are even

⁵² *CSX Corp.*, 562 F. Supp. 2d at 521.

⁵³ An appreciation in the value of the underlying stock can be detrimental to the investment bank due to its short position in the stock. Since the investment bank must satisfy its short position when the swaps terminate, any market appreciation in the stock will make doing so a losing proposition. *See id.* (noting that the investment bank “is subject to the risk that the referenced asset will appreciate during the term of the TRS” and that the “*quid pro quo* for [receiving the interest payments] is the exposure to the risk of market appreciation in the referenced security”).

⁵⁴ *Id.*

⁵⁵ *See infra* note 115 (discussing the notion that an investment bank's interest in cultivating a solid client relationship with its hedge fund counterparty motivates it to vote the underlying shares according to the hedge fund's desires).

⁵⁶ *See CSX Corp.*, 562 F. Supp. 2d at 522.

⁵⁷ *See id.* at 522 n.17 (explaining that the safely hedged, typical institutional investor locked in as the short counterparty to a TRS would only take interest in the underlying security's performance if the long counterparty “became insolvent and thus unable to perform its obligation to hold [its counterparty] harmless against any decline in the value of the referenced security”).

⁵⁸ The reality that the short counterparty to a TRS will almost always hedge its underlying shares has key implications for Rule 13d-3(a)'s focus on investment power. *See id.* at 541-46; *infra* text accompanying notes 116-118.

greater than those to the investment bank. Among the economic incentives are certain tax advantages⁵⁹ and the ability to better leverage its stake in the underlying security since the hedge fund does not put up money to directly purchase the shares.⁶⁰ An even more important tactical incentive is created when the parties agree that the swaps can be settled-in-kind⁶¹—by entering into several of these types of TRSs with multiple counterparties, a hedge fund can rapidly accumulate large shares in a company to the surprise of other public shareholders simply by terminating the swaps.⁶² Even if the TRSs are cash-settled, the hedge fund has the advantage of knowing that its counterparties will most likely sell their hedged shares back into the market upon termination, thereby affording the hedge fund a prime opportunity to acquire physical shares if it decides that the time is right to launch its takeover battle.⁶³

With this in mind, probably the most appealing aspect of the swap arrangement for the hedge fund is its potential to prevent beneficial ownership from vesting, due to the nominal division of ownership.⁶⁴ This potential non-vesting of beneficial ownership allows activist shareholders to acquire effective stakes in a public company without having to disclose such stakes to the company's other shareholders. The hedge fund can thus acquire a substantial position in the company and can ultimately choose the right time to ambush it with a takeover battle.⁶⁵ Which counterparty in a TRS should qualify as the beneficial

⁵⁹ One such tax advantage is the potential to avoid capital gains tax on the market value appreciation of the underlying security. Since the investment bank is the entity that actually owns the underlying stock, any dividends or appreciation in value that the hedge fund receives first flows through the investment bank. If the hedge fund owned the stock outright and sold said stock for more than the purchase price, it would have to pay a capital gains tax on any appreciation in the stock's value. Thus, by utilizing swaps, the hedge fund can realize the cash value of the stock's appreciation without having to pay the capital gains tax. *Cf.* KOLB & OVERDAHL, *supra* note 33, at 205 (discussing a similar tax advantage from the position of the short counterparty).

⁶⁰ *CSX Corp.*, 562 F. Supp. 2d at 522.

⁶¹ *See supra* note 48.

⁶² *CSX Corp.*, 562 F. Supp. 2d at 523.

⁶³ *See id.* (“[E]ven if . . . TRSs [are] settled in cash, the disposition by the short counterparties of the referenced shares held to hedge their swap exposures would afford a ready supply of shares to the market at times and in circumstances effectively chosen and known principally by the long party. The long party therefore likely would have a real advantage in converting its exposure from swaps to physical shares even if it does not unwind the swaps in kind.”).

⁶⁴ *See id.* at 522-23.

⁶⁵ *See id.* at 523. Judge Kaplan expands upon the advantages of not having to disclose the swap arrangements:

The avoidance of public disclosure can confer significant advantages on the long party. By concealing its activities, it may avoid other investors bidding up the referenced stock in anticipation of a tender offer or other corporate control contest and thus maximize the long party's profit potential. Second, it permits a long party who is interested in persuading an issuer to alter its policies, but desirous of avoiding an all-out battle for control, to select the time of its emergence to the issuer as a powerful

owner of the underlying stock was exactly the issue litigated in *CSX Corp.*, where even though the defendant funds were ultimately found liable under subsection (b) for purposely evading the reporting requirements of Section 13(d) through the use of TRSs, the case left open the question of the proper characterization of the swaps for Schedule 13D purposes.

C. *Illustration: How the Defendants in CSX Corp. Utilized Total Return Swaps*

The defendants in *CSX Corp.* were activist hedge funds (and their directors) that sought to wage a proxy contest over the plaintiff railroad company in order to drive up the value of its stock.⁶⁶ The Children's Investment Fund (TCI)⁶⁷ was the primary hedge fund to invest in CSX. It eventually teamed up with 3G Capital Partners (3G)⁶⁸ for its proxy battle. Before officially waging the proxy, TCI utilized TRSs to quickly accumulate large shareholder interests in CSX.⁶⁹

Perhaps the most striking feature of TCI's utilization of TRSs to obtain a significant exposure to CSX stock is its own admission that the swap arrangements created a position for TCI in CSX. TCI made its first investment in CSX in late October 2006; by the end of the month it had entered into various TRSs that collectively referenced 1.7 percent of CSX stock.⁷⁰ Even at this early stage, TCI reached out to CSX to

player to a moment of its choosing, which may be when its exposure is substantially greater than 5 percent. In other words, it permits a long party to ambush an issuer with a holding far greater than 5 percent.

Id.

⁶⁶ *See id.* at 516; *see also id.* at 523 ("TCI began to research the United States railroad industry in the second half of 2006 and rapidly focused on . . . CSX, [one of] the two largest railroads in the eastern portion of the country. It decided to concentrate on CSX because it had [substantial] legacy contracts that were below market value prices and, in TCI's view, [was running] less efficiently than [it should]. In short, [TCI] felt that changes in policy and, if need be, management could bring better performance and thus a higher stock price." (internal quotation marks omitted)).

⁶⁷ TCI collectively refers to three separate funds: The Children's Investment Fund Management (UK) LLP, The Children's Investment Fund Management (Cayman) Ltd., and The Children's Investment Master Fund. *See id.* at 518.

⁶⁸ 3G also collectively refers to three separate funds: 3G Fund L.P., 3G Capital Partners L.P., and 3G Capital Partners Ltd. *See id.*

⁶⁹ *See id.* at 523-37. To be sure, conflating TCI's exposure to CSX stock via TRSs with direct ownership of CSX shares is technically, if only nominally, incorrect. The language supplied in the following narrative traces Judge Kaplan's language in *CSX Corp.*, which often fails to distinguish TCI's swap position in CSX from a direct shareholder's position. Since both Judge Kaplan's understanding of how TCI utilized TRSs to gain a foothold in CSX and TCI's own belief that its TRSs referencing CSX stock provided TCI with a position in the underlying security are central to this Note's proposal (i.e., that beneficial ownership should be presumed in the long counterparty to a TRS), Judge Kaplan's perception of the transpiring events is preserved.

