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, et al.,

Defendant-Third-Party-Plaintiff-Counter-Claimants-Appellee-Cross Appellants,

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

BRIEF OF *AMICI CURIAE*
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. AND SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 29(c) and 26.1(a), the International Swaps and Derivatives Association, Inc. ("ISDA") and the Security Industry and Financial Markets Association ("SIFMA") hereby state as follows:

1. *Amicus curiae* ISDA is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

2. *Amicus curiae* SIFMA is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

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The International Swaps and Derivatives Association, Inc. ("ISDA") and the Security Industry and Financial Markets Association ("SIFMA") submit this *amici curiae* brief in support of the request of defendants-appellees-cross-appellants to reverse the opinion of the United States District Court for the Southern District of New York (Kaplan, J.) entered on June 11, 2008. All parties have consented to the filing of this brief.

STATEMENT OF INTEREST

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association by number of member firms. ISDA was chartered in 1985 and today has over 825 member institutions from 56 countries on six continents. ISDA has pioneered efforts to reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions for its members on the enforceability of netting and collateral arrangements; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. ISDA Master Agreements serve as the contractual foundation for more than 90% of derivatives transactions globally.

SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

The district court's decision addressed the circumstances under which cash-settled equity swaps can lead to beneficial ownership under Section 13(d) of the Securities Exchange Act of 1934 ("Exchange Act"). *Amici*'s members enter into countless equity swap transactions on a daily basis, most of which are governed by ISDA's Master Agreement. Thus, *amici* are uniquely positioned to address issues relating to cash-settled equity swaps and have a substantial interest in ensuring that laws governing their use promote legal certainty and market stability.

PRELIMINARY STATEMENT

Amici file this brief because, despite purporting to base its opinion on defendants' narrow conduct, the district court misconstrued Rules 13d-3(a) and 13d-3(b) and thereby created substantial uncertainties for the equity derivatives and capital markets that require correction on appeal, regardless of the outcome of this particular case.

First, *amici* believe that the district court erred in expanding the "scheme to evade" language of Rule 13d-3(b) in a way that the SEC has never applied (or intended) and no legal authority has supported. Despite the SEC's clear and long-standing position that cash-settled equity swaps do not confer beneficial ownership to the long party[1] to an equity swap, the district court read Rule 13d-3(b) to require Section 13(d) disclosures for certain of these swaps. The court's interpretation is unsupported by the language of the Rule and improperly extends its application beyond the scope of Section 13(d) of the authorizing statute.

Second, although ultimately not deciding whether defendants became "beneficial owners" under Rule 13d-3(a) by virtue of their long positions in equity swaps, the district court, in its analysis, applied a novel "influence" standard for beneficial ownership that cannot be supported by the applicable legal precedent.

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1 The "long" party in an equity swap is the party entitled to cash payments equal to any appreciation and dividends on the referenced shares from, and obligated to make cash payments equal to any depreciation on the referenced shares plus an interest rate component to, the "short" party.

The definition of "beneficial ownership" under Rule 13d-3(a), as well as all relevant authority, requires a showing of *control* over the voting or disposition of securities, and not, as the district court stated in its decision, mere "influence" with respect to voting or disposition.

ARGUMENT

I. The District Court Misinterpreted The "Scheme To Evade" Language Of Rule 13d-3(b)

The district court interpreted Rule 13d-3(b) to reach "arrangements that ... [do] not [themselves] amount to beneficial ownership." SPA-75.[2] Relying primarily on the general purposes of Section 13(d) disclosures, the district court expanded the application of Rule 13d-3(b)'s "scheme to evade" language to impose Section 13(d) disclosure obligations "where there is accumulation of securities by any means with a potential shift of corporate control," including in circumstances that do not amount to "beneficial ownership." SPA-75. This interpretation stretches Rule 13d-3(b) beyond its intended meaning, beyond the SEC's understanding of its own rules, and beyond the scope of Section 13(d), which expressly limits the disclosure requirements to the "beneficial ownership of any equity security [registered under Section 12 of the Exchange Act]," 15 U.S.C. § 78m(d)(1).

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2 "JA" and "SPA" refer to the Joint Appendix and Special Appendix, respectively.

A. **The District Court's Expansive Reading Of Rule 13d-3(b) Contradicts The SEC's Interpretation Of The Rule And All Other Relevant Authority**

Rule 13d-3(b) provides that, any person who "creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose o[r] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) and (g) of the [Exchange] Act shall be deemed for the purposes of such sections to be the beneficial owner." 17 C.F.R. § 240.13d-3(b).

On its face, the Rule indicates that but for the enumerated arrangements, a person would fall within the definition of "beneficial owner." Not any "device" will do; it must be one that has the purpose or effect of "divesting" or "preventing the vesting of beneficial ownership." See JA-5550. Thus, at a minimum, the implication of Rule 13d-3(b) requires an analysis of whether, absent the "device," a person would be a "beneficial owner." The SEC's 1977 release promulgating Rule 13d-3 makes this clear. There, the SEC gave as its illustration of a Rule 13d-3(b) violation a transaction where a party entered into a scheme to evade the reporting requirements to "avoid[] disclosure of *his beneficial ownership*." See Exchange Act Release Nos. 33-5808, 34-13291, 42 Fed. Reg. 12,342, 12,347 (Mar. 3, 1977) ("1977 Release") (emphasis added).

Second, the "device" must be part of a "plan" or a "scheme" to evade Section 13(d) filing requirements. The district court found there was a "scheme" in the sense that defendants were motivated, in part, to use equity swaps to avoid disclosure. SPA-65-66. This reading of the "scheme" requirement admits of little, if any, limitation. Under the district court's reading, virtually any arrangement entered into by a person as an alternative to buying shares outright can be deemed a "scheme to evade," as long as the person involved is motivated in part by the wish to avoid disclosure. That plainly was not what the SEC intended.

