08-2899-cv(L)

08-3016-cv(XAP)

United States Court of Appeals

for the

Second Circuit

CSX CORPORATION,

PLAINTIFF-APPELLANT-CROSS-APPELLEE,

MICHAEL WARD,

THIRD-PARTY-DEFENDANT,

–AGAINST–

THE CHILDREN'S INVESTMENT FUND MANAGEMENT (UK) LLP, THE CHILDREN'S INVESTMENT FUND MANAGEMENT (CAYMAN) LTD., THE CHILDREN'S INVESTMENT MASTER FUND, 3G CAPITAL PARTNERS LTD., 3G CAPITAL PARTNERS, L.P., 3G FUND, L.P., CHRISTOPHER HOHN, SNEHAL AMIN AND ALEXANDRE BEHRING, ALSO KNOWN AS ALEXANDRE BEHRING COSTA,

DEFENDANTS-THIRD-PARTY-PLAINTIFFS-COUNTER-CLAIMANTS-APPELLEES-CROSS-APPELLANTS.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF FORMER SEC COMMISSIONERS AND OFFICIALS AND PROFESSORS AS *AMICI CURIAE* IN SUPPORT OF APPELLANT CSX CORPORATION AND AFFIRMANCE

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July 18, 2008

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Listing of *Amici Curiae*

The Honorable Arthur Levitt Jr., who served as Chairman of the SEC from 1993 to 2001.

The Honorable Roel Campos, who served as Commissioner of the SEC from 2002 to 2007.

The Honorable Joseph A. Grundfest, who served as Commissioner of the SEC from 1985 to 1990, and who is the William A. Franke Professor of Law and Business and Co-Director of the Rock Center on Corporate Governance at Stanford Law School. [1]

The Honorable Roberta S. Karmel, who served as a Commissioner of the SEC from 1977 through 1980 (during which time Ruled 13d-3 was promulgated), and who is the Centennial Professor of Law at Brooklyn Law School.

The Honorable Steven Wallman, who served as Commissioner of the SEC from 1993 to 1997.

John Coates IV, the John F. Cogan, Jr. Professor of Law and Economics at Harvard Law School.

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[1] Professors Grundfest and Hu have been retained by CSX to provide counsel in this matter. In that capacity, they submitted (together with Professor Marti G. Subrahmanyam, an expert witness for CSX at the trial in this case) a memorandum to the SEC that addressed some of the subjects addressed in this brief. Professors Grundfest and Hu were not, however, separately compensated in connection with the preparation of this brief.

James Cox, the Brainerd Currie Professor of Law at Duke University School of Law.

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G. William Schwert, the Gleason Professor of Finance and Statistics at the William E. Simon Graduate School of Business Administration, University of Rochester.

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Statement of Interest of *Amici Curiae*

Amici curiae are a group of former commissioners and officials of the United States Securities and Exchange Commission ("SEC"); prominent law professors who teach and write about corporate law, securities markets, and regulation; and leading economics and finance professors with corporate governance, derivatives, and securities expertise. *Amici* have devoted material portions of their professional careers to implementing, interpreting, drafting, and/or studying the federal securities laws, including the application of those laws to ensure the fair and efficient disclosure of information consistent with statutory text and legislative intent. *Amici* are interested in questions that arise in connection with the application of the "beneficial ownership" standard under Section 13(d) of the Exchange Act and the SEC's Rule 13d-3(b) to total return equity swaps. *Amici* support the District Court's decision on this issue and believe that the existing "anti-evasion" provisions of Rule 13d-3(b) mandate disclosure of swap positions accumulated under the specific and narrow facts and circumstances presented on the facts found below. For the purposes of this brief, we take the facts directly from the District Court's opinion.

The individual *amici* are identified separately in the Listing of *Amici Curiae*. This brief reflects the consensus view of the *amici*, all of whom believe that the

decision below should be affirmed. Each individual *amicus* may not endorse every argument presented herein, however.

All parties have consented to the filing of this brief.

Summary of Argument

Section 13(d) requires disclosure of every large aggregation of securities that might herald a change of corporate control so that investors can make informed decisions. Congress has set the reporting threshold at 5%. In this case, hedge funds actively seeking to force changes to the management and governance of CSX Corporation ("CSX") used swap arrangements to gain effective control of the disposition and voting of a block of CSX shares well over the 5% threshold, but did not make the required filing. In a thorough and well-reasoned opinion, the District Court held that Defendants engaged in a "scheme to evade the reporting requirements of section 13(d)," in violation of the SEC's Rule 13d-3(b), and therefore are deemed the "beneficial owners" of the shares referenced in the swap agreements.

