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Brian T. Sullivan

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CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership*

INTRODUCTION

In the midst of a severe economic crisis, the country's attention has focused increasingly on financial markets regulation. Prompting this heightened attention is the perception that the inadequacy of the current market regulations has been a precipitating force in the current economic turmoil.¹ The hedge fund² industry is one industry that has taken advantage of this limited regulation to grow rapidly and increase its market impact.³ Consequently, there has been an increase in the number and size of so-called "activist funds," which are hedge funds that seek to affect the governance and control of companies in which they invest.⁴ Activist funds' strategies for exerting influence over target companies pose challenges for corporate governance and the federal securities laws' current disclosure requirements.⁵

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1. See Justin Fox, *Pointing Fingers: The Financial Crisis Blame Game*, TIME, http://www.time.com/time/specials/packages/article/0,28804,1869041_1869040,00.html (last visited Apr. 8, 2009) (listing the top twelve reasons for America's recent economic crisis); Joseph Stiglitz, *Nobel Laureate: How to Get Out of the Financial Crisis*, TIME, Oct. 17, 2008, <http://www.time.com/time/business/article/0,8599,1851739,00.html>.

2. A hedge fund is "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter SEC STAFF REPORT].

3. See Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 12–19 (2007). The total number of hedge funds is over 13,000, and their impact on financial markets is enhanced by their high trading levels. *Id.* at 12–16. For a discussion of the history of hedge fund regulation, or the lack thereof, and a plan for effective future regulation, see generally *id.*

4. *Id.* at 6–7; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029 (2007) (Activist funds try "to influence the business strategy and management of corporations."). "This activism takes a variety of forms, from public pressure on a . . . company to change its business strategy, to the running of a proxy contest to gain seats on the board of directors, to litigation against present or former managers." Kahan & Rock, *supra*, at 1029.

5. See Kahan & Rock, *supra* note 4, at 1022; William Savitt, *The Dilemma of Empty Voting: When Votes are Cast by Investors with No Stake in a Corporation, Rationale for*

The recent case, *CSX Corp. v. Children's Investment Fund Management (UK) LLP*,⁶ highlighted the conflict between hedge fund strategies for influencing corporate policy and Securities and Exchange Commission⁷ ("SEC") disclosure requirements for the mass accumulation of securities.⁸ One of the defendants in the case was The Children's Investment Fund Management ("Children's Fund"), an activist hedge fund attempting to increase CSX Corporation's ("CSX") value by pursuing changes in the management and control of the company.⁹ Children's Fund, however, did not invest in CSX in the traditional manner by buying shares of the company's stock, but rather obtained an economic interest in the shares through the use of derivative investments known as total return equity swaps ("TRSs").¹⁰ By using swaps, Children's Fund believed it could gain an influential interest in CSX without triggering SEC disclosure requirements for accumulations of stock that could shift corporate control.¹¹ In the first major case to address this issue, the court disagreed, holding that the fund used a scheme to avoid disclosure and should be deemed the "beneficial owner" of the shares held by its counterparties.¹² This rendered the fund beneficial owner

Vote Is Imperiled, NAT'L L.J., Nov. 17, 2008, at S1 ("[N]ontraditional derivative-based corporate ownership and voting arrangements have moved from the fringes to the mainstream, raising questions about prevailing disclosure regimes . . .").

6. 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd*, No. 08-2899-cv, 2008 WL 4222848 (2d Cir. Sept. 15, 2008). The decision was affirmed only with regard to the denial of CSX's claim for enjoining Children's Fund from voting the CSX shares that it owned at the annual meeting. The other issues remain on appeal.

7. The Securities and Exchange Commission was created by the Securities Exchange Act of 1934 and is the primary regulatory body for securities transactions. JAMES D. COX ET AL., CORPORATIONS 707 (1997).

8. If a person acquires more than five percent of a company's securities, disclosures must be sent to the SEC, the company, and any exchange on which the security is traded. 15 U.S.C. § 78m(d) (2006). The disclosures must include, among other things, the "background, identity, and residence" of the security owner, the "source and amount of the funds" used to purchase the securities, any plans to change the control or structure of the corporation, and the number of shares the person owns or has a "right to acquire." *Id.*

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

10. For a description of TRSs and the mechanics of the transaction, see *infra* notes 28-36 and accompanying text.

11. *CSX Corp.*, 562 F. Supp. 2d at 517. Disclosing the swap positions would have made Children's Fund's possible takeover plans public and likely resulted in an increase in share price, making it more expensive for the fund to purchase additional shares. *Id.* at 523. Children's Fund's disclosure avoidance also allowed it to conceal its interest in the company until a time of its choosing, a strategy the court labeled an "ambush." *Id.*

12. *Id.* at 517 ("Rule 13d-3(b) . . . provides in substance that one who creates an arrangement that prevents the vesting of beneficial ownership as part of a plan or scheme to avoid the disclosure that would have been required if the actor bought the stock outright is deemed to be a beneficial owner of those shares. That is exactly what the

of enough shares to trigger the SEC's disclosure requirements, and therefore, the fund's failure to timely disclose its positions violated federal securities laws. The court's decision addressed a number of issues of first impression, but the two most controversial were: (1) whether Children's Fund was the beneficial owner of shares held by its counterparties in the total return equity swap agreements; and (2) whether Children's Fund used the swap transactions as part of a scheme to avoid disclosure.¹³

This Recent Development argues that, although the current SEC definition of "beneficial ownership" should be expanded to cover an economic interest in securities arising out of total return equity swaps, the court's decision to deem Children's Fund a beneficial owner of CSX shares held by its counterparties was an improper judicial expansion of the term under *current* SEC guidelines. First, this Recent Development will briefly overview the major securities laws and their impact on hedge funds and hedge fund investment strategies. Next, it will analyze the *CSX Corp.* decision in light of the plain language of the disclosure rule, prior case law, and SEC guidance, concluding that the court's decision to deem Children's Fund the beneficial owner of its counterparties' CSX shares incorrectly expands the definition of beneficial ownership. Finally, this Recent Development asserts that while the definition of beneficial ownership should be expanded to cover economic interests arising from total return equity swaps, expansion should come from the SEC, not the courts. The SEC, as opposed to the court system, is in the best position to expand the definition and provide much-needed clarity and uniformity.

