ARTICLES

LAWS, SAUSAGES, AND BAILOUTS:

TESTING THE POPULIST VIEW OF THE CAUSES OF THE ECONOMIC CRISIS*

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INTRODUCTION

While the lingering economic crisis has drawn much attention to individual products and private sector villains thought to have caused the market meltdown, a pointed study of the full range of government causes (and their attendant depth) has to date proven less attractive to authors and critics. It is now axiomatic—even among the financial survivors and victors of the crisis—that Wall Street fell victim to an unprecedented myopia. It is commonly accepted that regulation was flawed, but the exact degree to...
which any one public sector can be blamed has, like the corresponding remedies presently languishing in Congress, been seemingly postponed until a consensus can be reached on the ultimate means of ending the downturn. Moreover, such a direct allocation of culpability may just be a condition precedent to our economy’s recovery. For example, the savings and loan crisis of the late 1980’s, which led to the demise of over 1000 regional banks, arguably stopped short of a financial Armageddon because Federal Judge Stanley Sporkin lambasted the accounting and legal professions. The Stock Market Crash of 1987, which was over in less than a month, was blamed on those gamblers known as ‘program traders,’ thus resulting in new rules designed to shut down the stock exchanges when

In the years leading up to the crisis, our financial regulatory regime permitted an excessive build-up of risk, both inside and outside of the traditional banking system. The shock absorbers critical to preserving stability – capital, margin, and liquidity cushions in particular – were inadequate. Outdated, ineffective regulation left our system too weak to withstand the failure of major institutions.

Id.

Likewise, Federal Reserve Chairman, Benjamin Bernanke, recently stated “[s]tronger regulation and supervision aimed at problems with underwriting practices and lenders’ risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates.” Catherine Rampell, Lax Oversight Caused Crisis, Bernanke Says, N.Y. TIMES, Jan. 4, 2010, at A1; see also SEC OFFICE OF INSPECTOR GEN., Executive Summary to INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF’S PONZI SCHEME 1 (2009), http://www.sec.gov/news/studies/2009/oig-509-exec-summary.pdf (“[T]he SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination . . . despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed.”).


6. The full quote from Judge Sporkin reads as follows:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn’t any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.

Lincoln Sav. & Loan Ass’n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990) (upholding the seizure by the OTS of the Phoenician resort and affiliated thrift).
daily trading swings proved too volatile. Meanwhile, the mortgage debt crisis of the early ‘90s lost steam once the Orange County Treasurer went to jail and counterparty firms paid unprecedented fines. Earlier this decade, when a number of large corporations evidenced accounting irregularities, specific company management was indicted, prompting a law that obligated CEOs and CFOs to swear to the accuracy of financial statements.

Mindful of the pressing need for such resolute finger-pointing, this Article seeks to provide a cross-boundary analysis of the statutes, initiatives, cases, agency decisions, and regulatory reporting lines that either paved the way or aggravated the economic crisis of 2007–2010 (the Crisis). Accordingly, this Article seeks to test postulates of blame in four distinct categories: the enactments of the federal legislature, the decisions by the federal judiciary, the mortgage policy of the Department of Housing and Urban Development (HUD) (as steered by the White House), and the actions/omissions by the Securities and Exchange Commission (SEC or Commission). To that end, this Article identifies the popular wisdom concerning the culpability of each government sector, locates predating trends in the underlying “law,” and compares the two for a variance. The resulting five postulates are summarized as follows:

- The perceptions of the Crisis’ causes are hindered by the search for predicate actions in the past five years, while the true origins of the Crisis seem to be rooted in decades past.
- The more that a perception focuses on an investment product, the less illustrative the critique.
- The contributions to the Crisis by the judiciary and White House during its genesis period are, to one degree or another, understated.
- The ultimate causes for the Crisis may be more subtle and atmospheric than direct and empirical.
- Not only have the laws governing the contributors to the Crisis grown outdated, so has our collective ability to levy blame. Until we recognize that the nightmare scenario of Wall Streeters victimizing the commoner has been supplanted by more complex wrongs, the corresponding analysis will continue to stagger and fall short.