We urge the Court to affirm the District Court's decision in this respect.[2] Based on the extensive findings of fact below, Defendants engaged in an elaborate

[2] We express no views on the other portions of the District Court's decision that are the subject of appeal and cross-appeal in this case, including when Defendants TCI and 3G formed a "group" for purposes of Section 13(d)(3), and whether the District Court had the authority to enjoin the voting of shares acquired by Defendants in violation of Section 13(d).

and sophisticated series of transactions that, taken together with Defendants' other conduct, establish a "scheme to evade the reporting requirements." We believe it is helpful to organize the District Court's factual findings into a list of six factors present in this case that together are, in our view, clearly sufficient to establish evasion in violation of Rule 13d-3(b):

1. Defendants acquired a position in the derivative markets that, if held in the form of the registrant's voting equity, would trigger a disclosure requirement. (We emphasize that this factor constitutes a necessary but insufficient condition for a violation of Rule 13d-3(b)'s anti-evasion provision.);
2. Defendants engaged in significant efforts to influence corporate management or corporate control;
3. Defendants engaged in efforts with the purpose or effect of influencing the voting position of counterparties who, by virtue of the foreseeable equity hedges held as a result of the equity swap positions at issue, owned the registrant's voting shares;
4. Defendants caused a pre-positioning of the registrant's voting shares in a manner that materially facilitates the rapid and low-cost acquisition of a reportable position upon the termination or other unwinding of the derivative transactions at issue;

5. Defendants caused the derivative positions at issue to be structured in a manner calculated to prevent counterparties from becoming subject to disclosure obligations under the Federal securities laws; and
6. The information regarding Defendants' activities withheld from the market (*e.g.*, Defendants' equity or derivative positions) is material.

While we do not suggest that these six factors should be adopted as a formal legal test, or that each of these factors is a necessary element of a violation of Rule 13d-3(b), we respectfully submit that these factors taken together demonstrate that Defendants engaged in a "scheme to evade the reporting requirements of section 13(d)" and therefore violated Rule 13d-3(b). We further suggest that if the foregoing conduct does not constitute a "scheme to evade the reporting requirements of section 13(d)" then Rule 13d-3(b) would be rendered a nullity.

We believe that the fact-based approach taken by the District Court addresses the obvious evasion of Rule 13(d)'s reporting requirements presented on the facts of this case without causing any dislocation of larger, well-established market practices in the international markets for derivative instruments. Indeed, Defendants have presented no evidence that the narrow approach taken by the District Court will have any adverse effect whatsoever on the operation of any capital markets, and we believe that the narrow ruling below gives rise to no such adverse effect.

Argument

I. THE DISTRICT COURT CORRECTLY HELD THAT DEFENDANTS ARE BENEFICIAL OWNERS UNDER SECTION 13(d) AND RULE 13d-3(b).

A. Section 13(d) Defines Beneficial Ownership Broadly.

Section 13(d) of the Exchange Act, enacted as part of the Williams Act in 1968, is designed to inform shareholders about potential changes in corporate control. As this Court has repeatedly observed, "the purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).[3]

The statute provides that:

> Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78*l* of this title, . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, [file the required disclosure statement].

Section 13(d)(1), 15 U.S.C. § 78m(d)(1). The breadth of the disclosure requirement is indicated by the statutory language requiring disclosure by anyone who is "directly or indirectly the beneficial owner." Similarly, the legislative

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[3] This Court has quoted this language most recently in *Egghead.com, Inc. v. Brookhaven Capital Mgmt., Inc.*, 340 F.3d 79, 84 (2d Cir. 2003).

history speaks broadly of requiring disclosure by "persons who have acquired a substantial interest" in stock. *See* H. Rep. No. 1711, 90th Cong., 2d Sess. 8 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2818. The use of these expansive phrases, sweeping beyond plain-vanilla stock purchases, was deliberate. "A shift in the *loci* of corporate power and influence is hardly dependent on an actual transfer of legal title to shares, and the statute and history are clear on this." *GAF Corp.*, 453 F.2d at 718.

The legal trigger for the disclosure requirement of Section 13(d) is beneficial ownership. As Manuel F. Cohen, then Chairman of the SEC, testified before Congress in favor of the Williams Act: "[B]eneficial ownership is the test. [The acquiring entity] might try to get around it, and that would be a violation of law, but the legal requirement is beneficial ownership." *Takeover Bids: Hearings before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong., 2d Sess. 41 (1968) (hereinafter *House Hearings*).

In 1978, the Commission promulgated regulations under Section 13(d), including Rule 13d-3, which defines "beneficial ownership." Under the rule, there are at least two separate ways in which someone can be a "beneficial owner" for purposes of § 13(d), as set forth respectively in Rules 13d-3(a) and 13d-3(b):

> (a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or

> indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:
>
> > (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
> >
> > (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.
>
> (b) 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 [or] 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 sections 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of the security.