⁷⁰ *Id.* at 523-24.

inform it of TCI's nearly \$100 million stake in CSX stock.⁷¹ That stake was up to \$300 million two weeks later, and TCI apprised CSX of its potential to increase it even further.⁷² Even as TCI waited to meet with CSX's executives in November, it entered into an additional seventeen TRSs with various financial institutions, thereby increasing its exposure in the company to 2.7 percent by the middle of the month.⁷³ By all accounts, even those of TCI, the swap arrangements were understood as establishing a considerable stake for TCI in CSX.⁷⁴ Thus, from the very beginning, TCI informed CSX of its intention to acquire the company's stock by way of the very instruments it later deemed unnecessary to disclose.

By February 2007, TCI had amassed fourteen percent of CSX stock exclusively through various TRS arrangements.⁷⁵ It then tried to convince other hedge funds to acquire CSX stock as well in order to pressure the company to acquiesce in TCI's power play.⁷⁶ Specifically, since TCI endeavored to change CSX's direction,⁷⁷ it was desirable to obtain the support of other hedge funds that were in line with TCI's strategic goals.⁷⁸ Through October 2007, TCI continued to utilize multiple financial institutions⁷⁹ as the short counterparties to its TRS contracts in order to keep each investment bank below the five percent reporting threshold for Section 13(d) purposes.⁸⁰ However, on October 30, 2007, TCI started to unwind its swaps with the financial institutions and replaced them with new TRSs that exclusively used Deutsche Bank and Citigroup as the short counterparties; this practice ultimately shifted nine percent of TCI's exposure to CSX into TRSs with the two banks.⁸¹ Judge Kaplan ignored TCI's proffered economic explanation⁸² for these

⁷¹ *Id.* at 524.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ During an early encounter between executives from both sides, one TCI official candidly informed CSX's assistant vice president of treasury and investor relations that "TCI's swaps, the only type of investment exposure TCI then had in CSX, could be converted into direct ownership at any time." *Id.*

⁷⁵ *Id.* at 525.

⁷⁶ *Id.*

⁷⁷ *See id.* at 523 ("TCI embarked on a course designed from the outset to bring about changes at CSX."); *id.* at 524 ("TCI[] belie[ved] that it could profit substantially if it could alter CSX's policies or, if need be, management . . .").

⁷⁸ *Id.* at 525 ("[TCI] intended to promote the acquisition of CSX shares by hedge funds that TCI regarded as favorably disposed to TCI and its approach to CSX in an effort to build support for whatever course of action it ultimately might choose with respect to the company.").

⁷⁹ These included Credit Suisse, Goldman Sachs, J.P. Morgan, Merrill Lynch, Morgan Stanley, and UBS. *Id.* at 529.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² TCI claimed that it was "motivated by the credit market crisis, believing that Deutsche Bank and Citigroup, as commercial banks backed by governmental central banks, would reduce TCI's exposure to counterparty credit risk." *Id.*

tactical moves, instead finding TCI's main motivation for involving Deutsche Bank and Citigroup to be that they might be more inclined to vote their hedged shares in line with TCI's wishes.⁸³

Meanwhile, 3G made its initial investment in CSX in early February 2007.⁸⁴ It continued accumulating CSX stock sporadically throughout the year and owned a 4.9 percent stake in the company (4.1 percent outright and 0.8 percent via swaps) by November 8, 2007.⁸⁵ Throughout this period, 3G and TCI consistently discussed their respective investments in CSX.⁸⁶ On December 19, 2007, both funds filed a Schedule 13D with the SEC disclosing their joint formation of a group,⁸⁷ yet each one disclaimed beneficial ownership of the referenced shares of CSX stock in their various TRSs.⁸⁸ A proxy fight ensued,⁸⁹ and CSX learned of defendants' multiple undisclosed TRS arrangements that would put them well over the five percent threshold if defendants qualified as the beneficial owners of the shares.⁹⁰ CSX reacted by filing its lawsuit, arguing that the defendants had violated Section 13(d) by filing deficient and materially false Schedule 13Ds and seeking, *inter alia*, sterilization of the undisclosed voting shares that were in excess of five percent.⁹¹

⁸³ *Id.* at 529-30. Here, Judge Kaplan suggests that TCI had more established or superior relationships with Deutsche Bank and Citigroup than it did with the other six financial institutions such that Deutsche Bank and Citigroup were more inclined to follow TCI's recommendation on how to vote the shares. Despite substantial evidence suggesting that Deutsche Bank backed TCI's bid, Judge Kaplan ultimately declined to make a factual finding on whether such an agreement—explicit or implicit—existed between the counterparties. *Id.* at 543-45.

⁸⁴ *Id.* at 530.

⁸⁵ *Id.* at 530-32.

⁸⁶ *Id.*

⁸⁷ In addition to CSX's claims that TCI violated Section 13(d) by not disclosing its TRSs involving CSX stock, the railroad company also alleged that TCI failed to timely disclose its formation of a group with 3G. As such, CSX urged, both TCI and 3G additionally violated Section 13(d) because they cumulatively owned more than five percent of CSX stock and delayed in so disclosing. *See id.* at 552-55. While a construction of TRSs that presumes beneficial ownership in the long counterparty certainly implicates Section 13(d)'s group filing requirements, further discussion of that topic is outside the scope of this Note.

⁸⁸ *Id.* at 535-36.

⁸⁹ *Id.* at 537.

⁹⁰ *Id.* at 538.

⁹¹ *Id.* at 518. Sterilization describes a type of relief under which the owner of shares is enjoined from voting them. If a party illegally obtains shares, a court can enjoin the owner from exercising its voting rights, which effectively "sterilizes" the shares and prevents the wrongdoer from profiting from its misconduct. As to the relief granted, Judge Kaplan ultimately found that prior precedent restrained him from granting CSX's request for the court to sterilize the voting shares that TCI obtained through its TRS contracts. Under *Rondeau v. Mosinee Paper Corp.*, a plaintiff must demonstrate that there exists a threat of irreparable injury for a court to order sterilization. 422 U.S. 49 (1975). Having concluded that CSX could not make such a showing, Judge Kaplan found that his hands were tied and that he could not grant such relief. *CSX Corp.*, 562 F. Supp. 2d at 568-72. However, Judge Kaplan did intimate his desire to levy such a drastic penalty on the defendants when he stated that "[w]ere the Court free as a matter of law . . . to grant such an injunction, whether on the basis that such relief is warranted to afford deterrence or