In sum, unlike studies of prior financial crises, the clearest (and least self-serving) reconstructions of the most recent catastrophe have been undertaken by the financial press. This Article seeks to put such populist perceptions to the legal test. Owing homage to the existing literature

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confirming the sins of over-exotic products and profligate spending, this Article eschews any focus on private actors (e.g., credit rating agencies) in favor of examination of government accelerants and responses (much in the same way that a scrutiny of gaming laws confesses the existence of gambling but refuses to blame the horses or dice). Overall, this Article hopes to contribute to academia a categorical assessment of the service offered by the public servants collectively charged with maintaining the first line defense against the very economic abyss that continues to threaten both national and international markets. Stated otherwise, one should be forced to see how meltdowns and bailouts are made, if only to prevent their frequent recurrence.

I. THE POPULIST VIEW ON THE ORIGINS OF THE CRISIS

Although it has become politically expedient to characterize the prolonged economic slump as unforeseeable, in fact, nothing could be further from the truth. It is the position of this Article that in government, industry, and academia, the warning signs were almost as pronounced and as old as the seeds of the crisis themselves. Perhaps, when the fear of inviting blame has subsided, all parties will accede to this simple truth.

A. RELEVANT TIMELINE FOR THE ANALYSIS OF THE SUBPRIME MELTDOWN

Wall Street possesses a time-honored affection for novel investment vehicles. While individual residential mortgage loans are insignificant to investment bankers, during the relevant years, these mortgages were bundled and sold, about half of the time, to entities known as “government sponsored enterprises” (GSEs) such as Fannie Mae and Freddie Mac. The purchases of securitized bundles by GSEs, often called Collateralized Debt Obligations (CDOs) grew rapidly, from $81 billion of such securities in 2003 to $169 billion in 2005.

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11 See infra notes 151, 152.


The Federal Reserve helped spur the growth of the exotic investments. The Federal Funds rate was lowered to 1% and kept there throughout the 2004 fiscal year. This prompted lenders to make loans, and to disregard vague suitability guidelines. In turn, the entities that bought these loans shot right past all rational limits on their purchasing ability. The result was a dramatic increase in a risky category of debt known as “subprime lending,” which represented just 8.6% of all mortgage debt in 2001 but rose to over 20% in 2006.

The growth was also attributable in part to academic hubris. In 2003, a University of Chicago professor and winner of a Nobel Prize in Economics, haughtily declared that the “central problem of depression-prevention has been solved, for all practical purposes.” Ultimately, radical credit became the must game in town. The now defunct Lehman Brothers ratcheted up its debt to leverage ratio from twenty-five times equity to thirty-five times equity in one year. Surprisingly, instead of inviting scorn, its model became the standard to which large firms aspired. CEOs quickly learned that, regardless of their intuition, unfettered faith in the upswing of the real estate market was the only course of action if they intended to prove their competitive entrepreneurialism to corporate boards.

B. DRAMATIC ACTIONS TAKEN BY THE WELL-HEELED

In an era characterized by the free flow of money, significant eyes took heed. In 2005, insurance giant AIG stopped underwriting CDOs. In 2006, insurance giant AIG stopped underwriting CDOs. In 2006,
the Consumer Federation of America published its famed report, *Exotic or Toxic: An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders.*

In February 2007, HSBC, an international banking giant, announced that it was reserving $10 billion to cover non-performing American mortgages. The next month, the burgeoning scrutiny of bank regulators prompted Senator Christopher Dodd to send letters to Federal Reserve Chairman Ben Bernanke and other officials decrying lagging supervision of subprime lenders.