The SEC staff informed the district court of the boundaries of the "scheme to evade" requirement, stating that it is intended to reach arrangements that, through deception, conceal the existence of beneficial ownership. See JA-5550-5551. See also SEC v. Softpoint, 958 F. Supp. 846, 861 (S.D.N.Y. 1997) (requiring "preconceived artifice" for "scheme to evade" in Regulation S context); SEC's *amicus* letter in In re Healthsouth Sec. Litig, No. CV-03-BE-1500 (N.D. Ala.) (same in Rule 144A context), available at http://www.sec.gov/litigation/briefs/2006/healthsouthbrief.pdf. The history of Rule 13d-3 makes clear that acquisition of "economic interests" in securities, divorced from control over voting or disposition, cannot be considered a "scheme to evade" Section 13(d) disclosure obligations.

In 1975, the SEC proposed rules implementing Section 13(d). Those rules initially would have defined "beneficial ownership" to include "the right to receive or the power to direct the receipt of dividends from or the proceeds from the sale" of equity securities, Exchange Act Release Nos. 33-5609, 34-11616, 35-19140, 40 Fed. Reg. 42,212, 42,213 (Sept. 11, 1975) ("1975 release") – almost exactly the economic interest received by the long party in a swap referencing equity securities. In adopting the Rules in 1977, however, the SEC expressly declined to include those arrangements within the definition. See 1977 Release, 42 Fed. Reg. at 12,348. Not that the SEC overlooked "economic interests;" it decided to include, in the schedules to be filed by the *actual beneficial owners* of more than 5% of an equity security, disclosure requirements with respect to "any *other person* [] known to have an economic interest," such as the right to receive dividends or sale proceeds. Id. at 12,352 (emphasis added). In other words, the SEC consciously distinguished between "beneficial ownership" and "economic interests." Surely, in promulgating Rule 13d-3(b), the SEC did not intend that an arrangement it had expressly concluded should not fall within the definition of beneficial ownership would result in its participants being "deemed" beneficial owners under the "scheme to evade" provision.

In the 30 years since the SEC rules were promulgated, the SEC has never suggested that the "scheme to evade" language encompassed circumstances in which a party entered into equity swaps, or otherwise acquired only an economic interest in a security. Indeed, SEC rules specifically provide that an economic interest alone does *not* give rise to beneficial ownership. See Exchange Act Release Nos. 34-28869, 35-25254, 56 Fed. Reg. 7242, 7244 (Feb. 26, 1991) ("1991 Release") (purely non-voting securities are excluded from Section 13(d)); accord, e.g., JA-5471 (citing 2 Edward F. Greene et al., U.S. Regulation of the International Securities and Derivatives Markets § 13.02(2) n.25 (7th ed. 2004)). And the SEC staff took the same position in this case.[3] See JA-5550-5551.

Even though Rule 13d-3(b) expressly takes as its point of departure situations that would result in "beneficial ownership" but for the interposition of a "scheme," the district court decision looked to an ostensibly different touchstone – whether "one 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." SPA-75 (citing to language describing the purpose of Section 13(d) in GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971)). Other than applying this "test" to "deem" defendants the beneficial owner of the

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[3] The Court need not detain itself long on the question of how much deference should be accorded to the interpretation propounded below by the SEC staff. While experience suggests that a staff letter is hardly a frolic and detour, the salient point is that, until the district court's decision here, no legal authority, including the SEC, had suggested that entering into an equity swap triggers the reporting requirements of Section 13(d).

securities held by their swap counterparties, the district court did not explain what it meant by "accumulation of securities" and how that differs from "beneficial ownership." As far as we are aware, the phrase has been used *only* to connote "beneficial ownership." In enacting Section 13(d) and promulgating its implementing rules, Congress and the SEC used the term "accumulation" interchangeably with the term "acquiring," which in turn has been equated with "achieving beneficial ownership." See S. Rep. No. 90-550, at 4 ("This bill would ... provide for full disclosure in connection with ... techniques for *accumulating* large blocks of equity securities of publicly held companies. Under this bill ... the person or group ... *acquiring* a substantial amount of securities would be disclosed." (emphasis added)); H.R. Rep. No. 90-1711, at 4 (same); Takeover Bids: Hearing on H.R. 14475 and S. 510 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce, 90th Cong. 40-41 (1968) (statement of SEC Chairman Manuel Cohen) ("[B]eneficial ownership is the test [for Section 13(d)]. [The acquiring entity] might try to get around it, and that would be a violation of the law, but the legal requirement is beneficial ownership."); 17 C.F.R. § 240.13d-5(a) ("A person who becomes a *beneficial owner* of securities shall be deemed to have *acquired* such securities for purposes of section 13(d)(1) ...." (emphasis added)); see also Arnold S. Jacobs, The Williams Act – Tender Offers and Stock Accumulations § 2:10, at 28-29 (2008 ed.) ("'[A]cquire' has no independent definition – it is wholly dependent on a person becoming a beneficial owner.").

The district court reasoned that the principle of statutory construction disfavoring redundancy required it to reject any reading of the "scheme to evade language" that permitted the identical arrangement to constitute "beneficial ownership" under Rule 13d-3(a). SPA-68. The "rule" of statutory construction the district court described can be useful in interpreting statutes, but the SEC would not be the first agency to resort to "belt-and-suspenders" in drafting rules intended to be all-inclusive. Moreover, although there may be some overlap between Rules 13d-3(a) and 13d-3(b), under any reading they are not coextensive. Among other things, the definition of "beneficial ownership" under Rule 13d-3(a) does not address deception and concealment. There is nothing prohibiting alternative bases for regulating or prohibiting the same or similar conduct, particularly in the context of the SEC's regulation of the complex and dynamic financial markets. In fact, the securities laws and regulations are replete with overlapping provisions that cover the same or similar conduct. See, e.g., Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1003 n.6 (9th Cir. 2002) ("The upshot is that Rules 10b-5 and 14e-3 largely overlap with regard to the scope of insider trader liability, although they differ in some respects not here pertinent.").