I. THE SECURITIES LAWS AND HEDGE FUND REGULATION

Securities are primarily regulated through five federal statutes that focus on disclosure. The relevant laws are contained in the Securities Act of 1933 ("Securities Act"),¹⁴ the Securities Exchange

defendants did here in amassing their swap positions. In consequence, defendants are deemed to be the beneficial owners of the referenced shares.").

13. *See id.*

14. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006). The Securities Act covers the issuance of stock to the public and requires registration with the SEC and dissemination of a prospectus disclosing information necessary for potential investors to make an informed investment decision. COX ET AL., *supra* note 7, at 695. The goal of the Act is to prevent securities fraud by disclosing the details of the securities offering to potential investors. *Id.* at 697.

Act of 1934 (“Exchange Act”),¹⁵ the Investment Company Act of 1940,¹⁶ the Investment Advisers Act of 1940,¹⁷ and the Sarbanes-Oxley Act.¹⁸ The regulatory provision at issue in *CSX Corp.*—and thus, in this Recent Development—was part of the Williams Act,¹⁹ passed in 1968. The Williams Act amended the Exchange Act of 1934 and added five new sections aimed at addressing a rash of corporate takeovers.²⁰ One of those additions, section 13(d), requires a person to disclose the acquisition of “more than a five percent beneficial ownership” of a public company’s securities.²¹ This section, central to the *CSX Corp.* decision, seeks to prevent the secret accumulation of large blocks of corporate securities that could shift corporate control.²²

Hedge funds, as entities, have avoided regulation under the major securities laws by strategically structuring themselves to take advantage of available exemptions.²³ The primary reason funds

15. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006). The Exchange Act’s scope is much broader than that of the Securities Act, and it governs all securities transactions occurring after the initial offering. *COX ET AL.*, *supra* note 7, at 707. The Exchange Act is aimed at “supervision and maintenance of the integrity of the marketplace.” *Id.* The Exchange Act also includes a general antifraud provision, which, in addition to combating fraud, is frequently used to address insider trading violations. *Id.* at 711.

16. Investment Company Act of 1940, 15 U.S.C. § 80a (2006).

17. Investment Advisers Act of 1940, 15 U.S.C. § 80b (2006).

18. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 and 18 U.S.C.). Interestingly, the enactment of each piece of legislation tended to follow closely on the heels of a major economic crisis, indicating that securities regulation has been more reactionary than proactive in nature. *See* Pearson & Pearson, *supra* note 3, at 49. The Securities Act and the Exchange Act closely followed the 1929 stock market crash. *Id.* The Investment Company Act and the Investment Advisers Act were passed in response to the Great Depression. *Id.* The Sarbanes-Oxley Act was enacted in the wake of Enron and other similar corporate scandals. *Id.* Given this history, it would be no surprise to witness another wave of regulations in response to the current economic crisis.

19. Williams Act, 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e), 78n(f) (2006).

20. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 11.1 (rev. 5th ed., 2005). *See generally* Steven M. Davidoff, *The SEC and the Failure of Federal Takeover Regulation*, 34 FLA. ST. U. L. REV. 211 (2007) (discussing the history and shortcomings of federal takeover regulation).

21. HAZEN, *supra* note 20, §11.1.

22. *See CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 538 (S.D.N.Y. 2008), *aff’d*, No. 08-2899-cv, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

23. Investments in hedge funds do qualify as securities under the Securities Act. SEC STAFF REPORT, *supra* note 2, at 11–22. However, the Securities Act contains an exemption for nonpublic offerings to a specified class of investors, an exemption for which hedge funds typically qualify. *Id.* at 14. The Exchange Act, which covers virtually all sales of securities, only applies to entities that are considered “dealers” under the statute. Pearson & Pearson, *supra* note 3, at 50. Hedge funds are thought to qualify for an exemption from dealer status under the “trader exception.” *Id.* Hedge funds have also

prefer to remain unregulated is to maintain the confidentiality of their trading strategies by avoiding the securities laws' disclosure requirements.²⁴ While hedge funds have avoided SEC regulation as entities, as investors, hedge funds remain subject to the SEC's general disclosure and antifraud provisions because these provisions apply to all investors.²⁵ Accordingly, hedge funds are subject to section 13(d)'s

managed to avoid regulation under the Investment Company Act of 1940, which, as its name indicates, governs investment companies. *Id.* at 50–51. Exemption from this Act generally comes under either section 3(c)(1) or 3(c)(7). SEC STAFF REPORT, *supra* note 2, at 11–13. Both exemptions require nonpublic offerings and apply to companies with less than 100 investors or those consisting solely of investors that are “qualified purchasers,” respectively. *Id.* In general, the “qualified purchaser” classification applies to sophisticated and high-wealth investors who are thought not to require the protection of the statute. *Id.* at 12–13. Hedge funds are able to qualify for both exemptions by limiting the number and type of investors that are allowed to participate in the fund. *Id.* at 11–13. Finally, hedge fund managers have avoided registration under the Investment Advisers Act of 1940 based on a de minimis exemption. *Id.* at 21. Because a hedge fund is considered a single client, an adviser can support up to fourteen hedge funds before the Act requires registration, but very few advisers ever reach this threshold. *Id.* The SEC has attempted to promulgate rules directly aimed at regulating hedge fund advisers. These attempts, however, have been largely unsuccessful. The SEC adopted a rule in 2004 that caused many hedge fund advisers to qualify for regulation under the Investment Advisers Act, subjecting them to registration and disclosure requirements. Pearson & Pearson, *supra* note 3, at 54; see Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004), available at <http://edocket.access.gpo.gov/2004/pdf/04-26879.pdf> (providing background of the SEC's decision to draft the new rule and amendments, which are codified at 17 C.F.R. § 275.203(b)(3)-2, available at [http://edocket.access.gpo.gov/cfr_2008/aprqrtr/pdf/17cfr275.203\(b\)\(3\)-2.pdf](http://edocket.access.gpo.gov/cfr_2008/aprqrtr/pdf/17cfr275.203(b)(3)-2.pdf)). The rule, however, was short-lived. In 2006, the Circuit Court of Appeals for the District of Columbia declared the new hedge fund adviser rule invalid. Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006); Pearson & Pearson, *supra* note 3, at 56–57. Thus, hedge funds have essentially avoided regulation under all of the major securities laws.