17 C.F.R. § 240.13d-3.

The Commission intended Rule 13d-3(a) to be a "broad definition" that would "obtain disclosure from all those persons who have the ability to change or influence control." Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978). Yet, mindful of human ingenuity in structuring financial transactions, the Commission added Rule 13d-3(b) as a backstop. As the Commission stated at the time: "The purpose of the rule is to ensure that Rule 13d-3(a) is not circumvented by an arrangement to divest a person of beneficial ownership or to prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d)." *Id.*

B. Swaps Are Not Categorically Excluded From Rule 13d-3(a).

This case involves cash-settled total return equity swaps. As explained in the District Court's opinion (A-5566-69), a total return swap is a private agreement by which one party (the "short" party) agrees to pay the counterparty (the "long" party) the total return on the underlying asset in exchange for a benchmark interest rate such as LIBOR. Where (as here) the underlying asset is common stock, the long party receives any dividends or other distributions on the stock, and also any appreciation in value of the stock. A swap can be settled in kind (when the short party provides the underlying stock in exchange for its market value at that time) or it can be cash settled (when the short party pays cash in the amount of the market appreciation). A swap "places the long party in substantially the same economic position that it would occupy if it owned the referenced stock." (A-5568.)[4]

Total return equity swaps can be a means of acquiring a substantial control position without holding legal title to shares.[5] The reporting requirements of the Williams Act are based on the fundamental corporate law principle that economic ownership of the firm and voting rights go hand in hand. Swaps can decouple

[4] For a fuller explanation of cash-settled total return equity swaps, see the Expert Report of Marti G. Subrahmanyam ¶¶ 60-72 (A-1227-34).

[5] Swaps are, of course, also used for purposes other than acquiring a control position, *e.g.*, for tax reasons.

economic ownership, held by the long party, from voting rights, retained by the short party, as can be the case in such transactions when there is no effort to influence management or corporate control, and therefore no scheme to avoid required disclosure. But if the long party in the swap has effective access to the short party's voting rights when needed, as the District Court found to be the case here, the long party in effect has both economic ownership and voting power. In other words, the long party has all the substantive attributes of share ownership except formal legal title. Professors Henry Hu and Bernard Black, who have extensively studied this decoupling phenomenon, refer to this situation as "hidden (morphable) ownership." *See* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811, 825-26 (2006); Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625, 638 (2008).

In this case, the facts as found by the District Court suggest that TCI (the long party) had the ability to influence significantly, and perhaps control, the disposition and voting of CSX shares. First, TCI's counterparties (the short parties) hedged their exposure to movement in CSX's stock price by purchasing CSX stock. The District Court found that TCI's counterparties, the swap desks of investment banks, "did so on virtually a share-for-share basis and in each case on

the day or the day following the commencement of each swap." (A-5612.) Indeed, this was known to TCI because, for the investment banks to avoid taking on enormous risk, "it was inevitable that they would hedge the TCI swaps by purchasing CSX shares." (*Id.*) Second, TCI sought to influence its counterparties to vote the shares in TCI's favor. For example, the District Court found that TCI's managing partner moved many of TCI's swaps to Deutsche Bank in the "belief that he could influence the voting of the shares it held to hedge TCI's swaps." (A-5616.) With respect to the other investment banks, there was insufficient proof to make a finding, but the District Court stated "there . . . is reason to believe that TCI was in a position to influence the counterparties, especially Deutsche Bank, with respect to the exercise of their voting rights." (A-5621.)[6]

In light of these facts, we disagree with Defendants' categorical argument that an arrangement that involves cash-settled equity swaps cannot under any circumstances confer beneficial ownership under Rule 13d-3(a), *i.e.*, that the simple expedient of using swaps insulates all investor conduct from Rule 13d-3(a)'s purview. (Br. 46.) On the other hand, we agree with the staff of the SEC's Division of Corporation Finance, who in an *amicus* letter submitted to

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[6] Despite the absence of formal agreements on voting rights between swap counterparties, Professors Hu and Black have observed that "a market practice may well be emerging in which both sides expect that the dealer, if asked, will either unwind the swap and sell the shares to its clients . . . or vote the matched shares as its client wants." Hu & Black, 79 S. Cal. L. Rev. at 837-38.

the District Court 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." (A-5549.) The SEC staff further stated that the mere "presence of economic or business incentives that the counterparty may have to vote the shares as the other party wishes or to dispose of the shares to the other party" does not confer beneficial ownership. (*Id.*) But the SEC staff carefully left open the question whether the long party to the swap (here TCI) is the beneficial owner under Rule 13d-3(a) when the counterparty has an "understanding, arrangement, or restricting relationship" with the long party regarding voting or disposition, and states that an "analysis of all the relevant facts and circumstances is essential" in formulating the answer. (*Id.*)

Under Rule 13d-3(a), a person is the beneficial owner of a security even if he only indirectly—through an "understanding, relationship, or otherwise"—"shares" the power to "direct the voting" or "direct the disposition" of the security. 17 C.F.R. § 240.13d-3(a). The rule has been interpreted to cover anyone who has the ability significantly to *influence* the voting or disposition of security. The Commission itself, when adopting regulations defining beneficial ownership under a different statute (Section 16(a)), stated that Rule 13d-3(a) "emphasizes the ability to control *or influence* the voting or disposition of the securities." Interpretive

Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed. Reg. 48,147, 48,149 n.17 (Oct. 1, 1981) (emphasis added). Courts have agreed. *See Calvary Holdings, Inc. v. Chandler*, 948 F.2d 59, 63 (1st Cir. 1991); *SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993), *aff'd sub nom. SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994), *cert. denied*, 513 U.S. 1077 (1995).