The district court also suggested that its expansive reading of Rule 13d-3(b) was justified by its view that the SEC had the *power* to extend the boundaries of the Rule to circumstances "that would not fall within the statutory meaning of th[e] term [beneficial ownership]." SPA-74. As an abstract proposition, this may or may not be so, although an agency's rulemaking authority cannot be used to expand or contradict the express language of the statute. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976) ("[R]ulemaking power granted to an administrative agency .... is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." (internal citations omitted)); Pratt & Whitney Aircraft v. Sec'y of Labor, 649 F.2d 96, 103 (2d Cir. 1981) ("[A]n agency may not interpret a regulation in a manner that enlarges its scope beyond that of the enabling act under which it was promulgated.").

More importantly, whatever the SEC *might* have power to do, there is no indication that the SEC *in fact* exercised its rule-making authority to expand Rule 13d-3(b) to situations "that would not fall within the statutory meaning of th[e] term [beneficial ownership];" indeed, the SEC staff specifically disclaimed any such interpretation, noting in its *amicus* letter that "Rule 13d-3, properly construed, is narrower in coverage than the statute." JA-5549 (emphasis added).

Amici do not claim that an equity swap can never be employed as part of a scheme to evade under Rule 13d-3(b). But use of swaps, without more, cannot by itself constitute such an evasion. There must be some additional act of deception that conceals the true ownership of the relevant equity security.

B. The District Court's Rule 13d-3(b) Analysis Runs Afoul Of Congress' Express Prohibition Of SEC Regulation Of Equity Swaps

The district court's application of Rule 13d-3(b) conflicts directly with the Commodity Futures Modernization Act of 2000 ("CFMA"). Congress enacted the CFMA in part to prohibit the SEC from promulgating, interpreting, or enforcing rules that impose reporting or recordkeeping requirements on equity swaps, other than limited exceptions under Section 16(a) of the Exchange Act. 15 U.S.C. § 78c-1(b)(3). The court, by expanding the application of Rule 13d-3(b), cannot give to the SEC powers that Congress expressly withheld.

The CFMA's legislative history confirms that Congress intended equity swaps to fall outside the SEC's general regulatory purview. In discussing the proposed CFMA legislation at a Congressional hearing, then-Federal Reserve Chairman Alan Greenspan disavowed a broader scheme of regulation, stating that the over-the-counter derivatives market "is best maintained with a minimum of regulation." <u>The Commodity Futures Modernization Act of 2000: Joint Hearing on S. 2679 Before the S. Comm. on Agric., Nutrition and Forestry and the S.</u>

Comm. on Banking, Hous. and Urban Affairs, 106th Cong. 31 (2000). Then-Treasury Secretary Lawrence Summers similarly testified that "[a]s a general matter, we do not believe that swaps should be regulated as securities" and stated that the CFMA's purpose was "not so as to extend some net of regulation to OTC derivatives in a way that they are not now subject to regulation, but only to assure that the basic protections we provide in our cash markets [against insider trading, fraud and manipulation] do not become circumvented through this legislation." Id. at 7, 14.

Responding to these concerns, Congress enacted Section 3A of the Exchange Act to bar the SEC from imposing reporting requirements with respect to equity swaps, except under the limited exceptions of Section 16(a). Indeed, Congress took unusual steps to ensure that the SEC could not, through interpretation and deference, claim broader authority to regulate swaps; it specifically placed the definition of "swap agreement" and "security-based swap agreement" in a "neutral statute ... that is, legislation that is not specifically a part of banking, securities or commodities law.... [that] makes it clear that *the SEC is not to impose regulations on such instruments* as prophylactic measures." See 146 Cong. Rec. S11867 (2000) (statement of Senate Banking Committee Chairman Phil Gramm) (emphasis added).

II. The District Court's Analysis Of "Beneficial Ownership" Under Rule 13d-3(a) Was Both Legally And Factually Flawed

Although ultimately not deciding whether the defendants were "beneficial owners" of CSX shares under Rule 13d-3(a), the district court engaged in an analysis that would extend Rule 13d-3(a)'s definition of "beneficial ownership" to include those who have mere "influence" or are in a "position to influence" voting or investment power for the securities. SPA-58, 65. The court's analysis is contrary to the plain language of Rule 13d-3(a), as well as relevant legal authority.

A. The District Court's Rule 13d-3(a) Analysis Is Unsupported By The Rule's Plain Language, The SEC's Interpretation Of It And Relevant Case Law

Rule 13d-3(a) defines "beneficial ownership" as the "power to vote, or to direct the voting of, [a] security; and/or ... the power to dispose, or to direct the disposition of, [a] security." 17 C.F.R. § 240.13d-3(a). These are words of art: as used in the federal securities law, the "power to direct" means "control," not mere "influence." See Levy v. Southbrook Int'l Invs. Ltd., 263 F.3d 10, 15-16 (2d Cir. 2001) (Section 13(d) requires "disclosure of shareholder *control*" (emphasis added)); see also SEC Rule 12b-2, 17 C.F.R. § 240.12b-2 ("'[C]ontrol' ... means the *power to direct or cause the direction* of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." (emphasis added))[4]; TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 451 n.13 (1976).