24. Pearson & Pearson, *supra* note 3, at 48. Confidentiality is important because investors choose which funds to invest in based on the fund's success. These investors are paying a substantial management fee and a percentage of their profits to invest in the fund and gain access to the fund's unique trading strategy. See Kahan & Rock, *supra* note 4, at 1064–65 (indicating that the management fee is typically between one and two percent of the investor's total investment and that the fund also receives twenty percent of profits). If funds are required to disclose information regarding their securities holdings and trading strategies, then it becomes easier for other investors or funds to mimic their investment strategy, which removes the fund's competitive advantage. See Gregory Zuckerman, *A Peek at Moneymakers' Cards—Hedge Fund Filings on Holdings Can Clue Investors in on Strategy; Taking Joys on Bets Gone Awry*, WALL ST. J., May 19, 2006, at C1.

25. *Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, United States Securities & Exchange Commission), available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm> (“[H]edge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws.”); Kahan & Rock, *supra* note 4, at 1062.

disclosure requirements for beneficial owners²⁶ of more than five percent of a company's equity securities.²⁷ With Children's Fund subject to section 13(d)'s provisions, the question in *CSX Corp.* was whether the fund's interest in the CSX shares amounted to beneficial ownership, thus triggering the section's disclosure requirements.

II. THE COURT'S IMPROPER JUDICIAL EXPANSION OF BENEFICIAL OWNERSHIP

In order to understand the court's reasoning, a brief explanation of the total return equity swap is necessary.²⁸ In essence, a TRS is a contract in which one party receives the cash flows that it would have received if it owned a certain security or block of securities.²⁹ In return, that party agrees to pay interest on a specified amount of money (called the "notional amount").³⁰ The notional amount generally is "the value of the referenced asset at the time the transaction is [entered into] and may be recalculated periodically."³¹ The swap involves two parties, a "short party" and a "long party." The short party agrees to pay the long party any dividends declared by the underlying security plus any increase in the reference security's value.³² Typically, the short party hedges its swap position by purchasing the reference security.³³ The long party agrees to pay to the short party interest on the notional amount of money plus any decrease in the reference security's value.³⁴ An equity swap is considered a "derivative" investment because its value is derived from the underlying reference security.³⁵ In *CSX Corp.* specifically, Children's Fund was the long party and essentially entered into

26. The term "beneficial owner" is a term of art used for the purposes of section 13(d). For a definition of beneficial ownership, see *infra* notes 41–44 and accompanying text.

27. Kahan & Rock, *supra* note 4, at 1062.

28. For a thorough explanation of the structure and purpose of Children's Fund's total return swaps, see *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 519–23 (S.D.N.Y. 2008), *aff'd*, No. 08-2899-cv, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

29. Kevin Dolan & Carolyn DuPuy, *Equity Derivatives: Principles and Practice*, 15 VA. TAX REV. 161, 164 (1995).

30. *Id.* at 171.

31. *CSX Corp.*, 562 F. Supp. 2d at 520 n.13.

32. Dolan & DuPuy, *supra* note 29, at 171 (using "B" to represent the short party). As a result, the long party obtains the economic interest in the reference security from the short party. Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816 (2006).

33. Hu & Black, *supra* note 32, at 816.

34. Dolan & DuPuy, *supra* note 29, at 171 (using "A" to represent the long party).

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

contracts with its counterparties to receive the cash flows that it would have received if it had owned CSX shares.³⁶

CSX's action against Children's Fund was grounded in the violation of section 13(d) of the Exchange Act³⁷ and Rule 13d-3 promulgated thereunder.³⁸ With Children's Fund subject to section 13(d)'s provisions, the question in *CSX Corp.* was whether the fund's interest in the CSX shares amounted to beneficial ownership under Rule 13d-3. In general, section 13(d) requires "beneficial owners" of five percent or more of a company's securities to file a disclosure statement with the company and the SEC.³⁹ As the court stated, "[t]he concept of 'beneficial ownership' is the foundation of [section 13(d)]."⁴⁰ As such, Rule 13d-3's provisions set forth the definition of beneficial ownership.⁴¹ Rule 13d-3(a) provides the general definition of beneficial ownership, which includes any person having either "investment" or "voting" power over the securities.⁴² This definition of beneficial ownership covers, among other things, traditional stock ownership.⁴³ Rule 13d-3(b)'s definition of beneficial ownership supplements that of Rule 13d-3(a) by finding beneficial ownership if a person enters into an arrangement to prevent or divest beneficial ownership under Rule 13d-3(a) as part of a scheme to avoid section 13(d) disclosure requirements.⁴⁴ The court analyzed beneficial ownership under both subsections of Rule 13d-3. It chose not to rule on beneficial ownership under subsection (a) but deemed Children's Fund a beneficial owner of the CSX shares under subsection (b), which triggered disclosure requirements.⁴⁵ The fund's failure to file timely disclosure statements was a violation of section 13(d).⁴⁶

36. *Id.* at 521.

37. 15 U.S.C. § 78m(d) (2006).

38. 17 C.F.R. § 240.13d-3 (2008).

39. 15 U.S.C. § 78m(d)(1).

40. *CSX Corp.*, 562 F. Supp. 2d at 539.

41. 17 C.F.R. § 240.13d-3.

42. 17 C.F.R. § 240.13d-3(a).

43. *See CSX Corp.*, 562 F. Supp. 2d at 540.

44. 17 C.F.R. § 240.13d-3(b); *see CSX Corp.*, 562 F. Supp. 2d at 540.

45. *CSX Corp.*, 562 F. Supp. 2d at 517.