II. WHY JUDGE KAPLAN'S TREATMENT OF TOTAL RETURN SWAPS IN *CSX CORP.* FALLS SHORT

A. *Resolution of CSX Corp.*

Despite his detailed discussion of the facts regarding the TRSs utilized by the defendants in *CSX Corp.* and how they may very well have conferred beneficial ownership of the underlying stock on TCI,⁹² Judge Kaplan ultimately declined to decide the question of whether TRS contracts “in and of themselves” confer beneficial ownership of the underlying securities on the long counterparties under Rule 13d-3(a).⁹³ Judge Kaplan instead held defendants liable under Rule 13d-3(b), finding that TCI entered into the swap agreements for the sole purpose of evading the disclosure requirements of Section 13(d).⁹⁴ Judge Kaplan's analysis of Section 13(d) and his ultimate resolution of the case certainly rest on a plausible reading of subsection (b). However, given the structure of TRSs, a better rule can be based on a reasonable interpretation of subsection (a). Such a rule would extract greater disclosure—the hallmark of the Williams Act—than one that fashions liability on subsection (b).⁹⁵

B. *Problems with Judge Kaplan's Reliance on Rule 13d-3(b)*

While Judge Kaplan's decision to ground Section 13(d) liability on TCI under subsection (b) is eminently reasonable—especially given that TCI's pattern of entering into TRSs suggested that TCI purposefully chose the swap contracts to evade the reporting requirements—this resolution presents some key difficulties. First, such fact-specific inquiries require close scrutiny of the hedge fund's overall investment strategies and objectives regarding the underlying security. Telling of this demanding task is the fact that Judge Kaplan's discussion of the facts in *CSX Corp.* spans nearly fifteen pages.⁹⁶ This is not to suggest that such inquiries are impossible or that Judge Kaplan got it wrong. Rather, the very complexity of the analysis shows how challenging the

on another basis, it would do so.” *Id.* at 572.

⁹² *See id.* at 517 (“There are persuasive arguments for concluding, on the facts of this case . . . that defendants beneficially owned at least some and quite possibly all of the referenced CSX shares held by their counterparties.”).

⁹³ *Id.* at 546-48.

⁹⁴ *Id.* at 552.

⁹⁵ *See infra* Part II.C.

⁹⁶ *See CSX Corp.*, 562 F. Supp. 2d at 523-37.

inquiry is when grounding liability under subsection (b).⁹⁷ Furthermore, the information needed to assess a hedge fund's motivation for utilizing TRSs only emerges during discovery, which requires the initiation of a lawsuit. This means that hedge funds will be able to use TRSs to purposefully evade the disclosure requirements so long as a person or company fails to sue.⁹⁸

Another problem with grounding liability under subsection (b) is that hedge funds can be much more careful than the defendants in *CSX Corp.* to ensure that there is no evidence of intent to purposefully circumvent the statute. For example, future activist investors could take advantage of fewer TRSs than TCI did in *CSX Corp.*, but enough to give them a greater than five percent stake in a company's stock. Surely one of the strongest factors in Judge Kaplan's decision to find TCI liable was the great extent to which TCI availed itself of multiple TRSs with at least ten different counterparties, amounting to at least fourteen percent of CSX stock amassed exclusively through swap contracts.⁹⁹ If a hedge fund directly owned four percent of a company's stock and then entered into TRSs that equaled an additional two percent, the hedge fund could potentially acquire a six percent stake in a company in a much less blatant manner than did the defendants in *CSX Corp.* Additionally, the hedge fund in this type of situation would probably have a better chance of persuading a court that its motivation for participating in TRSs was solely economic, thus allowing it to hide its true intentions of avoiding disclosure.¹⁰⁰

Lastly, there is a more fundamental issue with fastening liability under subsection (b). When fact inquiries like the one conducted by Judge Kaplan in *CSX Corp.* suggest TRSs have been used intentionally to circumvent the reporting requirements of Section 13(d), the

⁹⁷ Such fact-specific inquiries present the difficult task of proving one's state of mind—a task that resists judgment as a matter of law, that threatens to constrain scarce judicial resources, and that always runs the risk of promoting uncertainty. Of course, many areas of the law cannot avoid these complications, as the element of mens rea is deeply embedded in American jurisprudence. But Section 13(d) provides a way of avoiding these difficulties when subsection (a) applies. In a way, the juxtaposition of subsections (a) and (b) presents a perfect platform for the debate over which legal tool better serves to promote justice: rules or standards. Despite his focus on antitrust law, Daniel Crane offers a helpful discussion of both sides of the debate, ultimately favoring per se rules (at least in the context of antitrust doctrines). See Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 WASH. & LEE L. REV. 49 (2007).

⁹⁸ To be sure, in every area of the law there exists the possibility that individual crimes will go unnoticed. But a judicial holding that TRSs are presumed to be per se mandatory disclosures under Rule 13d-3(a) would most likely increase the number of swap transactions that are voluntarily reported, as opposed to those uncovered only through the process of litigation.

⁹⁹ See *CSX Corp.*, 562 F. Supp. 2d at 525.

¹⁰⁰ Surely a court could still view this pattern of behavior as suspicious and ultimately find a hedge fund liable under Rule 13d-3(b), just as Judge Kaplan did in *CSX Corp.* However, utilizing TRSs to acquire a slightly-greater-than-five-percent position in a company would certainly have a better chance of flying under the radar and being excused as innocent conduct.

implication is that both the hedge fund and the investment bank participating in the arrangement shared the understanding that the swaps did in fact confer beneficial ownership on the hedge fund. Judge Kaplan was very interested in the fact that TCI substituted Deutsche Bank and Citigroup as the primary short counterparties to its TRS contracts because TCI believed that these two financial institutions would be willing to vote the underlying shares of CSX stock according to its wishes.¹⁰¹ This type of influence over the voting rights¹⁰² would certainly constitute “voting power” as described in subsection (a), which explicitly includes the power to “direct the voting” of the underlying shares of stock.¹⁰³ Thus, although eventually imposing liability, Judge Kaplan’s thorough fact inquiry might well be more complicated than it needs to be when, in the end, it suggests the hedge fund would qualify as a beneficial owner of the underlying stock under subsection (a).¹⁰⁴ A presumption of beneficial ownership in the long counterparty would avoid such long-winded fact inquiries. A closer look at the language of subsection (a) will further buttress this suggestion.

C. *Why Courts Should Presumptively Treat Long Counterparties to Total Return Swaps as the Beneficial Owners of the Underlying Securities Under Rule 13d-3(a)*

1. Statutory Interpretation Arguments

Subsection (a) of Section 13(d) defines beneficial ownership in terms of “voting power” and “investment power.”¹⁰⁵ TCI argued in *CSX Corp.*, as do proponents of maintaining the status quo,¹⁰⁶ that because long counterparties to TRSs do not have the *legal* right to vote or dispose of the underlying shares, they cannot be deemed the beneficial owners of the stock.¹⁰⁷

There is, however, a fatal flaw in this argument: Rule 13d-3(a)

¹⁰¹ *CSX Corp.*, 562 F. Supp. 2d at 529-30.

¹⁰² See *infra* note 115.

¹⁰³ See SEC Regulation 13D-G, 17 C.F.R. § 240.13d-3(a) (2009).

¹⁰⁴ Grounding liability under subsection (b) is therefore less efficient than doing so under subsection (a). For a general discussion on the efficiency-related advantages of preferring rules over standards, see Crane, *supra* note 97, at 80-84.

¹⁰⁵ 17 C.F.R. § 240.13d-3(a).