The SEC has consistently required control (and not just influence) over voting and disposition for "beneficial ownership" under Rule 13d-3(a). In the 1977 Release promulgating the Rule, the SEC expressly stated that it "adopted the standard of voting *power* or investment *power* for the determination of beneficial ownership." 1977 Release, 42 Fed. Reg. at 12,348 (emphasis added). Most recently, the SEC staff, in its *amicus* letter, stated that the "more reasonable interpretation of the terms 'voting power' and 'investment power' as used in the Rule, which are based on the concept of the *actual authority* to vote or dispose or the *authority to direct* the voting or disposition, is that they are not satisfied merely by the presence of economic incentives." JA-5549 (emphasis added). Accord 17 C.F.R. § 240.13d-101 (itemizing beneficial ownership for disclosures under Section 13(d) as consisting of "[s]ole voting power," "[s]hared voting power," "[s]ole dispositive power" and "[s]hared dispositive power," *not* voting or dispositive "influence"). Indeed, in promulgating Rule 13d-3(a), the SEC affirmatively *eliminated* a proposed regulation that would have expanded

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[4] Rules 12b-2 and 13d-3 are to be read *in pari materia*. See 17 C.F.R. § 240.12b-1 (rules "govern all registration statements pursuant to Section 12(b) and 12(g) of the Act and all reports filed pursuant to Sections 13 and 15(d) of the Act").

"beneficial ownership" to include all relatives living in the same household – certainly persons with "significant influence" over the decisions to vote or dispose of shares – as being "totally inapposite to the *voting/investment power* approach" of Rule 13d-3(a). 1977 Release, 42 Fed. Reg. at 12,348 (emphasis added).

The district court's subjective "influence" standard of "beneficial ownership" would undermine one of the SEC's key goals in promulgating Rule 13d-3(a). When Section 13(d) was first enacted, there was "no explicit definition of the term 'beneficial owner' for purposes of this section." 1975 Release, 40 Fed. Reg. at 42,213. The SEC amended Rule 13d-3(a) in 1977 to define beneficial ownership specifically "[i]n order to provide *more objective standards* for the application of [Section 13(d) reporting] requirement[s]." 1977 Release, 42 Fed. Reg. at 12,342 (emphasis added). An "influence" standard based on "practical realities" of the "real world," SPA-66, unconstrained by the plain language of Rule 13d-3(a), would infuse significant subjectivity into a Rule that was promulgated for the specific purpose of creating an objective standard.

There are many circumstances where one's actions "influence" (without controlling) another's purchase or sale of securities. None has ever been thought to make the actor their beneficial owner. Mutual fund investors, by their investments and redemptions, cause funds to purchase and sell securities. Lenders who finance the purchase of securities, by withdrawing the credit, can cause the disposition of the securities. Research analysts exist to influence purchases and sales of securities. As a practical matter, "influence" cannot be the standard for beneficial ownership.

In extending the definition of "beneficial ownership" to those who are merely in a "position to influence" or have the "power to influence" voting or disposition, SPA-65, the district court relied on inapposite references to "influence" used in relation to descriptions of the purpose of Section 13(d) and improperly inserted them into Rule 13d-3's definition of "beneficial ownership." See SPA-53-55, 62 (citing the 1977 Release; Exchange Act Release Nos. 33-5925, 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978) ("1978 Release"); Exchange Act Release No. 34-18114, 46 Fed. Reg. 48,147 (Oct. 1, 1981) ("1981 Release")).

In the 1978 Release, the SEC stated that "[t]he legislative history of [Section 13(d)] indicates that it was intended to provide information to the public and the affected issuer about rapid accumulations of its equity securities in the hands of persons who would then have the potential to change or influence *control of the issuer*," not the potential to "influence" (but not control) the voting of the *securities*. 1978 Release, 43 Fed. Reg. at 18,484 (emphasis added). Similarly, in the 1977 Release, the SEC used the term "influence" to emphasize that the purpose of determining beneficial ownership under Section 13(d) was to identify the party that "was able to change or influence the control of [the issuing corporation]." 1977 Release, 42 Fed. Reg. at 12,346 ex. 3. It made no mention of "influence" over voting or investment decisions.[5] See also, e.g., Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the S. Comm. on Banking and Currency, 90th Cong. 24 (1967) (statement of SEC Chairman Manuel Cohen) (discussing "the power to *influence* the management and control *of the corporation*" (emphasis added)).[6]

The court decisions that the district court relied on fail to support its "influence" standard. SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587,

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5 The district court's reliance on the 1981 Release was also misplaced. SPA-55, 62. The court cited to a footnote in the release – focused on Section 16(a) – stating that "[w]hile the concepts of beneficial ownership under Section 16(a) and under Rule 13d-3 have much in common, the former stresses the economic benefit to be derived from the securities and the latter emphasizes the ability to control or influence the voting or disposition of shares." 46 Fed. Reg. at 48,149 n.17. This passing observation about Section 13 in a release devoted to rules promulgated under Section 16 is not enough to overcome the Rule's plain language and Congress' statutory scheme as set forth in Section 13(d), not to mention the clearly contradictory releases discussed above. See also 1991 Release, 56 Fed. Reg. at 7244 (the SEC, adopting Rule 13d-3 test for beneficial ownership for Section 16, states "[t]he section 13(d) analysis, such as the exclusion of nonvoting securities and counting *only* those derivative securities exercisable or convertible within 60 days, are [sic] imported into the ten percent holder determination for section 16 purposes." (emphasis added)).

6 The Exchange Act itself evidences the intended context for the term "influence." See 15 U.S.C. § 78m(d)(5) (providing an exception to the full disclosure requirements of Section 13(d)(1) for persons whose beneficial ownership of securities was acquired "in the ordinary course of [their] business and [was] not acquired for the purpose of and [does] not have the effect of changing or *influencing* the control *of the issuer*." (emphasis added)).

607 (S.D.N.Y. 1993), never addresses whether "influence" alone can give rise to beneficial ownership, since the defendants in that case expressly agreed to "park" securities with a third party in a way that left actual control over the securities with the defendants. Id. at 590-91. Drexel Burnham stands only for the proposition that legal ownership is not a *necessary* prerequisite to a finding of "beneficial ownership" under Section 13(d). Similarly, Wellman v. Dickinson, 682 F.2d 355, 366-67 (2d Cir. 1982), holds only that an investment banker who *actually controlled* the disposition of shares held in both the accounts he managed and those held by investment funds he advised was a "beneficial owner" of shares in both funds.