Determination of beneficial ownership under Rule 13d-3(a) requires "[a]n analysis of all relevant facts and circumstances in a particular situation." Adoption of Beneficial Ownership Disclosure Requirements, Exchange Act Release No. 34-13291, 42 Fed. Reg. 12,342, 12,344 (Mar. 3, 1977). There is no reason why, in an appropriate case, an arrangement relating to cash-settled equity swaps could not confer upon a swap holder the ability significantly to influence the voting or disposition of a security.[7]

[7] Defendants also suggest that "cash-settled swaps are analogous to cash-settled security futures." (Br. 46-47.) That is incorrect. As the District Court noted, futures are "impersonal exchange traded transactions." (A-5621 n.189.) The major differences between futures and swaps include different treatment of dividends, different regulatory structure, different margin requirements, and different informational environments. Additionally, the market for single-stock futures is too small or illiquid to allow for hedging swaps approaching 5% of the value of a company the size of CSX. Finally, cash-settled swaps are individually negotiated and thereby present the opportunity for abuse, such as was found here. Thus, the SEC's interpretive release on futures (cited in Defendants' Br. at 47) is inapplicable here.

Rule 13d-3(a) is not, however, the focus of our brief. Although the District Court found "persuasive arguments for concluding, on the facts of this case," that TCI had beneficial ownership of some or "quite possibly all" of the referenced CSX shares, the District Court declined "to decide the beneficial ownership question under Rule 13d-3(a)" (A-5624), and we do not believe this Court need opine on the scope of Rule 13d-3(a) either, given what we believe is the clear violation, on the facts found below, of Rule 13d-3(b).

C. Defendants Engaged in a Plan or Scheme to Evade the Reporting Requirements of Section 13(d), in Violation of Rule 13d-3(b).

Treating the use of cash-settled equity swaps as causing all conduct to be exempt from Rule 13d-3(b) would run contrary to the goals of the Williams Act (which Rule 13d-3(b) seeks to implement), would eviscerate Rule 13d-3(b), and would render compliance with Section 13(d) essentially voluntary. Rule 13d-3(b) deems a person to be the beneficial owner of a security if the person uses a contract, arrangement or device of some kind to prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements. 17 C.F.R. § 240.13d-3(b). To be sure, little has been said by the Commission about this prong of Rule 13d-3, which we call the "anti-evasion test", and little case law interprets it. Our analysis is thus based primarily upon the plain language of the Rule 13d-3(b) and the overall goal of Section 13(d), which is "to alert the marketplace to every large, rapid aggregation or accumulation of securities,

regardless of technique employed, which might represent a potential shift in corporate control." *GAF Corp.*, 453 F.2d at 717. We are mindful of the Commission's guidance that beneficial ownership is "interpreted . . . broadly." Exchange Act Release No. 34-18114, 46 Fed. Reg. at 48,149. We are also mindful that Rule 13d-3(b) must have substantive content independent of Rule 13d-3(a) and is not mere surplusage.

We do not undertake here to identify all of the circumstances under which a person might use cash-settled equity swaps and engage in other swap-related conduct to evade the reporting requirements. One can imagine any number of plans or schemes to that end. But, at a minimum, we believe that a person engages in a plan or scheme—and should thus be deemed a beneficial owner under Section 13(d)—when that person has:

1. Acquired a position in the derivative markets that, if held in the form of the registrant's voting equity, would trigger a disclosure requirement (We emphasize that this factor constitutes a necessary but insufficient condition for a violation of Rule 13d-3(b).);
2. Engaged in significant efforts to influence corporate management or corporate control;
3. Engaged in efforts with the purpose or effect of influencing the voting position of counterparties who, by virtue of the foreseeable equity

hedges held as a result of the equity swap positions at issue, own the registrant's voting shares;

4. Caused a pre-positioning of the registrant's voting shares in a manner that materially facilitates the rapid and low-cost acquisition of a reportable position upon the termination or other unwind of the derivative transactions at issue;

5. Caused the derivative positions at issue to be structured in a manner calculated to prevent counterparties from becoming subject to disclosure obligations under the Federal securities laws; and

6. Withheld from the market information regarding the person's activities (*e.g.*, the person's equity or derivative positions) that is material.