¹⁰⁶ See *infra* Part II.D.

¹⁰⁷ *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 546 (S.D.N.Y.) (“TCI . . . argues strenuously against a finding that it has beneficial ownership of the shares, focusing heavily on the fact that it had no legal right to direct its short counterparties to buy or sell shares or to vote them in any particular way, indeed at all.”), *aff’d in part*, 292 F. App’x 133 (2d Cir. 2008).

makes no mention of the possession of a “legal right” to vote or dispose of shares as being a requisite for establishing beneficial ownership—this language simply is not used anywhere in the statute. Additionally, subsection (a) does not exhaustively define what it means to possess voting or investment power, as the statute prefaces both of these definitions with the qualifier “includes.”¹⁰⁸ Indeed, Judge Kaplan explicitly acknowledges this important point of statutory construction.¹⁰⁹ Rule 13d-3(a) was thus intended from its inception to encompass a “broad definition” of beneficial ownership,¹¹⁰ and certainly does not turn on the issue of whether or not the owner has a formal, technical and legal right to vote or dispose of the shares.¹¹¹

Furthermore, the statute seems to account for extraordinary arrangements that nevertheless have the capacity to confer beneficial ownership. This is evident in the language of Rule 13d-1(a), which applies to “[a]ny person who, after acquiring directly or *indirectly* the beneficial ownership” of a given security is “directly or *indirectly* the beneficial owner of more than five percent” of the security’s stock.¹¹² In a similar vein, Rule 13d-3(a) defines the beneficial owner of a security as anyone who “directly or *indirectly*, through any contract, arrangement, understanding, relationship, or otherwise has or *shares*”¹¹³

¹⁰⁸ 17 C.F.R. § 240.13d-3(a).

¹⁰⁹ Judge Kaplan aptly points out:

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. The phrases “directly or indirectly” and “any contract, arrangement, understanding, relationship, or otherwise” reinforce that point and demonstrate the focus on substance rather than on form or on the legally enforceable rights of the putative beneficial owner.

CSX Corp., 562 F. Supp. 2d at 540 (footnote omitted).

¹¹⁰ *See id.*

¹¹¹ Moreover:

[B]eneficial ownership can arise out of “arrangements,” “relationships,” and “devices,” as well as “contracts” and “understandings.” Deliberate efforts to conceal legal ownership do not affect the determination of beneficial ownership. Indeed, it does not turn on who owns legal title to the stock, or who is the registered owner, or in whose name it is held. Instead the inquiry focuses on any relationship that, *as a factual matter*, confers on a person a significant ability to affect how voting power or investment power will be exercised, because it is primarily designed to ensure timely disclosure of market-sensitive data about changes in the identity of those who are able, as a practicable matter, to *influence* the use of that power.

SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587, 607 (S.D.N.Y. 1993) (internal quotation marks omitted) (second emphasis added), *aff’d sub nom.* *SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994).

¹¹² SEC Regulation 13D-G, 17 C.F.R. § 240.13d-1(a) (2009) (emphases added).

¹¹³ While the term “shares” in this context could be alluding to Section 13(d)’s discussion of a group formation, *see supra* note 21, there is no clear indication that such is the case. Rather, a fair reading of the language in light of Congress’s intention to define “beneficial ownership” as broadly as possible, *see supra* note 31 and accompanying text, suggests that Section 13(d) is capable of encompassing the TRS structure.

either voting power or investment power in the security.¹¹⁴ Thus, on its face, the statute appears to recognize and account for TRSs and other types of contracts that do not explicitly create voting or investment power in a direct manner. Still, one of these capacities—either voting power or investment power—must be shown to exist in the long counterparty in order for the presumption to work under Rule 13d-3(a).

Concededly, the textual argument that voting power is created in the long party when it utilizes TRSs is a tenuous one. Despite the very real possibility that many investment banks do in fact vote according to their counterparties' desires,¹¹⁵ this type of understanding between the two parties would most likely exist implicitly and behind the scenes, and there would be no concrete evidence of its existence. When asked if such an understanding was in place, both parties could easily deny it so being, even if in fact the hedge fund directed the investment bank's vote.

A much stronger case can be made when it comes to arguing that TRSs create investment power in the long counterparties. For purposes of Rule 13d-3(a), investment power includes "the power to dispose, or to direct the disposition of, such security."¹¹⁶ This provision was included in the statute because the SEC wisely deemed investment power to be closely tied with voting power, given that the power to dispose of shares would make them available to other investors who could then obtain voting power over them.¹¹⁷ This is a particularly

¹¹⁴ SEC Regulation 13D-G, 17 C.F.R. § 240.13d-3(a) (2009) (emphases added).

¹¹⁵ Since investment banks enter into TRSs for purely economic reasons, they theoretically have very little interest in voting their underlying shares. Also, because investment banks are concerned with forging a solid business relationship with their hedge fund counterparties, it intuitively makes sense that they would vote however the hedge funds want. This assumption is a popular one in the marketplace despite the fact that it may be difficult to prove. In England, it is essentially taken for granted:

When a dealer hedges through share ownership, a *de facto* practice is apparently emerging, at least in the U.K., in which the dealer, if asked, will either unwind the swap and sell the shares to its client . . . or vote the shares as its client wants To refuse would risk the dealer's business relationship with its client, and perhaps its market reputation as a reliable counterparty. Indeed, dealers may hedge with matched shares precisely because doing so lets the swap dealer accommodate its client by unwinding the swap or voting the shares if needed. The Code Committee of the U.K.'s Panel on Takeovers and Mergers recently explained that it is "frequently the expectation" of a long equity swap holder that the derivatives dealer would "ensure" that the shares are available to be voted by its customer and/or sold to the customer on closing out the contract. If the dealer hedged in another way, the holder would "normally expect" the dealer to acquire the necessary shares, even if this resulted in cost to the dealer.

Hu & Black, *supra* note 2, at 1030-31 (footnotes omitted).

¹¹⁶ 17 C.F.R. § 240.13d-3(a).

¹¹⁷ See Filing and Disclosure Requirements Relating to Beneficial Ownership, Securities Act Release No. 5925, Exchange Act Release No. 14,692, Investment Company Act Release No. 10,212, 14 SEC Docket 862, 1978 WL 170898, at *13 (Apr. 21, 1978) ("The Commission nevertheless continues to believe that the power to dispose, without more, gives its holder the

relevant concern as it pertains to TRSs given the reality that most investment banks hedge their short exposures in the underlying securities.¹¹⁸ Moreover, when there is the added possibility of TRSs being settled-in-kind,¹¹⁹ coupled with the long counterparty's ability to unwind the swaps prior to maturity,¹²⁰ the full picture suggests that TRSs do in fact provide hedge funds with sufficient investment power under Rule 13d-3(a) to confer upon them beneficial ownership of the underlying security. Indeed, Judge Kaplan's analysis of the facts of *CSX Corp.* revealed that TCI's influence over its bank counterparties amounted to the exact form of investment power over the underlying shares that Rule 13d-3(a) contemplates.¹²¹

2. Policy Considerations

Beyond these statutory interpretation arguments, there are two additional reasons why courts should presumptively treat the long counterparties in TRS contracts as beneficial owners of the underlying securities under Rule 13d-3(a).¹²² First, such a presumption best

ability to change or influence control and is therefore essential to eliciting the type of information within the purview of Section 13(d). This is attributable to the fact that the power to vote inheres in the security and may be relocated in the hands of any person to whom the holder of the power to dispose wishes to sell. Thus, the holder of the power to dispose potentially has the ability to bring about the rapid shift in control at which Section 13(d) is aimed even though he does not have the power to vote or to direct the voting of the security.”)