46. 15 U.S.C. § 78m(d) (2006). As a remedy for the violation, the court enjoined Children's Fund from future violations of section 13(d). *CSX Corp.*, 562 F. Supp. 2d at 573-74. The court, however, denied CSX's claim to enjoin Children's Fund from voting its CSX shares at the company's annual shareholder meeting. *Id.* at 572. This holding was subsequently upheld in an appellate opinion limited to the claim to enjoin the voting of CSX shares. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, No. 08-2899-cv, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

A. *Rule 13d-3(a)*

The court's consideration of Children's Fund's beneficial ownership began with an analysis of the definition of the term in Rule 13d-3(a). Although the court's decision was not based on subsection (a),⁴⁷ the court's analysis remains significant because future cases interpreting beneficial ownership are likely to arise in the Southern District of New York since it is home to Wall Street and the vast majority of financial transactions. The Rule itself, which focuses on voting and investment power, reads:

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.⁴⁸

In analyzing Children's Fund's potential beneficial ownership, the court acknowledged that Children's Fund did not enter into an agreement that would give it direct voting or investment power over CSX shares.⁴⁹ Thus, the court's focus shifted to whether the fund had indirect investment or voting power over its counterparties' shares.

The court found strong arguments that Children's Fund had the power to influence investment and voting decisions for its counterparties' CSX shares. The court also concluded that Children's Fund knew that its counterparties would hedge their swap positions by purchasing the referenced shares in amounts nearly identical to those referenced in the swap.⁵⁰ Given this knowledge, the question became whether Children's Fund could affect investment or voting power in the shares.⁵¹ The court found that Children's Fund "significantly influenced the banks to purchase the CSX shares that

47. *CSX Corp.*, 562 F. Supp. 2d at 517.

48. 17 C.F.R. § 240.13d-3(a).

49. *CSX Corp.*, 562 F. Supp. 2d at 541.

50. *Id.* at 542. By the time Children's Fund filed its section 13(d) disclosure statements it owned 4.2% of CSX's outstanding stock, a total of 17,796,998 shares, and had exposure to an "additional 11% of CSX shares outstanding" through its swap agreements. Keith E. Gottfried & Barry H. Genkin, *U.S. District Court Rules Against Hedge Fund in CSX Corp. v. The Children's Investment Fund et al.: Holds That Equity Swaps Were Used to Avoid Disclosure Under Rule 13d-3(b) of the Exchange Act*, WALL ST. LAW., Aug. 2008, at 1, 5.

51. *CSX Corp.*, 562 F. Supp. 2d at 541.

constituted their hedges” and “significantly influenced the banks to sell the hedge shares when the swaps were unwound.”⁵² Further, the court found that there was “reason to believe that [Children’s Fund] was in a position to influence the counterparties . . . with respect to the exercise of their voting rights.”⁵³ As evidence of this, the court pointed out that many of the swaps were moved to one particular counterparty on the eve of CSX’s annual meeting, a counterparty over which the court believed Children’s Fund had more influence.⁵⁴

The court’s interpretation of Rule 13d-3(a) was inconsistent with its plain language. The facts of the case clearly indicated that Children’s Fund did not have the “power to vote” or the “power to dispose” of the shares held by its counterparties, meaning that it could not have been a beneficial owner under the first part of either prong of Rule 13d-3(a).⁵⁵ Accordingly, the court focused on the statutory language, which asked whether Children’s Fund had the power to direct the voting of or the power to direct the disposition of such shares.⁵⁶ It found “no evidence that Children’s Fund explicitly directed the banks.”⁵⁷ Instead of ending its inquiry there, the court moved past the plain language of the statute to inquire into the hedge fund’s ability to *influence* the disposition and voting of the shares.⁵⁸

The court’s influence inquiry fell outside the scope of actions covered under Rule 13d-3(a).⁵⁹ A clear distinction can be drawn between the power to “direct” and the power to “influence,” and the latter falls outside Rule 13d-3(a)’s definition of beneficial ownership. The SEC chose not to include “influence” over voting and disposition in the definition of “beneficial ownership.”⁶⁰ Further, precedent

52. *Id.* at 543.

53. *Id.* at 546.

54. *Id.* at 543–44. The court offered as support for this finding a statement from the fund’s managing partner that part of the reason the swaps were moved to the particular counterparty was that they felt the votes were more likely to go in their favor. *Id.* at 544. The court also went on to suggest that Children’s Fund shared a common interest in CSX with one of the counterparties’ internal hedge funds, which it believed it could exploit to influence the votes. *Id.*

55. 17 C.F.R. § 240.13d-3(a) (2008).

56. *CSX Corp.*, 562 F. Supp. 2d at 541.

57. *Id.* at 543.

58. *Id.* at 546.

59. Brief of Amici Curiae International Swaps and Derivatives Ass’n, Inc. and Securities Industry and Financial Markets Ass’n at 3, *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (Nos. 02-2899-cv(L), 08-3016-cv (XAP)), 2008 WL 3924620 [hereinafter ISDA Brief].

60. For a discussion of potential reasons why the SEC did not include the ability to influence the voting and disposition of shares, see *id.* at 16. (arguing that a vast amount of

supports such a distinction, indicating that “power to direct” under Rule 13d-3 is concerned with control and not influence.⁶¹ The SEC draws this distinction itself in its letter to the court in which it stated “[t]he more reasonable interpretation of the terms ‘voting power’ and ‘investment power’ . . . are based on the concept of actual authority.”⁶² As the court freely admitted, Children’s Fund had no actual authority over the voting or disposition of its counterparties’ CSX shares.⁶³ Thus, the court’s finding that Children’s Fund had the ability to influence the voting and disposition of the shares did not constitute the “power to direct” Rule 13d-3(a) requires, and the court’s indication that such influence was sufficient to constitute beneficial ownership was erroneous.

The court’s interpretation of “beneficial ownership” under Rule 13d-3(a) is also inconsistent with SEC guidance on the Rule’s scope. The scope of beneficial ownership is broad.⁶⁴ Limits on the scope, however, do exist. In particular, the SEC indicated that “economic or business incentives, in contrast to some contract, arrangement, understanding, or relationship concerning voting power or investment power between the parties to an equity swap, are not sufficient to create beneficial ownership under Rule 13d-3.”⁶⁵ The court’s indication that there were persuasive arguments in support of beneficial ownership under Rule 13d-3(a) is in opposition to the plain language of the SEC’s guidance. In this situation, there was no legal or contractual obligation for the counterparties to buy, sell, or vote

actions exist that can influence the disposition of shares, many of which clearly do not amount to beneficial ownership of the shares).