We need not address whether all such conditions must be satisfied in order to constitute a plan or scheme to evade under Rule 13d-3(b), or whether in appropriate circumstances a defendant's behavior with respect to only some of the conditions may be sufficient to satisfy the Rule. And, in this case, it is not necessary to determine the boundaries of or the interactions among the conditions. Based on the District Court's findings of fact, each of the six conditions is satisfied:

1. By the end of 2006, TCI had accumulated swaps referencing approximately 8.8% of the CSX shares then outstanding, handily surpassing the 5% reporting threshold that undeniably applied if TCI had purchased CSX shares directly. (A-5575.) TCI crossed the 5% threshold on December 6, 2006. (A-5686.) Before TCI ever began to convert its swaps into CSX shares, on March 30, 2007, TCI owned swaps referencing approximately 14.1% of the CSX shares then outstanding. (A-5580.)

2. TCI sought to influence and control CSX by soliciting executives to replace senior management (A-5581), canvassing potential nominees for the CSX board (A-5584-85, A-5587), engaging D. F. King, a proxy solicitation firm, for a proxy contest for the CSX board (A-5585), sending the CSX board an open letter demanding various management changes (A-5585-86), meeting with the presiding director of the CSX board to discuss governance changes (A-5602), and engaging investment advisors to consider changes to the ownership structure of CSX, such as through a leveraged buyout (A-5575-76, A-5579-80).

3. Through its swap arrangements, TCI effectively and foreseeably put the matching shares, and their corresponding voting rights, in the hands of the counterparties, as opposed to whoever else would otherwise have held the shares. (A-5612-14.) TCI selected its

counterparties based, at least in part, on its assessment of the parties' willingness to vote with TCI in a proxy contest. (A-5587, A-5618-19.) Moreover, TCI sought to influence at least one of its swap counterparties, Deutsche Bank, to vote in its favor in the proxy fight, based on TCI's connection to a hedge fund owned by Deutsche Bank known as Austin Friars. (A-5615-16.) Anomalies in Deutsche Bank's ownership profile of CSX immediately surrounding its initial record date suggest that TCI was successful in its efforts to influence Deutsche Bank. (A-5616-18.)

4. When TCI unwound its swaps, TCI's counterparties had no practical choice but to unwind their hedges by selling their matching physical shares. TCI was thereby "afford[ed] a ready supply of shares to the market at times and in circumstances effectively chosen and known principally by the long party [TCI]." (A-5573.) Accordingly, a TCI partner told CSX representatives that TCI's swaps "could be converted into direct ownership at any time" and on February 15, 2007, stated that TCI "owned" a quantity of shares that "clearly included the shares held by its counterparties." (A-5575, A-5614.) And when TCI terminated a swap, its counterparty almost always "sold the same number of physical shares that were referenced in the unwound swap and [] did so on the same day that the swap was terminated." (A-5614.) TCI was thus able in April 2007 to shift a

sizeable portion of its swaps (referencing over 4% of CSX shares, just below the reporting threshold) into CSX shares, "keeping its exposure to CSX 'roughly constant.'" (A-5581.)

5. TCI (a) divided its swaps among eight counterparties; (b) attempted to ascertain and monitor continuously their hedging strategies and holdings to keep them from acquiring matching physical shares in excess of 5% (which would have required disclosure by the counterparties); and (c) after concentrating its swaps with two counterparties, kept token positions (swaps referencing 1,000 shares each) with the remaining six counterparties so as "to obscure the identities of its principal counterparties." (A-5586, A-5615 & n.170, A-5620, A-5625-26.)

6. The information TCI withheld from disclosure—*i.e.*, that it held a significant stake in CSX and was seeking influence and control through swaps—was plainly material. As the District Court found, "TCI admitted that one of its motivations in avoiding disclosure was to avoid paying a higher price for the shares of CSX, which would have been the product of front-running that it expected would occur if its interest in CSX were disclosed to the market generally." (A-5626.)

Based on these narrow facts (as found by the District Court), it is in our view correct to conclude that Defendants engaged in a "plan or scheme to evade the

reporting requirements of section[] 13(d)" and are therefore properly "deemed for purposes of such section[] to be the beneficial owner of the security," here the securities referenced in the swap agreements.