¹¹⁸ See *supra* notes 56-58 and accompanying text.

¹¹⁹ See *supra* note 48.

¹²⁰ See *supra* note 41.

¹²¹ Judge Kaplan appropriately notes:

To be sure, there is no evidence that TCI explicitly directed the banks to purchase the hedge shares upon entering into the swaps or to sell them upon termination. Nor did it direct the banks to dispose of their hedge shares by any particular means. But that arguably is not dispositive. . . . [I]t is quite clear that TCI significantly influenced the banks to purchase the CSX shares that constituted their hedges because the banks, as a practical matter and as TCI both knew and desired, were compelled to do so. It significantly influenced the banks to sell the hedge shares when the swaps were unwound for the same reasons.

CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 543 (S.D.N.Y.), *aff'd in part*, 292 F. App'x 133 (2d Cir. 2008). One author suggests that the power to influence the disposition of a counterparty's shares “falls outside Rule 13d-3(a)'s definition of beneficial ownership.” Brian T. Sullivan, Recent Development, *CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership*, 87 N.C. L. REV. 1300, 1308 (2009). However, this position fails to consider that the drafters of Section 13(d) and the rules promulgated thereunder intended the concept of beneficial ownership to be as broad as possible, *supra* note 31 and accompanying text, that Rule 13d-3(a)'s definition of beneficial ownership is not exclusive, *supra* note 109, and that prior case law interprets the concept of beneficial ownership to include the ability to influence voting or investment power over shares of stock, *supra* note 111.

¹²² Presumably, one could argue that long counterparties to TRSs should be presumptively treated as the beneficial owners of the underlying securities under Rule 13d-3(b). This might

comports with the congressional intent that motivated the enactment of the Williams Act—transparency for the ordinary shareholder.¹²³ The disclosure requirements of Section 13(d) aim to apprise shareholders of any potential shift in control of their company's management.¹²⁴ A rule that presumes beneficial ownership in the hands of hedge funds when they utilize TRSs will best serve to protect the interests of shareholders by ensuring that they will not be kept in the dark about an activist investor's plans to change the company's course.¹²⁵

A second point in favor of the presumption is its potential to promote judicial efficiency. This type of rule will save judges from having to conduct the intensive inquiries that are required when deciding whether to impose liability under subsection (b).¹²⁶ If the rule were in place, a future judge in a similar position as Judge Kaplan in *CSX Corp.* would be able to reach the same correct conclusion—that the defendant hedge fund was the beneficial owner of the underlying shares

intuitively follow from Judge Kaplan's fastening liability on TCI under subsection (b) for purposefully evading the reporting requirements. But there are many legitimate reasons why a long counterparty might enter into a TRS, and a presumption that uses subsection (b) would send the wrong message that swaps are fundamentally "bad." That is certainly not the case, as swaps and other derivatives are integral cogs in the workings of the marketplace. Therefore, subsection (a) is the more appropriate part of the statute on which to tailor the presumption. See *infra* note 131 and accompanying text.

¹²³ See *supra* note 16; see also *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d 537, 552 (S.D.N.Y. 2006) ("[Section 13(d)] was enacted to protect shareholders."); *id.* at 557 ("[T]he underlying purpose of the Williams Act is to make sure that 'pertinent information' is placed before the shareholders . . . so that they can 'decide for themselves' what they wish to do." (quoting *Macfadden Holdings, Inc. v. JB Acquisition Corp.*, 802 F.2d 62, 66 (2d Cir. 1986))).

¹²⁴ Cf. *supra* note 14 (describing the purposes of the Williams Act's tender offer rules as being similar to the purposes of Section 13(d)'s reporting requirements). Congress has underscored the importance to shareholders of being accurately informed about the direction of their company's management:

The competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to stockholders. Secrecy in this area is inconsistent with the expectations of the people who invest in the securities of publicly held corporations and impairs public confidence in securities as a medium of investment.

H.R. REP. NO. 90-1711, at 2 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2812.

¹²⁵ In addition to protecting the ordinary shareholder, stock ownership disclosure rules seek to improve market efficiency and corporate governance. For a terrific examination of how non-disclosed equity derivatives threaten to undermine these two goals, with a particular focus on the European regulatory scene, see Michael C. Schouten, *The Case for Mandatory Ownership Disclosure*, 15 STAN. J.L. BUS. & FIN. (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327114.

¹²⁶ Cf. THEODORE N. MIRVIS ET AL., WACHTELL, LIPTON, ROSEN & KATZ, DECISION IN *CSX ON DERIVATIVES AND BENEFICIAL OWNERSHIP REPORTING REQUIREMENTS—EXTREME CAUTION FLAG AND ROADMAP FOR REFORM 1* (June 12, 2008), available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15735.08.pdf> ("The analysis in the opinion underscores that regulatory reform is best undertaken via the rulemaking process, which can provide certainty and uniformity to all market participants—rather than fact-specific adjudications applying existing regulatory concepts in a necessarily *post hoc* and *ad hoc* manner.").

of the TRSs—via a much easier path.¹²⁷

D. *Arguments Against Treating Total Return Swaps as Presumptively Conferring Beneficial Ownership on the Long Counterparties, and Why They Fail*

Proponents of maintaining the status quo—that is, not construing TRSs as conferring beneficial ownership on the long counterparties—argue that any such contrary ruling will “upset settled expectations of the market.”¹²⁸ These proponents urge that the threat of increased disclosure burdens or liability will chill the use of swap transactions to the detriment of such an integral part of the financial universe.¹²⁹ These types of fears, however, are unfounded. First, Section 13(d) only enters the picture when the beneficial ownership of publicly traded securities exceeds five percent; TRSs that use different underlying assets do not trigger the statute and therefore would be unaffected by the presumption.¹³⁰

Second, presumptively treating the long counterparties to TRSs as beneficial owners of the underlying stock by no means suggests that these contracts are to be frowned upon or discouraged.¹³¹ Ultimately, the “burdens” that would be imposed amount to the simple completion of a single form and the responsibility of investors to be more conscientious of their trading practices.¹³² These two obligations hardly

¹²⁷ See *supra* note 104 and accompanying text.

¹²⁸ *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 547 (S.D.N.Y.), *aff’d in part*, 292 F. App’x 133 (2d Cir. 2008).

¹²⁹ See *id.* at 546–48. The ISDA filed an amicus brief in *CSX Corp.* highlighting this concern. See Brief of Amici Curiae International Swaps & Derivatives Ass’n & Securities Industry & Financial Markets Ass’n at 19, *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (No. 08 Civ. 2764) (“A mistaken judgment about beneficial ownership under [Section 13(d)] can . . . result in substantial legal and financial penalties, and the risk of such a result has significant potential to chill otherwise legitimate and desirable investment and risk management activity.”).