61. *Id.* at 14. (citing *Levy v. Southbrook Int’l Invs. Ltd.*, 263 F. 3d 10, 15–16 (2d Cir. 2001)).

62. Letter from Brian Breheny, Deputy Dir., SEC Div. of Corp. Fin., to Judge Lewis A. Kaplan, U.S. Dist. Court Judge, S. Dist. of N.Y. (June 4, 2008), *available at* www.gibsondunn.com/publications/Documents/CSX-BrianBrehenyLtrToJudgeKaplan.pdf [hereinafter SEC Letter]. It is necessary to point out that the letter submitted to the court was not the result of a full Commission vote, but rather an opinion expressed by the Division of Corporation Finance. *Id.* As a result, the letter of opinion does not receive the same amount of deference that an opinion from the full Commission would. *Id.* Opinions of the full commission are binding on the court, unless they are clearly erroneous. The opinion of the Division of Corporation Finance is only persuasive authority. *CSX Corp.*, 562 F. Supp. 2d at 551 n.205.

63. *CSX Corp.*, 562 F. Supp. 2d at 541.

64. *Id.* at 540 (citing Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978)).

65. SEC Letter, *supra* note 62. The SEC also indicated that the scope of Rule 13d-3 is narrower than that of its overlying statutory provision, section 13(d). *Id.*

the CSX shares at the Children's Fund's direction.⁶⁶ The only "influence" that Children's Fund could have had over the investment power of the shares would have been the economic incentive associated with hedging the swap positions.⁶⁷ Similarly, the only incentive to vote according to Children's Fund's interests was the economic benefit of fostering additional business with the Fund. Thus, for the court to make its statement regarding the likelihood of beneficial ownership under Rule 13d-3(a),⁶⁸ it had to ignore the SEC's guidance in regards to the Rule's scope, or at least engage in a strained reading of that guidance.

Not only was the court's interpretation of Rule 13d-3(a)'s beneficial ownership standard contrary to the Rule's plain language and the SEC's interpretation thereof, it was also inconsistent with market participants' general practices and perceptions. The current SEC Rule's failure to require disclosure for shares held by counterparties in TRSs has been cited as a serious problem in calls for new regulation.⁶⁹ Proponents of regulatory change have pointed out that "with some attention to legal niceties" TRSs "can often be structured" so as not to trigger disclosure under Rule 13d-3(a).⁷⁰ This conclusion is also consistent with international decisions interpreting securities laws patterned after Rule 13d-3(a).⁷¹ In addition, the U.S.

66. *CSX Corp.*, 562 F. Supp. 2d at 541 ("The contracts embodying [Children's Fund's] swaps did not give [Children's Fund] any legal rights with respect to the voting or disposition of the CSX shares referenced therein. Nor did they require that its short counterparties acquire CSX shares to hedge their positions.").

67. *See, e.g., id.* (indicating that the counterparty's investment decisions with regards to CSX shares were aimed at hedging financial risks associated with the swaps, and not the result of contractual or legal obligations).

68. In analyzing beneficial ownership under Rule 13d-3(a), the court stated that "there are substantial reasons for concluding that [Children's Fund] is the beneficial owner of the CSX shares held as hedges by its short counterparties." *Id.* at 545.

69. *See generally* Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) (elaborating on the importance of the decoupling problem and suggesting additional long term solutions); Hu & Black, *supra* note 32 (arguing that the use of derivatives to secretly accumulate voting interests in securities without triggering SEC disclosure requirements is a serious problem and suggesting a number ways to remedy the current lack of regulation).

70. Hu & Black, *supra* note 32, at 818; *see also* Savitt, *supra* note 5 (indicating that interests in securities resulting from swap contracts do not usually trigger section 13(d) disclosure requirements).

71. *See* Hu & Black, *supra* note 32, at 868-69 (discussing cases from Australia and New Zealand in which cash settled equity swaps did not trigger disclosure requirements similar to those under section 13(d)). In the case from New Zealand, the court indicated that one reason for not finding beneficial ownership "was that it believed similar disclosure would not be required in Australia, the United States, or the United Kingdom." *Id.* at 837.

law firms most familiar with the derivative markets have issued guidance that total return equity swaps do not establish beneficial ownership of shares held by the short counterparty under Rule 13d-3(a).⁷² It would appear from the SEC's guidance in *CSX Corp.* that market participants were justified in reaching such a conclusion regarding beneficial ownership. In its letter to the court, the SEC quite bluntly stated that "a standard cash settled equity swap agreement, in and of itself, does not confer on a party, here the investment fund, any voting power or investment power over the shares a counterparty purchases to hedge its position."⁷³ There is no evidence, despite the court's conclusory statement indicating otherwise,⁷⁴ that the swap transactions that Children's Fund entered into were anything but standard. The evidence and the state of the law at the time provide a strong argument that beneficial ownership did not exist under Rule 13d-3(a).

The court in *CSX Corp.* piled up arguments in support of finding beneficial ownership under Rule 13d-3(a) only to leave the issue unresolved because it decided the case on other grounds. As such, the court created uncertainty in what was previously a well-established and objective interpretation of Rule 13d-3(a) by issuing a substantial amount of nonbinding dicta indicating that the power to *influence* investment or voting decisions may constitute beneficial ownership.

B. Rule 13d-3(b)

Ultimately, the court resolved the case by deeming Children's Fund the beneficial owner of the CSX shares under Rule 13d-3(b). The rule focuses on schemes to avoid beneficial ownership and reads:

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

72. *Id.* at 868 (indicating that two prominent law firms in the derivative markets have issued guidance to their clients advising that cash settled equity swaps do not trigger disclosure requirements under section 13(d)).