It is well settled in this Circuit that, unless and until a party obtains *actual* voting or investment power over securities, it is not a "beneficial owner" under Rule 13d-3(a), even if attaining that power was entirely foreseeable or even likely. See, e.g., Transcon Lines v. A.G. Becker, 470 F. Supp. 356, 370 (S.D.N.Y. 1979) (expectation from business dealings and personal relationship that party would acquire securities did not give rise to beneficial ownership); Levner v. Saud, 903 F. Supp. 452, 462 (S.D.N.Y. 1994) (owner of preferred stock, convertible to common stock on contingencies, was not a "beneficial owner"), aff'd, 61 F.3d 8 (2d Cir. 1995); Todd Shipyards Corp. v. Madison Fund, Inc., 547 F. Supp. 1383, 1391 (S.D.N.Y. 1982) (brokerage firm with the option to acquire shares from an individual, subject to contingencies, was held to not be the beneficial owner of shares).

Two foreign courts have addressed the issue whether long parties in equity swaps are beneficial owners of the securities acquired by swap dealers as a hedge; both held that they are not. In Ithaca (Custodians) Ltd. v. Perry Corp., [2004] 1 N.Z.L.R. 731, 2003 NZLR LEXIS 76 (C.A. Nov. 4, 2003), the New Zealand Court of Appeals held that even the "market reality" that the holder of an equity swap could reasonably expect that it would be able to purchase the referenced securities from its counterparty, upon request, at the unwinding of the swap did not create an "arrangement or understanding" sufficient to trigger the disclosure requirements of New Zealand's equivalent to Section 13(d), Section 5(1)(f) of its Securities Markets Act. Id. ¶¶ 73-74. Similarly, in In re Sears Canada Inc., 22 B.L.R.4th 267 (Ont. Sec. Comm'n 2006), aff'd, 84 O.R.3d 61 (Super. Ct. Justice (Div. Ct.) 2006), the Ontario Securities Commission, in a decision affirmed by the Ontario Superior Court, held that a swap transaction, without more, does not give rise to "beneficial ownership," even if entered into for the purposes of avoiding reporting requirements, as the long party does not maintain any power to exercise control or direction over the underlying shares. Id. ¶ 104. The Ontario Securities Commission held that there had to be an understanding above and beyond the swap transaction in order to establish beneficial ownership. Id. ¶¶ 105-06.

As noted, the district court's interpretation of Rule 13d-3(a) also directly contravenes the CFMA, which prohibits the SEC from promulgating, interpreting, or enforcing rules that impose reporting or recordkeeping requirements on swap agreements other than as expressly permitted by Section 16(a). 15 U.S.C. § 78c-1(b)(3). See supra I.B.

B. The District Court's Rule 13d-3(a) Analysis Included Factual Generalizations That Do Not Accurately Reflect Market Reality

The district court, in its Rule 13d-3(a) analysis, emphasized the need to take into account how "[t]he securities markets operate in the real world" and the "practical realities of that world." SPA-66. Although we do not address the particular factual findings in this case, we are in a position to comment on the "practical realities" of the market, and we take issue with certain of the court's generalizations about the equity swap market.

On the perceived ability of a long party to an equity swap to influence the disposition of referenced shares, the district court stated that "[t]he very nature of the TRS transactions, as a practical matter, require[] the counterparties to hedge their short exposures" and noted that, "while there theoretically are means of hedging that do not require the purchase of physical shares, in the situation before the Court it is perfectly clear that the purchase of physical shares was the only practical alternative." SPA-64. In the "real world," nothing in the "very nature" of cash-settled equity swaps requires counterparties to hedge their short positions, and more than a mere "theoretical" possibility exists that a swap dealer might address its swap exposure in whole or in part in a way other than the purchase (and retention until the swap's expiration) of the exact number of referenced shares. A 2007 PricewaterhouseCoopers LLP survey ("PwC Survey") commissioned by the U.K. Financial Services Authority ("FSA") (in which a number of *amici*'s members and affiliates were surveyed), available at http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf (Annex 4), concluded, among other things, that:

- "most [market] participants ... do not necessarily hedge their CFD[7] positions by buying the underlying shares" and "found significant differences in practices depending on the size and type of organisation." PwC Survey at 3.

- 85% of the respondents said that "they sometimes hedge with the underlying asset," 46% hedged through "[o]ffsetting positions with derivatives" and 15% "in some other way" Id. at 16.

- 54% of respondents stated they never close out positions with physical settlement of underlying stock; 46% stated they do so only 1 to 20% of the time. Id. at 19.

The PwC Survey confirms that swap dealers' hedging practices are far from uniform, notwithstanding the district court's generalizations. Indeed, many

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[7] A CFD, or "Contract for Differences," is a derivative instrument common in the U.K. that is in all material respects relevant here, equivalent to cash-settled equity swaps. PwC Survey at 11.

swap dealers manage their equity exposures on a portfolio basis, not on a swap-by-swap basis. See generally Robert L. Tortoriello & Paul E. Glotzer, Guide to Bank Underwriting, Dealing and Brokerage Activities II-139-147, II-152-155 (2007). Thus, even swap dealers who initially hedge with the referenced shares may well dispose of them before the equity swap is terminated, and without the counterparty's knowledge, in circumstances including:

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

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

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

On the issue of voting, the district court noted – even under this case's unique circumstances and the court's novel "influence" standard – that the "situation is a bit murkier." SPA-65. Whatever the facts of this case, it is clear that, generally, long parties to cash-settled equity swaps do *not* have the power to vote or to direct the vote of the shares held by the swap dealers. The PwC Survey confirmed that most market participants "do not exercise their voting rights under their policies" and generally rebuff attempts by others to influence their votes.[8] See PwC Survey at 23-25. In addition, ISDA's standard documentation for equity swaps is explicit that the long party does not have any interest or expectation in any hedging transactions in which the other party may engage, much less the right to direct how hedged shares should be voted. See 2002 ISDA Equity Derivatives Definitions art. 13.2 (relevant portions attached hereto as Exhibit A).