In their appeal from the District Court's ruling that TCI was a beneficial owner under Rule 13d-3(b), Defendants rely heavily on the *amicus* letter from the SEC's Division of Corporate Finance. (Br. 28-30.) But, in our view, Defendants misread the letter, which in fact supports the District Court's decision here.[8]

First, the SEC staff stated, "In the Division's view, the long party's underlying motive for entering into the swap transaction generally is not a basis for determining whether there is 'a plan or scheme to evade.'" (A-5550.) That is plainly right. Rule 13d-3(b) does not require that a person have a motive to evade, much less that evasion be a person's sole, or even dominant, motive. The text of the rule is clear: it applies where an arrangement is used for the purpose *or* with the effect of evading the reporting requirements. An effect arises independent of any purpose, and "purpose" therefore cannot constitute an essential element of beneficial ownership under Rule 13d-3(b) without rendering the term "effect" a nullity. Consistent with the text of the rule, courts have held that *scienter* is not an

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[8] Because we believe the SEC staff's *amicus* letter supports the District Court's decision, we do not believe anything turns on the standard of deference to the staff's views.

element of a Section 13(d)(1) violation. *See, e.g.*, *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1167 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).

Second, the SEC staff stated in their *amicus* letter, "We believe that the mental state contemplated by the words 'plan or scheme to evade' [in Rule 13d-3(b)] is generally the intent to enter into an arrangement that creates a false appearance. . . . The significant consideration is not the person's motive but rather that the person knew or was reckless in not knowing that the transaction would create a false appearance." (A-5550.) Defendants seize, however, on a single sentence in the letter in which the SEC staff referred to "the false appearance of non-ownership of a security" (*id.*), and argue that this sentence requires that a person already own the security before Rule 13d-3(b) can come into play. (Br. 28-29.) Defendants' argument is contrary to the rule, and misconstrues the SEC staff's letter.

Rule 13d-3(b) provides an alternative method of finding beneficial ownership to voting or investment power under Rule 13d-3(a). As the District Court correctly held, requiring Rule 13d-3(a) to be satisfied before Rule 13d-3(b) would render 13d-3(b) superfluous (A-5628); one need not show beneficial ownership twice. Defendants' interpretation is also in plain conflict with the language of Rule 13d-3(b) itself, which expressly provides that it applies when a person does not have beneficial ownership either because of divestiture or

because beneficial ownership never vested in the first place. Accordingly, a person can violate Rule 13d-3(b) even if he is not a beneficial owner under Rule 13d-3(a). That is why 13d-3(b) exists.

Third, Defendants mischaracterize the SEC staff's letter by arguing that Rule 13d-(3)(b) "applies only to sham transactions designed to create a false appearance of non-ownership." (Br. 23.) The staff letter explicitly declined to offer a "general principle" for interpreting Rule 13d-(3)(b). (A-5550.) And the letter offered three independent examples of ways in which Rule 13d-3(b) could be triggered: (1) when there is an intent to enter into an arrangement that creates a false appearance; (2) when there is a "sham transaction"; or (3) when there are "some unusual circumstances" or "an egregious situation." (A-5550-51). Indeed, the District Court explicitly construed the SEC staff's reference to "false appearance" as merely an illustrative example for triggering Rule 13d-(3)(b) and not a necessary condition for application of the Rule. (A-5628.)

We agree, therefore, with the District Court's holding that the "false appearance" that is one of the triggers of Rule 13d-3(b) is not a false appearance of non-ownership, but a "false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control." (A-5629.) This construction of the rule gives effect to its language, which refers to "a plan or scheme *to evade the reporting requirements of section 13(d)*." 17 C.F.R.

§ 240.13d-3(b) (emphasis added). This construction is also consistent with this Court's repeated explanation that the purpose of Section 13(d) is "to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." *GAF Corp.*, 453 F.2d at 717. When a person enters into transactions with the potential for shifting corporate control pursuant to an arrangement that otherwise would evade the reporting requirements of Section 13(d), he falls within the ambit of Rule 13d-3(b), and therefore violates the rule under the circumstances established on the facts of this case.

This view of the staff's letter is also supported by the staff's analogy to Securities Act Rule 144A. Rule 144A denies its registration exemption to "any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the Act." 17 C.F.R. § 230.144A, preliminary note 3. In a previous *amicus* letter in another case, the Commission stated that "the availability of the safe harbor under Rule 144A does not turn on the security offeror's motive." November 28, 2006 SEC Amicus Letter to Judge Karon O. Bowdre in *In re HealthSouth Sec. Litig.*, No. 03-1500 (N.D. Ala.), at 1 (available at http://www.sec.gov/litigation/briefs/2006/ healthsouthbrief.pdf). The Commission proceeded to explain that the "plan or scheme to evade" language of Rule 144A

applies in situations "such as when the transaction is a sham designed to create the illusion that it should be exempt." *Id.* at 8.

The same reasoning underlies the District Court's construction of Rule 13d-3(b) here. TCI engaged in transactions and other conduct that were designed to create the illusion that its effective control over the disposition and voting of a large block of CSX shares should be exempt from the reporting requirements of Section 13(d). Yet TCI's conduct created the potential for a shift in corporate control, and as such was precisely the target of Rule 13d-3(b). Defendants engaged in a quintessential "plan or scheme to avoid the reporting requirements of section 13(d)."