¹³⁰ It is worth noting in this regard that the majority of the swaps market is concentrated in interest rate and foreign currency swaps. See KOLB & OVERDAHL, *supra* note 33, at 195.

¹³¹ Kolb and Overdahl point out that financial derivatives, including swaps, are socially beneficial in two key respects. First, they provide important financial engineering tools for managing risk that can be tailored to suit an individual portfolio’s specialized needs. *Id.* at 18. Second, “the trading of financial derivatives aids economic agents in *price discovery*—the discovery of accurate price information—because it increases the quantity and quality of information about prices.” *Id.* at 20. Such disclosure of accurate price information allows economic resources to be allocated more efficiently. *Id.*

¹³² The large majority of investors are already vigilant in maintaining their portfolios, with most keeping up-to-date figures on their exposures in each security in which they invest. What would additionally be required of investors were this Note’s proposal to be implemented is simply to keep track of all their equity swap positions and to add them to any existing positions in the swaps’ underlying stock—if this resulted in a greater than five percent stake in a given company, they would have to file a Schedule 13D.

represent significant obstacles to the swap market and certainly would not generate a rampant fear that the “sky . . . is likely to fall.”¹³³ Rather, such a holding would likely only disturb those investors that utilize TRSs to circumvent the reporting requirements of Section 13(d),¹³⁴ while leaving the vast majority of swap participants unaffected.¹³⁵

A more general argument that can be made against treating TRSs as conferring beneficial ownership on the long counterparties appeals to the notion of judicial restraint. Since the swaps market originated in the late 1970s¹³⁶—a full decade after the enactment of the Williams Act—the TRS structure in all likelihood could not have been contemplated by the drafters of Section 13(d). As such, some might argue that equity swaps were designed to operate at the borders of legality—since they do not appear to threaten direct violations of the Williams Act, courts should not be worried about them. These advocates might similarly maintain that any reform in this area should come at the hands of Congress, not judges.¹³⁷

While statutory reform may be the most preferable response to address the apparent disconnect between Rule 13d-3(a) and swap structures,¹³⁸ there is little indication that such reform of Section 13(d) is forthcoming.¹³⁹ The SEC administration in place at the time CSX

¹³³ *CSX Corp.*, 562 F. Supp. 2d at 548; *see also id.* at 547 (“[T]he Court is inclined to the view that the Cassandra-like predictions of dire consequences of holding that TCI has beneficial ownership under Rule 13d-3(a) have been exaggerated.”).

¹³⁴ Arguably, even hedge funds that rely heavily on swap contracts to maneuver secretly in companies will not be negatively affected to such a great extent by this Note’s proposal. Hedge funds would still be able to utilize TRSs to initially accumulate significant stakes (up to 4.99%) in a target company. Then, when the hedge fund is ready to launch the takeover, it can directly buy physical shares from the market, make a tender offer, or make use of additional TRSs to increase its stake in the company. It is only at this point that the hedge fund would have to disclose its earlier swap holdings. Thus, hedge funds would still be able to keep their intentions secret until they decided to make a move.

¹³⁵ *See CSX Corp.*, 562 F. Supp. 2d at 547.

¹³⁶ KOLB & OVERDAHL, *supra* note 33, at 195.

¹³⁷ Judge Kaplan may very well share this view. Indeed, one of the main themes of his opinion seems to be that of restraint. Despite his apparent desire to “call a spade a spade” by lambasting TCI time and again for manipulating the Section 13(d) reporting requirements, he ultimately refrained from issuing a ruling that would set a precedent in an area of securities law that is clouded with uncertainties and ripe with differing opinions.

¹³⁸ Statutory reform has the additional potential to address a wide range of Section 13(d) disclosure issues related to other derivatives and synthetics apart from TRSs. For an excellent commentary on *CSX Corp.* that urges for statutory reform, see THEODORE N. MIRVIS ET AL., *supra* note 126; *see also* THEODORE N. MIRVIS, ADAM O. EMMERICH & ADAM M. GOGOLAK, WACHTELL, LIPTON, ROSEN & KATZ, BENEFICIAL OWNERSHIP OF EQUITY DERIVATIVES AND SHORT POSITIONS—A MODEST PROPOSAL TO BRING THE 13D REPORTING SYSTEM INTO THE 21ST CENTURY (Mar. 3, 2008), available at <http://www.wlrk.com/webdocs/wlrknew/FirmMemos/WLRK/WLRK.15395.08.pdf> (arguing that Section 13(d)’s definition of beneficial ownership should be expanded to include any derivative instrument that provides a party with a direct or indirect pecuniary interest in the underlying security).

¹³⁹ To be sure, while currently there are no proposed amendments to Section 13(d), in response to the recent economic crisis, President Obama emphasized his Administration’s goal of

Corp. was being litigated did not seem too concerned over the issue—in fact, the SEC’s Division of Corporate Finance filed an amicus letter with the court supporting TCI’s position.¹⁴⁰ While this does not represent an official stance of the SEC on the matter, and though Judge Kaplan generally found the letter to be unpersuasive,¹⁴¹ it nevertheless evidences a lack of agency support in the push for regulatory reform in this area.¹⁴² In the meantime, while waiting for statutory improvements that may never come to fruition, shareholders are in need of better gatekeeping to ensure that they will timely receive pertinent information regarding the potential paths of their companies. Absent statutory reform, a judicial decree is necessary to prevent the policy goals of Section 13(d) from being contractually circumvented.

III. CRAFTING THE JUDICIAL PRESUMPTION: BENEFICIAL OWNERSHIP VESTS IN BOTH COUNTERPARTIES TO TOTAL RETURN SWAPS

A judicial doctrine that presumptively treats each counterparty to a TRS as a beneficial owner of the underlying security¹⁴³ will properly

reforming many of the U.S. securities laws and regulations. On June 17, 2009, the Department of the Treasury released a white paper outlining proposals for reforming the U.S. financial regulatory systems, including a call for federal supervision of the over-the-counter derivatives market. See U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION—REBUILDING FINANCIAL SUPERVISION AND REGULATION 43-49 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. While the proposal would seem to require participants in swap transactions to report their derivative contracts to an oversight commission, it is unclear whether the public would have access to such information. Moreover, as Congress has yet to vet any actual legislation in this area, the proposed regulations’ effect on Section 13(d)’s reporting requirements is merely speculative at this point.

¹⁴⁰ See Defendants’ Response to the SEC Amicus Letter at 1, *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (No. 08 Civ. 2764) (noting the SEC’s Division of Corporate Finance’s position that “[a] standard cash-settled equity swap agreement, in and of itself, does not confer on a party, here the [hedge] fund, any voting power or investment power over the shares a counterparty purchases to hedge its position”); see also *CSX Corp.*, 562 F. Supp. 2d at 549-51.

¹⁴¹ See *CSX Corp.*, 562 F. Supp. 2d at 550-51; see also *id.* at 551 n.205 (“As a staff interpretation, the Division’s views are entitled to no greater weight than flows from their persuasive qualities.”).