Even if inclined to vote, swap dealers may be unable to because they have lent the hedging shares to third parties under documentation that transfers voting rights to the borrower. See, e.g., Master Securities Loan Agreement art. 7.1, available at http://www.sifma.net/agrees/master_securities_loan_agreement_2000_version.pdf. Respondents to the PwC Survey reported that 24% of the shares acquired as hedges were held in a "stock lending book." PwC Survey at 16. Some dealers, as a matter of policy or practice, may vote in proportion to the balance of the balloting or simply follow the recommendations of institutional investor services. See A-5477. Finally, a swap dealer may aggregate and net share

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8 The district court noted that getting shares into the hands of parties who are not likely to vote can serve the purpose of keeping the shares away from those who will vote *against* a particular proposal in a proxy fight. SPA-63. There is, of course, a vast difference between believing that a party will not vote its shares and directing the vote of those shares under Rule 13d-3(a).

positions among multiple trading desks such that the dealer's overall position is to be short the shares, and thus it may control no shares to vote.[9]

In sum, market practices in the "real world" of cash-settled equity swaps are far from consistent, and they do not, by any stretch, establish a predictable level of influence by the long party over the voting and investment decisions of swap dealers. Any legal standard like that proposed by the district court that assumes such a uniform "market practice" will be flawed and unworkable.

III. The District Court's Interpretations Of Rules 13d-3(a) And 13d-3(b) Will Lead To Substantial Uncertainties In The Derivatives And Securities Markets

The district court's novel interpretations of Rules 13d-3(a) and 13d-3(b) contradict the intentionally objective language of the Rules and introduce significant subjectivity and uncertainty. The standards thus will create problems for *amici*'s members who regularly engage in equity derivatives and securities transactions. For example, among other potential consequences, market participants –

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[9] The district court emphasized the purported advantage a holder of a cash-settled equity swap might have in acquiring shares of the referenced company, because of "a ready supply of shares" at the time it settles its swap. SPA-17. As noted above, however, Congress's target was actual accumulation, not anticipatory steps that might facilitate or reduce the cost of a subsequent accumulation of shares.

- Will face substantial uncertainty as to when their participation in swap transactions may give rise to reporting obligations because they could be said, in retrospect, to have had "influence" over someone else who held securities or been part of a "scheme to evade" reporting requirements.
- Will have to design and implement highly sophisticated and extremely expensive monitoring systems, if even possible, to ensure that disclosure obligations are not triggered by securities that they do not own, but over whose owners they may have "influence" or whose "accumulation" may be considered to be part of a "scheme to evade" reporting requirements.
- Will face uncertainty as to how standards that largely depend on the "practical realities" of the "real world" will be affected by changes in market practices.
- Will constantly have to calibrate on a highly subjective scale how their actions might "influence" another to purchase or sell securities.

Swap dealers maintain a variety of relationships of "influence," including with clients who invest in, issue, buy, sell, lend, or borrow securities. They advise clients who want to buy, sell and take control of companies, or prevent the same. They provide financing to companies and banking and advisory services to issuers. The district court's standard leaves uncertain how and whether these relationships of "influence" should be evaluated.

The uncertainty created by the court's decision also could have effects beyond equity swaps and even beyond the reporting requirements of Section 13(d). For example, beneficial ownership under Section 13(d) also gives rise to potential liability for short swing profits under Section 16. See 17 C.F.R. § 240.16a-1(a)(1)

(Rule 13d-3's definition of beneficial ownership shall be used for Section 16). Mistaken judgment about beneficial ownership under Rule 13d-3 could result in significant liabilities under the punitive provisions of Section 16. The decision's consequences also could extend to other federal and state statutes that regulate or limit beneficial ownership and incorporate concepts of voting and investment control similar to those under Rule 13d-3.[10]

With the uncertainty, we are concerned that market participants will have to run a potentially unmitigatable risk of violating (or subsequently being found to have violated) reporting requirements and thus incurring substantial liabilities.[11] Unfortunately, one certain consequence will be increased litigation. Litigation – and protracted discovery – will become necessary to determine such subjective factors as "influence" and "motives," both of which play a central role in the district court's standards. We are not alone in these concerns. See JA-5551 (SEC concerned about "significant uncertainties for investors who have used equity swaps in accordance with accepted market practices understood to be based on reasonably well-settled law."); Letter from Sen. Schumer to SEC Chairman

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10 See, e.g., 12 U.S.C. § 1841(a)(2)(A) (Bank Holding Company Act of 1956); 15 U.S.C. § 80a-2 (Investment Company Act of 1940); N.Y. Ins. Law § 1501.

11 The equity derivatives market is significant in size. The Bank for International Settlements reports that, as of December 2007, the notional amount of equity forwards and swap contracts outstanding in the G-10 countries and Switzerland was $2.2 trillion. See http://www.bis.org/statistics/otcder/dt1920a.pdf.

(June 17, 2008), attached hereto as Exhibit B (concern that the district court's decision "would be difficult to administer evenhandedly and has the potential to lead to a rash of litigation that will drive up costs and ultimately reduce the competitiveness of the U.S. financial sector.").

The district court dismissed these legitimate concerns as "exaggerated," claiming first that "there is no reason to believe that there are many situations in which the 5 percent reporting threshold under Section 13(d) would be triggered by [its] ruling." SPA-67. The court's assertion, unsupported by any evidence from the factual record,[12] misses the point of *amici*'s concerns. The concern is not how many additional reports the new standard will generate, but the unacceptably subjective and vague standard that all market participants will face. Before any market participant can determine whether it has a reporting requirement, it first must determine the number of shares over which it might be considered a beneficial owner. Uncertainty creates costs and risks not only for those who ultimately file reports but for all market participants.