73. SEC Letter, *supra* note 62.

74. See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 541 (S.D.N.Y. 2008), *aff'd*, No. 08-2899-cv, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.⁷⁵

The court broke down the rule into three separate elements: (1) the use of a contract, arrangement, or device; (2) to divest or prevent beneficial ownership; and (3) as part of a plan or scheme to avoid section 13(d) disclosures.⁷⁶ The first requirement is clearly satisfied as the TRSs *are* contracts.⁷⁷ The court then combined the two remaining elements and considered whether the contract was used to divest or prevent beneficial ownership “as part of a plan or scheme to evade the reporting requirements of [s]ection 13d.”⁷⁸

The court interpreted Rule 13-3(b) to cover “one [who] enters into a transaction with the intent to create the false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control by evading the disclosure requirements of [s]ection 13(d) or (g) through preventing the vesting of beneficial ownership.”⁷⁹ Having set this standard, the court held that Children’s Fund hid its market accumulation by entering into TRSs for the purpose of preventing beneficial ownership and avoiding disclosure under section 13(d).⁸⁰ The Court found “overwhelming” evidence in support of a scheme to prevent beneficial ownership.⁸¹ The most persuasive piece of evidence cited by the court was a comment made by the fund’s chief financial officer indicating that the swaps were used specifically to prevent triggering the disclosure requirements.⁸² Thus, Children’s Fund was deemed beneficial owner of the CSX shares held by its counterparties,⁸³ which amounted to more than five percent of the outstanding shares and triggered section 13(d)’s disclosure requirements.⁸⁴ Its failure to file the disclosure statements within ten days of breaking the five percent threshold was a violation of section 13(d).⁸⁵

75. 17 C.F.R. § 240.13d-3(b) (2006).

76. *See CSX Corp.*, 562 F. Supp. 2d at 548 (quoting 17 C.F.R. § 240.13d-3(b)).

77. *Id.*

78. *Id.* at 548–49.

79. *Id.* at 550.

80. *Id.* at 552.

81. *Id.* at 549.

82. *Id.* (“Joe O’Flynn, the chief financial officer of [Children’s Fund] told its board, albeit not in the specific context of CSX, that one of the reasons for using swaps is ‘the ability to purchase without disclosure to the market or the company.’”).

83. *Id.*

84. 15 U.S.C. § 78m(d)(1) (2006).

85. *Id.*

The court was incorrect in deeming Children's Fund beneficial owner of the CSX shares held by its counterparties under Rule 13d-3(b). The court avoided the plain language of the SEC's guidance in favor of a strained interpretation of Rule 13d-3(b)'s intent requirement. In its letter, the SEC clearly stated that a party's "underlying motive for entering into the swap transaction generally is not a basis for determining whether there [was] 'a plan or scheme to evade' " under Rule 13d-3(b).⁸⁶ Yet, the court repeatedly referred to the fact that one of Children's Fund's purposes in using the swaps was to avoid disclosure.⁸⁷ By its repeated reliance on this fact, it is clear that while the SEC indicated that the motive for entering into a swap has no bearing on finding a scheme to evade, the court considered motive to be of the utmost importance. The SEC went on to state that "enter[ing] into a swap . . . with the intent to create the false appearance of nonownership of a security" is the relevant intent for the purpose of Rule 13d-3(b) beneficial ownership.⁸⁸ The SEC has made similar assertions in amici letters submitted in other cases, consistently holding that economic interests without the coupled power to control voting or disposition of the shares does not amount to a scheme to evade.⁸⁹ In Children's Fund's case, it would be impossible to create a false appearance of nonownership because Children's Fund never owned the shares.

Instead of relying on the false appearance of nonownership standard laid out by the SEC, the court interpreted the letter as creating a false appearance of non-accumulation standard.⁹⁰ The court accomplishes this incorrect interpretation by inserting ambiguity into an SEC letter that, on its face, was clear and direct.⁹¹ Moreover, the court went so far as to suggest that the SEC letter actually supports its holding.⁹² It did so in spite of the plain language of the letter which used words such as "rare," "unusual," and "egregious" to describe situations where it *may* be possible to find

86. SEC Letter, *supra* note 62.

87. *See CSX Corp.*, 562 F. Supp. 2d at 550–51.

88. SEC Letter, *supra* note 62.

89. ISDA Brief, *supra* note 59, at 6; *see* Letter from Jacob H. Stillman, Solicitor, SEC to Judge Karon O. Bowdre, U.S. Dist. Court Judge, N.D. of Ala. (Nov. 28, 2006), *available at* <http://www.sec.gov/litigation/briefs/2006/healthsouthbrief.pdf>.

90. *See CSX Corp.*, 562 F. Supp. 2d at 550.

91. *Id.* (interpreting the SEC's statement requiring " 'the intent to create the false appearance of non-ownership of a security' " to mean the intent "to create some false appearance, albeit not necessarily a false appearance of non-ownership" (quoting SEC Letter, *supra* note 62)).

92. *Id.* at 549.

beneficial ownership under Rule 13d-3(b) absent a “false appearance or sham transactions.”⁹³ In its closing paragraph, the letter stated that “interpreting an investor’s beneficial ownership under Rule 13d-3 to include shares used in a counter-party’s hedge, absent *unusual circumstances*, would be novel.”⁹⁴ The court, however, believed that a literal reading of the SEC letter requiring a false appearance of nonownership would render Rule 13d-3(b) superfluous.⁹⁵ Accordingly, the court interpreted Rule 13d-3(b) in a manner inconsistent with the SEC’s guidance and in contrast to the plain meaning of the SEC’s letter to the court on the subject.

It is helpful to consider what type of transaction *would* create beneficial ownership under Rule 13d-3(b). In its letter, the SEC gave the specific example of a sham transaction.⁹⁶ One such transaction may be a practice known as “parking.”⁹⁷ This practice involves purchasing stock (becoming an owner of the stock) and then transferring it to another party to hide ownership.⁹⁸ The true stock owner enters into an agreement with the transferee to repurchase the shares and insure against loss.⁹⁹ In this situation, the false appearance of nonownership is clear. The owner uses an arrangement to hide stock ownership by transferring title while retaining control over voting and disposition by promising to buy back the shares and insure against loss.¹⁰⁰ The argument can be made that Children’s Fund’s position with regards to the shares held by its counterparties was similar to a parking arrangement.¹⁰¹

93. SEC Letter, *supra* note 62 (“[I]n some unusual circumstances, a plan or scheme to evade the beneficial ownership provisions or Rule 13d-3 might exist where the evidence does not indicate a false appearance or sham transaction. . . . [T]he rare case might present an egregious situation qualifying as a scheme to evade without also involving the creation of a false appearance of fact.”).