Defendants argue erroneously that this reading of Rule 13d-3(b) is contradicted by an SEC Release from 1977. (Br. 33-34.) The Release provides an example of a violation of Rule 13d-3(b): one who "causes ten institutions to each acquire three percent of the outstanding shares of Z Corporation" and at the same time "gives an irrevocable proxy to A" is nonetheless "deemed a beneficial owner of the same Z shares for the period of the proxy as well as thereafter, and therefore must file a Schedule 13D." Exchange Act Release No. 34-13291, 42 Fed. Reg. at 12,347. Rather than support Defendants' position, we believe that the SEC's guidance undermines it.

The example in the SEC's Release is an illustration of what is known as stock parking—"a concealment of stock ownership achieved by placing the stock in an account in the name of a third party." *SEC v. First City Fin. Corp.*, 688 F. Supp. 705, 720 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989). Similar to TCI, the corporate activist in *First City Financial* argued that his stock parking allowed him to evade Section 13(d). But consistent with Chairman Cohen's testimony at the congressional hearing on the Williams Act, *see House Hearings* at 40-41 (shares held in street or nominee name are subject to disclosure), and the example in the SEC's 1977 Release, Exchange Act Release No. 34-13291, 42 Fed. Reg. at 12,347, courts have held that stock parking is subject to the reporting requirements of Section 13(d). *First City*, 688 F. Supp. at 720-24.

This case is analogous. As Professors Hu and Black have argued, "[h]idden (morphable) ownership might arguably be analogized to 'stock parking' for disclosure purposes."[9] Hu & Black, 79 S. Cal. L. Rev. at 869. Shares held in the friendly hands of derivatives dealers to avoid regulatory or other burdens of direct ownership, yet providing access to the desired shareholder rights, can, depending

[9] To be sure, there are distinctions between stock parking and equity swaps. "Parking involves an understanding that the client will buy the stock back at a later date and protect its counterparty against loss. With an equity swap, there is no such understanding, and the dealer must protect itself against loss." Hu & Black, 79 S. Cal. L. Rev. at 869. Here, TCI and its dealers worked closely together and eliminated dealer exposure.

on the circumstances, be characterized as "soft" or "hard" parking. Hu & Black, 156 U. Pa. L. Rev. at 638-39. The parking analogy takes on especial force when the "parkee" has no economic ownership in the shares and when informal expectations as to how the parkee will act become "harder" or more analogous to pure stock parking. *Id*. at 639. In the case of TCI, the District Court's opinion makes clear that TCI took affirmative steps to, among other things, assure itself that its counterparties were hedging the swaps with physical shares and thus had no economic ownership of CSX stock whatsoever, making the parking here of the hard variety. Accordingly, the example of the SEC's Release further supports the District Court's holding that, under the facts of this case, equity swaps violate Rule 13d-3(b).

Defendants argue further that, if Rule 13d-3(b) can extend to equity swaps, the rule "exceed[s] the agency's statutory authority." (Br. 36.) This argument misapprehends the Commission's authority to enact implementing regulations. The Commission enacted Rule 13d-3 pursuant to its authority under both Section 3(b), 15 U.S.C. § 78c(b), which authorizes the Commission to define terms used in the Exchange Act, and Section 23(a), 15 U.S.C. § 78w(a), which grants the Commission "power to make such rules and regulations as may be necessary or appropriate to implement the provisions of [the Exchange Act]." *See* Exchange Act Release No. 34-13291, 42 Fed. Reg. at 12,349; Exchange Act Release No.

34-14692, 43 Fed. Reg. at 18,395. As the District Court noted (A-5631 & n.210), a regulation issued pursuant to this type of general rulemaking authority "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. Housing Auth.*, 393 U.S. 268, 280-81 (1969)).

We have no doubt that Rule 13d-3(b) is a reasonable interpretation of the term "beneficial ownership" in Section 13(d), and should therefore be upheld under the deference due to the Commission's interpretation. *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *see also Polaroid Corp. v. Disney*, 862 F.2d 987, 995 (3d Cir. 1995) (upholding "all holders rule" under the Williams Act). Congress did not provide a definition of "beneficial ownership" in the Exchange Act.[10] Thus, until the issuance of Rule 13d-3, "[t]he term 'beneficial owner' [was] not defined" for the purposes of Section 13(d). Beneficial Ownership, Takeovers and Acquisitions by Foreign and Domestic Persons, Exchange Act Release No. 34-11003, 39 Fed. Reg. 33,835, 33,836 (Sept. 20, 1974). Following a public fact-finding investigation and notice-and-comment rulemaking, the Commission provided a definition in Rules 13d-3(a) and

[10] In hearings on the Exchange Act, Thomas G. Corcoran, a principal drafter of the Act, stated that "beneficial owner" "is the broadest term you can have." *Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. pt. 15, at 6556 (1934).

(b). As reasonable definitions of the term "beneficial ownership," these rules were squarely within the Commission's authority to enact.