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[12] Section 13(d)'s legislative history suggests otherwise. Concern over the potentially large number of five percent holders led Congress to promulgate Section 13(d)(5), which provides for short-form disclosure for certain categories of investors. See, e.g., Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen: Hearing on S. 3431 Before the Subcomm. on Securities of the S. Comm. on Banking and Currency, 91st Cong. 102-03, 108 (1970).

In response to *amici*'s concerns, the court also noted that the United Kingdom requires the disclosure of economic stakes greater than 1% in companies involved in takeovers and was considering requiring disclosure at the 3% level in other companies. SPA-67. *Amici*'s primary concern is not with the threshold disclosure levels *per se*, or even with a potential reporting requirement. Instead, *amici* are concerned about a beneficial ownership test that is based on the court's uncertain standards that replaced more objective – and well-settled – rules, standards that result not merely in reporting obligations, but potentially significant short swing trading liabilities under Section 16. Expansion of the reporting requirements through clear legislation and regulations, as was the case in the United Kingdom,[13] does not raise the same concerns raised by the court's decision here.

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[13] The United Kingdom's new regulatory thresholds provided full opportunity for notice and comments, and its current proposal includes an exemption for dealers, a limitation that can be achieved through rule-making, but not by the district court's decision. See Policy Update on Disclosure of Contracts for Difference (CFDs) (July 2, 2008), available at http://www.fsa.gov.uk/pubs/cp/cp07_20_update.pdf.

CONCLUSION

For the foregoing reasons, we respectfully request that the Court reverse the judgment of the district court.

Dated: New York, New York
July 18, 2008

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with the type-volume limitation of Federal Rules of Appellate Procedure 32(a)(7)(C) and 29(d). The text of this brief was prepared in Times New Roman 14 point font and consists of, according to Microsoft Word's word count feature, 6,968 words, including footnotes and excluding tables of contents and authorities and certificates of corporate ownership, compliance, anti-virus scanning and service.

Dated: New York, New York
July 18, 2008

Joon H. Kim

CERTIFICATE OF ANTI-VIRUS PROTECTION

Pursuant to Second Circuit Interim Local Rule 25(a)(6), I hereby certify that the PDF version of the brief and attachments submitted to civilcases@ca2.uscourts.gov have been scanned for viruses using Symantec AntiVirus 10.1.5.5000 and that no viruses were detected.

Dated: New York, New York
July 18, 2008

Willem Daniel Lee

CERTIFICATE OF SERVICE

I hereby certify that on July 18, 2008, I caused two true and correct copies of the foregoing brief to be served by Federal Express, and one electronic copy of the foregoing brief to be served by email, on the following counsel:

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Dated: New York, New York
July 18, 2008

Willem Daniel Lee

EXHIBIT A

2002 ISDA Equity Derivatives Definitions

ISDA®

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

notice of the determination by the Determining Party of such amount (denominated in the currency for settlement of the Transaction as determined by the Determining Party) and the party to pay such amount is effective, which notice shall be provided promptly following such determination.

ARTICLE 13

MISCELLANEOUS

Section 13.1. Non-Reliance. If "Non-Reliance" is specified as applicable in the related Confirmation, then unless agreed to the contrary expressly and in writing in the related Confirmation for a Transaction and notwithstanding any communication that each party (and/or its Affiliates) may have had with the other party, each party to a Transaction represents to the other party that: (a) it is entering into such Transaction as principal (and not as agent or in any other capacity); (b) neither the other party nor any of its Affiliates or agents are acting as a fiduciary for it; (c) it is not relying upon any representations except those expressly set forth herein or in the ISDA Master Agreement (including the related Confirmations between them); (d) it has consulted with its own legal, regulatory, tax, business, investments, financial, and accounting advisors to the extent that it has deemed necessary, and it has made its own investments, hedging, and trading decisions based upon its own judgment and upon any advice from such advisors as it has deemed necessary and not upon any view expressed by the other party or any of its Affiliates or agents; and (e) it is entering into such Transaction with a full understanding of the terms, conditions and risks thereof and it is capable of and willing to assume those risks.

Section 13.2. Agreements and Acknowledgments Regarding Hedging Activities.

(a) If "Agreements and Acknowledgments Regarding Hedging Activities" is specified as applicable in the related Confirmation, then unless agreed to the contrary expressly and in writing in the related Confirmation for a Transaction and notwithstanding any communication that each party (and/or its Affiliates) may have had with the other party, each party to a Transaction agrees and acknowledges that (i) when entering into, or continuing to maintain, such Transaction, neither party is relying on (A) the manner or method in which the other party or any of its Affiliates may establish, maintain, adjust or unwind its Hedge Positions, (B) any communication, whether written or oral, between the parties or any of their respective Affiliates with respect to any Hedging Activities of the other party or any of its Affiliates, or (C) any representation, warranty or statement being made by such party or any of its Affiliates as to whether, when, how or in what manner or method such party or any of its Affiliates may engage in any Hedging Activities and that (ii) (A) each party and its Affiliates may, but are not obliged to, hedge any Transaction on a dynamic, static or portfolio basis, by holding a corresponding position in the securities or indices referenced by or underlying such Transaction or in any other securities or indices or by entering into any Hedge Position; (B) any Hedge Position established by either party or any of its Affiliates is a proprietary trading position and activity of such party or such Affiliate; (C) each party or such Affiliate is not holding the Hedge Positions or engaging in the Hedging Activities on behalf or for the account of or as agent or fiduciary for the other party, and the other party will not have any direct economic or other interest in, or beneficial ownership of, the Hedge Positions or Hedging Activities; and (D) the decision to engage in Hedging Activities is in the sole discretion of each party, and each party and its Affiliates may commence or, once commenced, suspend or cease the Hedging Activities at any time as it may solely determine.

(b) "Hedge Positions" means any purchase, sale, entry into or maintenance of one or more (i) positions or contracts in securities, options, futures, derivatives or foreign exchange, (ii) stock loan transactions or (iii) other instruments or arrangements (howsoever described) by a party in order to hedge, individually or on a portfolio basis, a Transaction.