94. *Id.* (emphasis added).

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

96. SEC Letter, *supra* note 62.

97. For an example of a case involving a stock parking arrangement, see generally *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993).

98. See Brief of Former SEC Commissioners and Officials and Professors as Amici Curiae Supporting Appellant CSX Corporation and Affirmance at 24–25, *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (Nos. 08-2899-cv(L), 08-3016-cv(XAP)), available at <http://law.du.edu/documents/corporate-governance/disclosure/csx-v-the-childrens-amicus-brief-of-former.pdf> [hereinafter Commissioners’ Brief].

99. Hu & Black, *supra* note 32, at 869.

100. *Id.*

101. See Commissioners’ Brief, *supra* note 98, at 24–25; Hu & Black, *supra* note 32, at 869. The argument contends that as the counterparty’s economic interest in the shares

Real and significant differences, however, exist between TRSs and parking.¹⁰² First, in the case of parking, there is actual ownership of the shares, while, in the case of TRSs, the long party never actually owns the shares held by its short counterparty. This distinction is relevant because there can be a false appearance of nonownership in a stock parking agreement, but not in a TRS, because the long party never owns the shares. Second, and more importantly, in a parking transaction, the person parking the stock agrees to buy back the stock and insure against loss.¹⁰³ In contrast, in a TRS, the short party, of its own accord, seeks to protect against loss by purchasing the shares on the market.¹⁰⁴ In a stock parking arrangement, the stock's owner personally eliminates the transferee's economic interest in the shares, making it easier to exert control over voting and disposition of the shares.¹⁰⁵ In a TRS, however, the long party's relationship with the shares is more strained. The long party to a TRS neither owns the shares nor insures the counterparty against loss,¹⁰⁶ significantly reducing the ability to control the disposition and voting of shares held by the short party. While the two transactions may be similar, real differences exist, differences that, in terms of Rule 13d-3(b), mean that one falls within the definition of beneficial ownership and one does not.

In conclusion, the court in *CSX Corp. v. Children's Investment Fund Management (UK) LLP* improperly expanded the scope of beneficial ownership under Rule 13d-3. Ignoring the guidance of the SEC, prior case law, and the established understanding of market participants, the court interpreted the rule in a manner in which Children's Fund could not escape violation. In so doing, the court created confusion and uncertainty surrounding beneficial ownership as it relates to swap transactions. This is not only the opinion of those adversely affected, but also that of the SEC, the very authority entrusted with promulgating rules for the regulation of securities.¹⁰⁷

decreases, the swaps become more like a stock parking arrangement. Commissioners' Brief, *supra* note 98, at 24–25 (citing Hu & Black, *supra* note 69 at 638–39). In Children's Fund's case, it was argued that the counterparty's economic interest had been completely eliminated, rendering the situation almost identical to a formal parking agreement. *Id.* at 25.

102. Hu & Black, *supra* note 32, at 869.

103. *Id.*

104. *Id.* at 868–69.

105. *Id.* at 868.

106. In fact, the short party is the party who protects against loss by unilaterally deciding to purchase the shares. *See id.* at 868–69.

107. SEC Letter, *supra* note 62.

In the concluding paragraph of its letter to the court on the very subject, the SEC indicated that “interpreting an investor’s beneficial ownership under Rule 13d-3 to include shares used in a counterparty’s hedge, *absent unusual circumstances* . . . would create significant uncertainties for investors who have used equity swaps in accordance with accepted market practices understood to be based on reasonably well-settled law.”¹⁰⁸

The fact that Children’s Fund’s actions in this case or TRSs in general do not currently constitute beneficial ownership under Rule 13d-3 does not prevent the SEC from creating rules that provide otherwise. This Recent Development argues that beneficial ownership should be expanded to cover economic interests in shares derived from total return equity swaps, but in a manner that creates certainty and provides clear standards for guidance in the future. The court’s decision here failed to do that; instead it created the opposite effect by replacing what was considered settled law with a novel interpretation that provides little in the way of future guidance. Any law finding beneficial ownership in the long party to a TRS should not come from the courts, but from the SEC.

III. THE NEED FOR SEC ACTION

The sizable market presence of activist hedge funds and their use of derivative products to influence corporate governance necessitate SEC action.¹⁰⁹ Prior to the court’s decision in *CSX Corp.*, market participants based their trading strategies on what they believed to be a well-established legal truth: total return equity swaps do not trigger section 13(d) disclosure requirements.¹¹⁰ In spite of the court’s statements to the contrary,¹¹¹ the decision will create confusion and uncertainty in the market as a new body of law is developed based on the court’s holding.¹¹² The scope of the problem and the required

108. *Id.* (emphasis added).

109. For a thorough analysis of the failure of the current regulatory environment to address growing concerns about the separation of economic and voting interests in stock through derivatives and its impact on corporate governance, see generally Hu & Black, *supra* note 32, and Hu & Black, *supra* note 69.

110. See Hu & Black, *supra* note 32, at 868; SEC Letter, *supra* note 62.

111. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 547 (S.D.N.Y. 2008), *aff’d*, 2008 WL 4222848 (2d Cir. Sept. 15, 2008) (“[T]he Court is inclined to the view that the Cassandra-like predictions of dire consequences of holding that [Children’s Fund] has beneficial ownership under Rule 13d-3(a) have been exaggerated. . . . The issue here, moreover, is novel and hardly settled. And markets can well adapt regardless of how it ultimately is resolved.”).