¹⁴² The SEC’s recommendation letter should not be given too much weight because Section 13(d) was originally enacted by Congress, not the SEC. Even though the SEC promulgates rules governing the statute, Congress’s initial desires in enacting the Williams Act are dispositive. Further, the SEC is a political body that has recently changed course. As such, the judiciary serves an important “watchdog” role in this area.

¹⁴³ Although separately treating both counterparties to a TRS as the beneficial owners of the underlying stock might present some conceptual difficulties, in reality such reservations are unfounded. In practice, only the hedge fund will likely have to disclose a TRS in a Schedule 13D if the swap puts the hedge fund over the five percent reporting threshold. The bank counterparties as institutional investors, on the other hand, will almost certainly make sure not to cross the same threshold. This is no different than the current practice, whereby investment banks enter into

protect the disclosure goals of the Williams Act by requiring hedge funds to disclose the effective stakes they acquire in a company by way of the swap contract. TRSs have been shown to substantively provide the long counterparties with investment power (and perhaps voting power) in the underlying securities as contemplated by the statutory language of Rule 13d-3(a).¹⁴⁴ With the wiggle-room created through this reasonable interpretation of the statute, judges in future cases would be empowered to hold the disclosure of TRSs presumptively mandatory under subsection (a) of Section 13(d), provided that such swaps push the long counterparty over the five percent reporting threshold. The long counterparty could rebut this judicial presumption by satisfying its burden to convince a court that it in fact maintained no voting or investment power in the security.

A similar judicial presumption has been created in the plaintiff's favor in tort and negligence jurisprudence. In the seminal case of *Summers v. Tice*,¹⁴⁵ the California Supreme Court gave the benefit of the doubt to the plaintiff in his personal injury claim against two defendants who allegedly shot him in the face with birdshot while hunting.¹⁴⁶ The three hunters were arranged in a triangle, with the two defendants an equal seventy-five yards away from the plaintiff.¹⁴⁷ One of the defendants flushed a quail out of the bushes, which then proceeded to fly between the two defendants and the plaintiff.¹⁴⁸ Each defendant negligently shot in the plaintiff's direction, striking him in his eye and upper lip.¹⁴⁹

Since both defendants negligently fired their shotguns at the same time, and because the plaintiff could not decipher which defendant's bullets struck him in the face, the court presumed that each defendant was jointly and severally liable for the plaintiff's injuries.¹⁵⁰ Since the defendants were equally negligent in their actions and the plaintiff was not contributorily negligent, the court placed the burden on each defendant to bring forth evidence that his bullet did not strike the plaintiff—absent such exonerating evidence, both defendants would be

TRSs assuming that they are the sole beneficial owners of the underlying securities; thus, generally they do not come close to the five percent mark. Furthermore, assuming that a TRS were to trigger both counterparties' reporting requirements under Section 13(d), there is no significant impediment to requiring each side to disclose the same acquisition. Indeed, the statutory language accounts for "share[d]" voting or investment power for beneficial ownership purposes, SEC Regulation 13D-G, 17 C.F.R. § 240.13d-3(a) (2009), and requires multiple parties to file a joint Schedule 13D upon formation of a "group," 15 U.S.C. § 78m(d)(3) (2006). See *supra* notes 87, 113 and accompanying text.

¹⁴⁴ See *supra* Part II.C-1.

¹⁴⁵ 199 P.2d 1 (Cal. 1948).

¹⁴⁶ *Id.* at 1-2.

¹⁴⁷ *Id.* at 2.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 2-3.

accountable for the full extent of the harm caused.¹⁵¹ The court reasoned that the defendants should bear the burden of proof in this type of situation because, absent a presumption in his favor, the plaintiff would suffer the difficult—if not impossible—task of proving one defendant’s guilt over the other.¹⁵² Additionally, since the defendants were in a better position to know exactly what transpired, the court decided that they should be required to justify their own actions.¹⁵³

The *Summers* presumption framework is useful in the context of TRSs and Section 13(d). Since hedge funds inevitably utilize TRSs in order to circumvent the disclosure goals of the Williams Act, and given that the type of fact inquiries conducted by Judge Kaplan in *CSX Corp.* are so difficult to complete, hedge funds should bear the burden of disclaiming beneficial ownership of the underlying stock referenced in their swap contracts. A judicial construction of TRSs that presumes beneficial ownership in the hedge fund ultimately makes sense in light of Section 13(d)’s concern for the ordinary shareholder.¹⁵⁴

By way of additional comparison, the judiciary expanded upon a congressional presumption in the Longshore and Harbor Workers’ Compensation Act (LHWCA),¹⁵⁵ a federal statute that provides compensation relief for maritime employees¹⁵⁶ who are injured in the workplace. Many of the cases arising under the LHWCA involve

¹⁵¹ *Id.* at 3-4.

¹⁵² *See id.* at 4 (“When we consider the relative position of the parties and the results that would flow if plaintiff was required to pin the injury on one of the defendants only, a requirement that the burden of proof on that subject be shifted to defendants becomes manifest. They are both wrongdoers both negligent toward plaintiff. They brought about a situation where the negligence of one of them injured the plaintiff, hence it should rest with them each to absolve himself if he can. The injured party has been placed by defendants in the unfair position of pointing to which defendant caused the harm. If one can escape the other may also and plaintiff is remediless.”).

¹⁵³ *Id.* (“Ordinarily defendants are in a far better position to offer evidence to determine which one caused the injury.”).

¹⁵⁴ Concern for the ordinary shareholder has motivated the Supreme Court to create similar presumptions in the securities laws. For example, in Rule 10b-5 fraud cases (involving the purchase or sale of a security), reliance is presumed when material information is withheld. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-54 (1972) (“[P]ositive proof of reliance is not a prerequisite to recovery [in a Rule 10b-5 action where defendant failed to disclose information]. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [his or her investment] decision.”). Similarly, reliance is presumed for Rule 10b-5 purposes when an investor alleges the fraud-on-the-market theory. *See Basic Inc. v. Levinson*, 485 U.S. 225, 241-49 (1988). This presumption is rebuttable, however. *Id.* at 248-49.

The Supreme Court in *Basic Inc.* noted two significant advantages of presumptions. First, they “typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult.” *Id.* at 245. Second, presumptions are “useful devices for allocating the burdens of proof between parties,” and thus can serve to promote the underlying policies of our laws. *Id.* at 245-46. This Note’s proposed presumption framework is consistent with these features.

¹⁵⁵ 33 U.S.C. §§ 901-950 (2006).

¹⁵⁶ *See* 33 U.S.C. § 902 (2006) (describing who qualifies as an employee for purposes of the Act).

claims of asbestos-related cancer.¹⁵⁷ These claims are difficult to prove, especially considering their tendency to be brought by employees with a history of smoking;¹⁵⁸ however, Section 920(a) of the LHWCA establishes a causal presumption in favor of the claimant that the injury is related to the claimant's employment.¹⁵⁹ This reflects a Congressional decision to give the claimant the benefit of the doubt¹⁶⁰ based upon the consensus that the injury is usually work-related.