(c) "Hedging Activities" means any activities or transactions undertaken in connection with the establishment, maintenance, adjustment or termination of a Hedge Position.

Section 13.3. Index Disclaimer. If "Index Disclaimer" is specified as applicable in the related Confirmation, then each party to a Transaction entered into and subject to these Definitions agrees and acknowledges that such Transaction is not sponsored, endorsed, sold, or promoted by the Index or the Index Sponsor and no Index Sponsor makes any representation whatsoever, whether express or implied, either as to the results to be obtained from the use of the Index and/or the levels at which the Index stands at any particular time on any particular date or otherwise. No Index or Index Sponsor shall be liable (whether in negligence or otherwise) to any person for any error in the Index and the Index Sponsor is under no obligation to advise any person of any error therein. No Index Sponsor is making any representation whatsoever, whether express or implied, as to the advisability of purchasing or assuming any risk in connection with entering into any Transaction. Neither party to any Transaction shall have any liability to the other party for any act or failure to act by the Index Sponsor in connection with the calculation, adjustment or maintenance of the Index. Except as disclosed prior to the Trade Date, neither party nor its Affiliates has any affiliation with or control over the Index or Index Sponsor or any control over the computation, composition or dissemination of the Indices. Although the Calculation Agent will obtain information concerning the Indices from publicly available sources it believes reliable, it will not independently verify this information. Accordingly, no representation, warranty or undertaking (express or implied) is made and no responsibility is accepted by either party, its Affiliates or the Calculation Agent as to the accuracy, completeness and timeliness of information concerning the Indices.

Section 13.4. Additional Acknowledgments. If "Additional Acknowledgments" is specified as applicable in the related Confirmation, then unless agreed to the contrary expressly and in writing in the related Confirmation for a Transaction and notwithstanding any communication that each party (and/or its Affiliates) may have had with the other party, each party to a Transaction acknowledges that:

(a) neither the other party nor its Affiliates provides investment, tax, accounting, legal or other advice in respect of such Transaction;

(b) it has been given the opportunity to obtain information from the other party concerning the terms and conditions of such Transaction necessary in order for it to evaluate the merits and risks of the Transaction. Notwithstanding the foregoing, it and its advisors are not relying on any communication (written or oral and including, without limitation, opinions of third party advisors) of the other party or its Affiliates as (i) legal, regulatory, tax, business, investments, financial, accounting or other advice, (ii) a recommendation to enter into such Transaction or (iii) an assurance or guarantee as to the expected results of such Transaction; it being understood that information and explanations related to the terms and conditions of such Transaction are made incidental to the other party's business and shall not be considered (A) legal, regulatory, tax, business, investments, financial, accounting or other advice, (B) a recommendation to enter into such Transaction or (C) an assurance or guarantee as to the expected results of the Transaction. Any such communication should not be the basis on which the recipient has entered into such Transaction, and should be independently confirmed by the recipient and its advisors prior to entering into the Transaction; and

(c) the other party and/or its Affiliates may have banking or other commercial relationships with the issuer of the shares underlying such Transaction and may engage in proprietary trading in the Shares or the Index(es) (as applicable) or options, futures, derivatives or other instruments relating to the Shares or the Index(es) (as applicable) (including such trading as such party and/or its Affiliates deem appropriate in their sole discretion to hedge their market risk on such Transaction and other transactions relating to the Shares or the Index(es) (as applicable) between each party and/or its Affiliates and the other party or with third parties), and that such trading may affect the price of the Shares or the Index(es) (as applicable) and consequently the amounts payable or deliverable under such Transaction. Such trading may be effected at any time, including on or near the Valuation Date(s).

EXHIBIT B

CHARLES E. SCHUMER
NEW YORK

COMMITTEES:
JOINT ECONOMIC
BANKING
JUDICIARY
RULES
FINANCE

United States Senate

WASHINGTON, DC 20510

June 17, 2008

Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

I write today to express concern about the impact of *CSX Corp. v The Children's Investment Fund Management et al.*, decided by the United States District Court on June 11, 2008. The uncertainty created by this ruling will likely have a detrimental effect on the financial markets. Additionally, the inability for the court to fashion meaningful recourse for CSX will have consequences for future transactions involving equity swaps. I believe it is essential that the SEC provide clarification for the treatment of equity swaps under Section 13(d) in light of the court's recent findings that the use of equity swaps by The Children's Fund and 3G Capital Partners conferred beneficial ownership to these two entities and that they were subject to the resulting disclosure requirements.

In this case, the court suggested analyzing beneficial ownership based on the intent of the swaps buyers, and the likelihood of their ability to influence the voting decisions of their counterparties. While noble in its goals, this subjective framework would be difficult to administer evenhandedly and has the potential to lead to a rash of litigation that will drive up costs and ultimately reduce the competitiveness of the U.S. financial sector. The financial community needs clear rules for the treatment of equity swaps, so that parties to swaps agreements do not bear the risk of excessive litigation, and the investment community enjoys the benefits of the appropriate disclosures required by Section 13(d).

Additionally, I find it deeply disturbing that despite his clear finding that The Children's Investment Fund and 3G were in violation of Section 13(d), Judge Kaplan was unable to provide any meaningful equitable relief to CSX in this case. If there is no serious penalty for violations of Section 13(d), why should any investor adhere to its requirements? I am considering introducing legislation to correct this gap in the law, and would be very interested in discussing potential remedies, including the implications of granting CSX's request for voting rights sterilization and increased civil penalties, with the SEC.

I look forward to hearing from you regarding your plans for clarifying the definition of beneficial ownership and to a discussion of potential remedies under Section

13(d). If you should have any questions regarding this letter, please contact David Stoopler on my staff at 202-224-6542.

Sincerely,

Chuck Schumer

Charles E. Schumer
United States Senator