112. See ISDA Brief, *supra* note 59, at 25–29; SEC Letter, *supra* note 62.

changes in existing market practices warrant a broad and consistent solution, one the SEC is particularly well situated to provide. The most effective way to address the secret accumulation of interests in securities through equity swaps is SEC expansion of beneficial ownership under Rule 13d-3 to include economic interests arising from TRS contracts.¹¹³

Furthermore, applying the standard set out in *CSX Corp.* on a case-by-case basis would be virtually impossible and certainly impractical.¹¹⁴ All swap participants will have to reevaluate each of their positions in light of the court's dicta concerning the definition of beneficial ownership in Rule 13d-3(a) and its ruling on beneficial ownership under Rule 13d-3(b).¹¹⁵ Swap participants will have to ascertain the amount of "influence" they have over their counterparties and determine whether it could be considered beneficial ownership by a court adhering to the *CSX Corp.* guidance regarding Rule 13d-3(a).¹¹⁶ Complicating the swap participant's analysis is the fact that the court did not provide clear guidelines on what is and is not a sufficient level of influence.¹¹⁷ Additionally, participants will have to evaluate whether its swaps amount to an accumulation of securities as part of a "scheme to evade" disclosure

113. There is general agreement that the SEC could properly expand Rule 13d-3's definition of beneficial ownership in this manner. See *CSX Corp.*, 562 F. Supp. 2d at 550; Commissioners' Brief, *supra* note 98, at 25–27; ISDA Brief, *supra* note 59 at 11; Hu & Black, *supra* note 32, at 888–90. Section 23(a) of the Exchange Act grants the SEC power to enact regulations needed to accomplish the enabling legislation's goals. 15 U.S.C. § 78w(a) (2006). A regulation promulgated under this power "will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.'" *Mourning v. Family Pub. Serv., Inc.*, 411 U.S. 356, 369 (1973) (quoting *Thorpe v. Hous. Auth.*, 393 U.S. 268, 280–81 (1969)). The court agreed, stating that "the SEC . . . has the power to treat as beneficial ownership a situation that would not fall within the statutory meaning of that term." *CSX Corp.*, 562 F. Supp. 2d at 551. Thus, while *Children's Fund's* situation does not qualify as beneficial ownership under the current terms of Rule 13d-3, it would be reasonable, in light of the enabling legislation's purpose, for the SEC to specifically designate it as such. See *id.* at 551–52 ("The purpose of [s]ection 13(d) is to alert shareholders of '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), *cert. denied*, 406 U.S. 910 (1972))); Commissioners' Brief, *supra* note 98, at 26; Hu & Black, *supra* note 32, at 888–90 (indicating that the SEC could regulate the hidden (morphable) ownership created by equity swaps, but recommending against it in fear that such regulation would amount to over regulation).

114. See ISDA Brief, *supra* note 59, at 25–29.

115. *Id.* at 26; see also SEC Letter, *supra* note 62 (discussing the "significant uncertainties" that would be created by interpreting "beneficial ownership . . . to include shares used in a counter-party's hedge").

116. ISDA Brief, *supra* note 59, at 26.

117. *Id.*

requirements, which as a result of the court's holding constitutes beneficial ownership under Rule 13d-3(b).¹¹⁸ SEC guidance declaring that the long party in a TRS is beneficial owner of the counterparty's shares held as a hedge would eliminate the need to monitor positions in this manner by removing any uncertainty.

As a national regulatory body, the SEC can provide overarching, standardized solutions that are impossible to achieve through judicial interpretation and case law.¹¹⁹ SEC regulation tends to be "rule based," which affords the opportunity to establish an exact standard.¹²⁰ It is also the result of "a responsive deliberative process," which tends to be "more nuanced, targeted, and globally consistent than regulation issued on a case-by-case basis."¹²¹ Additionally, in promulgating new rules, the SEC actively seeks input from all parties affected, which often increases support for the new regulation.¹²² The end result is regulation that is crafted after considering "thousands of comments" from a variety of interested parties.¹²³ Further, the weight of authority that SEC action carries is unrivaled by that of a district court decision.¹²⁴ SEC action addresses the shortcomings associated with the court's decision by creating a definite national solution. Such action will create a consistent standard and enable market participants to adjust their investment strategies accordingly.

SEC expansion of Rule 13d-3's beneficial ownership definition to cover economic interests in securities arising from total return equity swaps also would be consistent with other countries' solutions to the same problem.¹²⁵ New Australian rules "require immediate disclosure of all equity derivative positions of [five percent] or more whenever there is a transaction that affects or is likely to affect control or potential control of the subject company or the acquisition of a substantial interest in a company."¹²⁶ In July 2008, the United Kingdom adopted a rule that requires investors to add derivative

118. *Id.*

119. Davidoff, *supra* note 20, at 266.

120. *See id.*

121. *Id.*

122. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 801-02 (2006).

123. *Id.* at 802.

124. Davidoff, *supra* note 20, at 266.

125. *See* Savitt, *supra* note 5 (indicating that Australia and the United Kingdom have recently promulgated rules that include swap positions in the determination of security ownership levels).

126. *Id.* (citing AUSTRALIAN TAKEOVERS PANEL, GUIDANCE NOTE 20: EQUITY DERIVATIVES (April 11, 2008), www.takeovers.gov.au/content/Guidance_Notes/Current/downloads/GN20_2008.pdf).

positions to stock ownership in determining total ownership for its mass accumulation disclosure requirements.¹²⁷ These regulations indicate a global convergence regarding the treatment of equity swap positions. The SEC should follow suit by explicitly expanding the definition of beneficial ownership to include interests derived from equity swaps for purposes of section 13(d) disclosure requirements.

CONCLUSION

The situation presented in *CSX Corp.* is merely one aspect of a much larger problem involving the inadequate regulation of hedge funds and derivative products. As evidenced by their role in the current market crisis, this is an area in desperate need of further government oversight. The court in *CSX Corp.* attempted to address such issues, but, unfortunately, overstepped its bounds in doing so and most likely caused more harm to the markets than good. In reaching its decision, the court inappropriately expanded the scope of Rule 13d-3, finding beneficial ownership in a situation in which the plain language of the Rule, precedent, and SEC guidance suggested otherwise. The court was right in wanting to see the scope of Rule 13d-3 expanded to include Children's Fund's actions, but wrong in expanding it on its own. Such expansion needs to come from the SEC in order to create a consistent national standard to guide corporations, shareholders, and market participants.

BRIAN T. SULLIVAN

127. *Id.* In the United Kingdom, investors are required to file disclosures when ownership exceeds three percent. *Id.*