Finally, Defendants argue that the District Court's construction of Rule 13d-3(b) conflicts with the definition of "security" in Exchange Act Section 3A, as added by the Gramm-Leach-Bliley Act of 2000. (Br. 42-43.) This argument reflects a misunderstanding of the Act. Section 3A provides that the definition of "security" under the Exchange Act "does not include any security-based swap agreement." 15 U.S.C. § 78c-1(b)(1); *see also* 15 U.S.C. § 78c(a)(10) (defining "security"). But that has no bearing on whether equity swaps can be subject to the reporting requirements of Section 13(d). The District Court did not hold that TCI's swaps are "securities." Rather, the District Court held that the swaps are a "contract, arrangement, or device with the purpose [or] effect of divesting [TCI] of beneficial ownership of a security or preventing the vesting of such beneficial ownership." (A-5624-27.) The referenced CSX shares (not the swaps) are the "securities." That TCI's swaps give rise to beneficial ownership of CSX shares for purposes of the reporting requirements of Section 13(d) does not mean that the equity swaps are themselves "securities."

The application of the facts found by the District Court to Rule 13d-3(b) is straightforward, standing in stark contrast to the transactions in which Defendants engaged to hide their position from the market. Defendants clearly used their

complicated web of swap agreements and other swap-related conduct as part of a plan or scheme to evade the reporting requirements of Section 13(d), and were therefore properly found liable under Rule 13d-3(b).

II. THE DISTRICT COURT'S RULING ON LIABILITY ADVANCES THE POLICIES UNDERLYING THE WILLIAMS ACT.

Defendants assert that the District Court's construction of Section 13(d) and Rule 13d-3(b) "represent[s] a sea change in law and policy" and "overturns settled expectations in the Nation's derivative markets." (Br. 2-3, 23.) But considering TCI's conduct as a plan or scheme to evade the reporting requirements would neither stretch the text of Rule 13d-3(b) nor create dislocations in the marketplace. Applying Rule 13d-3(b) as we describe would affect relatively few market participants. Disclosure would be required only where a person attains a greater than 5% economic interest for the purpose of exerting influence or control of the issuer and simultaneously seeks actually to influence or control the issuer and the voting of physical shares by swap counterparties. Put differently, the District Court's interpretation of Rule 13d-3(b) bites only when a party actively seeks to influence corporate management or corporate control, a context that is hardly at the core of the international derivatives market.

In addition, in our analysis, the hedged equity shares would have to be pre-positioned, the swaps would have to be structured in a manner calculated to reduce counterparty disclosure obligations, and the information withheld from the market

would have to be material. This is undoubtedly an infrequent occurrence and Defendants have cited to no other transactions that would be affected by this proposed standard. Moreover, disclosure by a holder of a 5% economic interest through swaps acquired under circumstances consistent with our proposed analysis is entirely in line with the Williams Act's goal that the public be put on notice of any large position in a company that a shareholder has with an intent to influence control. Accordingly, we agree with the District Court's conclusion that there is no reason to believe that "dire consequences will ensue from a determination of beneficial ownership in this case." (A-5623 n.192.)

We believe strongly in the case for requiring symmetrical disclosure of cash-settled equity swaps positions. Indeed, Professors Hu and Black recently summarized the policy considerations for more disclosure as follows:

> These requirements are rooted in the belief that investors, as well as society at large, should know who a company's major shareholders are. Investors should also know whether those shareholders are buying and selling and should have an opportunity to respond. From an economic standpoint, share pricing will be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. The integrity of, and confidence in, the stock market will be enhanced. We also identified reasons more directly related to equity decoupling. Disclosure can provide information on the frequency of empty voting and hidden (morphable) ownership. Disclosure may also deter some new vote buying: not everyone will do in the sunshine what they will do in the dark.

Hu & Black, 156 U. Pa. L. Rev. at 683-84. By disclosing their positions selectively, TCI and 3G were aware of, and traded on, information not available to

the public and not reflected in the share price. The integrity of the market for CSX stock was undermined and an uneven playing field was created.

Conclusion

We conclude that Defendants, in clear violation of Rule 13d-3(b), engaged in a "scheme to evade the reporting requirements of section 13(d)." We respectfully urge the Court to affirm the well-reasoned decision of the District Court with respect to Defendants' violation of Section 13(d) and Rule 13d-3(b).

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B) because it contains 6,988 words, excluding the cover page, listing of amici curiae, table of contents, table of authorities, signature block, and all parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii)

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I hereby certify that on July 18, 2008, I caused two copies of the foregoing Brief of Former SEC Commissioners and Officials and Professors as *Amici Curiae* in Support of Appellant CSX Corporation and Affirmance to be served by First Class mail, postage prepaid, and one electronic copy of the foregoing Brief to be served by e-mail, on the following counsel:

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