While the initial LHWCA presumption was congressionally enacted, judges have since developed their own burden-shifting framework, which is helpful in the TRS context. To invoke the presumption, the claimant need only establish a prima facie case of causation alleging that the injury resulted through the course of employment for the employer.¹⁶¹ Once the presumption has been successfully invoked, the burden then shifts to the employer to bring forth substantial evidence that the workplace conditions played no role in the claimant's injury.¹⁶² If the employer is able to meet its burden, the presumption disappears from the case altogether, and the administrative law judge¹⁶³ is left to weigh all the evidence in the record, with the claimant ultimately needing to prove the claim by a preponderance of the evidence.¹⁶⁴

These three judicially crafted burden-shifting steps could easily be applied by a judge when analyzing alleged Section 13(d) violations. In an action by a plaintiff against a hedge fund alleging materially false Schedule 13D filings due to non-disclosure of swap positions in the underlying security, the plaintiff would first have to establish its prima facie case that the hedge fund entered into TRSs that created a greater-than-five-percent aggregate position in the underlying security. Assuming the plaintiff passed this test, the burden would then shift to the hedge fund to present substantial evidence that the swaps did not actually provide it with any voting or investment power. This would have to be a severe test, however, as the hedge fund would predictably make arguments similar to those made by TCI in *CSX Corp.*,¹⁶⁵ and if these types of arguments were accepted by a court, the presumption would be meaningless.

¹⁵⁷ See, e.g., *Rainey v. Dir., Office of Workers' Comp.*, 517 F.3d 632 (2d Cir. 2008).

¹⁵⁸ See, e.g., *id.* at 634-35.

¹⁵⁹ Section 920(a) reads: "In any proceeding for the enforcement of a claim for compensation under this chapter it shall be presumed, in the absence of substantial evidence to the contrary . . . [t]hat the claim comes within the provisions of this chapter." 33 U.S.C. § 920 (2006).

¹⁶⁰ See *Rainey*, 517 F.3d at 637 n.2.

¹⁶¹ *Id.* at 634.

¹⁶² *Id.*

¹⁶³ All claims brought under the LHWCA must first be heard by an administrative law judge. 33 U.S.C. § 919(d) (2006).

¹⁶⁴ See *Rainey*, 517 F.3d at 634.

¹⁶⁵ See, e.g., *supra* note 82.

Therefore, the hedge fund would have to establish certain facts, which at a minimum might include: (1) the TRS contracts called for cash settlements upon termination, perhaps with an express agreement from the outset that this feature could not be altered in the future; (2) the short counterparty maintained a policy of not voting the underlying shares of the swaps;¹⁶⁶ and (3) the short counterparty did not hedge its short exposure to the underlying shares by directly purchasing an equal amount of common stock shares.¹⁶⁷ If a court were persuaded by the existence of these facts and others, the plaintiff would then carry the final burden of persuasion to convince the court by a preponderance of the evidence that the TRSs conferred beneficial ownership of the referenced shares on the hedge fund. This type of procedure would ensure that most Section 13(d) violators would be exposed, while allowing the truly innocent hedge fund to escape unwarranted liability.¹⁶⁸

CONCLUSION

Perhaps Judge Kaplan best hinted at the capability of TRSs to undermine the disclosure goals of Section 13(d) when, in the very first lines of his opinion in *CSX Corp.*, he cautioned that the defendants' secretive conduct in entering TRS contracts for the purpose of evading

¹⁶⁶ Indeed, in *CSX Corp.*, some of the original financial institutions that were short counterparties to TCI's TRSs had similar policies that prohibited them from voting any shares acquired to hedge the underlying shares referenced in the TRSs. See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 543 n.169 (S.D.N.Y.), *aff'd in part*, 292 F. App'x 133 (2d Cir. 2008). Of course, this type of policy may not be sufficient to eliminate the hedge fund's influence over the voting of the shares; if the financial institution planned to vote contrary to the hedge fund's wishes, a policy of not voting shares may in fact aid the hedge fund in its proxy contest. Judge Kaplan addressed this scenario:

[S]ome of the banks' policies gave TCI the power to prevent a share from being voted. Credit Suisse, for example, appears to follow a policy of not voting its hedge shares if it is solicited by its counterparty in a contested situation. In such instances, then, TCI could ensure that that bank's hedge shares would not be voted against it by the simple expedient of soliciting its counterparty. Thus, by entering into a TRS with Credit Suisse, TCI was in a position to ensure that Credit Suisse would purchase shares that otherwise might have been voted against TCI in a proxy fight and then to ensure that those shares would not be so voted. While this would not be as favorable a result as dictating a vote in its favor, it would be better than leaving the votes of those shares to chance.

Id. at 545 (footnote omitted).

¹⁶⁷ This element may go too far, as most investment banks need to manage their risk by hedging. But certainly not all investment banks do, and some might already have a long position in the underlying security that would suffice to act as a proper hedge. Perhaps a showing that the investment bank only minimally hedged its exposure, as opposed to purchasing an equal number of shares as referenced in the swaps, would satisfy this element.

¹⁶⁸ An exemption from the presumption might also be provided to institutional investors, just as they are exempted from other parts of the Williams Act. See *supra* notes 4, 17.

the reporting requirements skirted the line between legal and illegal activity.¹⁶⁹ While ultimately Judge Kaplan defended Section 13(d)'s aims by finding the defendants liable under subsection (b) of the statute, he left the door open for future investors to take advantage of TRSs to keep their percentage stock ownership below the five percent triggering mark and thereby defeat the goals of the statute. Granted, Judge Kaplan certainly sent a strong message to those considering such evasive tactics that may make some reconsider not disclosing TRS contracts in Schedule 13D filings.¹⁷⁰ Yet his hesitancy to hold that TRS contracts confer beneficial ownership of the underlying stock upon the long counterparty under subsection (a) of Section 13(d) may permit future intentional Williams Act violators to escape enforcement through the use of formalistic reasoning.

Given that "the Exchange Act is concerned with substance, not incantations and formalities,"¹⁷¹ we should ask ourselves what the long parties' true intentions are when entering into TRSs. Invariably those intentions revolve around a desire to snatch shares away from other investors, yet in such a manner as to keep other shareholders in the dark about a concerted effort to move the company in a given direction. The end result is an implicit sanctioning not of permissible shareholder activist strategies, but rather unfair and substantively illegal "shareholder ambushing."

¹⁶⁹ Judge Kaplan's opinion begins:

Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. This is such a case.

CSX Corp., 562 F. Supp. 2d at 516.

¹⁷⁰ See *supra* note 12.

¹⁷¹ *CSX Corp.*, 562 F. Supp. 2d at 517; see also *id.* at 547 ("The focus on TCI's legal rights under its swap contracts, while those rights certainly are relevant, exalts form over substance. The securities markets operate in the real world, not in a law school contracts classroom. Any determination of beneficial ownership that failed to take account of the practical realities of that world would be open to the gravest abuse. Indeed, this Court is not alone in recognizing that abuses would be facilitated by a regime that did not require disclosure of the sort that would be required if 'beneficial ownership' were construed as advocated by CSX.").