In March 2007, *The Wall Street Journal* openly questioned whether federal regulators were to blame in the disastrous expansion in subprime lending. In June 2007, a “seismic quiver” shot up the spine of Wall Street when it was disclosed that two Bear Stearns mortgage hedge funds could not meet margin calls. In September 2007, former Federal Reserve Chairman Alan Greenspan blandly confessed nearly two months of market turmoil, noting that “[t]he human race has never found a way to confront [stock market] bubbles.”

Regardless, that month, the dire news appeared in full swing, as a former Federal Reserve Governor turned author reminded the public that he foretold that the “predictable result” of the residential real estate boom was “carnage.”

### C. REGULATORY NOTICE

By the end of the summer of 2007, the brokerage industry’s chief regulator put firms on notice that sales of “complex structure products” such as mortgage-related securities would be expressly examined. The catastrophe became a bit more public in the fall, as more storied Wall Street firms admitted their bad bets. Shortly before Halloween, Merrill Lynch

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25. Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown; States, Federal Agencies Clash on Subprimes as Market Ballooned*, WALL ST. J., Mar. 22, 2007, at A1 (Senator Dodd wrote in a letter to regulators that “‘the crisis has been in the making for several years, and, in my view, it has taken far too long for the regulators to act.’”).

26. Id.


reported its first quarterly loss in nearly six years based upon a write-down of nearly $8 billion.\textsuperscript{32}

In December 2007, the SEC and other regulators were said to be investigating brokerages regarding the pricing of mortgage securities and the need for public disclosure of their rapidly declining prices.\textsuperscript{33} In the presence of $80 billion in write-downs in the last few months of the year, the Commission was said to have initiated three dozen investigations.\textsuperscript{34} However, such parries were usually tempered by uncertainties. For example, since the securities in question were difficult to accurately value, an SEC official was concurrently quoted as stating, “We don’t know now that we will be recommending any enforcement actions in the subprime area.”\textsuperscript{35}

Private watchdogs were less equivocal. In March 2008, a full six months before the newspapers publicized the onset of the Crisis, an investment advisor running a consumer friendly website posted the warning that “[t]he great credit unwind is upon us. Credit default swaps on all brokers, particularly Lehman [Brothers] and Bear Stearns, are blowing out, big time.”\textsuperscript{36}

\section*{D. Costly Starts and Stops, Public and Private}

Particularly disconcerting throughout 2008 were the unhalting trends, unfathomable losses, and unpunished errors. In late January 2008, Merrill Lynch, which had written down $10 billion of mortgage-related securities, disclosed its intent to abandon the structured credit business.\textsuperscript{37} The same month, New York’s Attorney General Andrew Cuomo directed his staff to issue subpoenas and utilize the broad Martin Act to examine whether big-name firms failed to disclose risks to customers.\textsuperscript{38} Yet again there was trepidation, as the sources for the story concurrently cited unrealistic credit firm ratings, thus undermining a direct link to investor harm.\textsuperscript{39}

In Spring 2008, it was reported that “6.35% of all mortgages were at least 30 days delinquent, not including those already in foreclosure.”\textsuperscript{40}

\begin{thebibliography}{99}
\bibitem{Pulliam2007} Pulliam & Scanell, \textit{supra} note 31.
\bibitem{Id} Id.
\bibitem{Id} Id.
\bibitem{Id} Id.
\bibitem{Cohan2008} COHAN, \textit{supra} note 19. “Lehman reportedly has two times [its] capital in [commercial mortgage backed securities].” \textit{Id.} at 11.
\bibitem{Id} Id.
\end{thebibliography}
next month, Merrill Lynch suffered its fourth consecutive quarterly loss, writing off another $9.75 billion in assets and bringing its overall write-downs for the year to $43 billion. Separately, banks worldwide reported write-downs of $335 billion.

The mammoth numbers, at times, seemed to eclipse the severity of the official observations. In May 2008, it was disclosed without fanfare by then SEC Chairman Christopher Cox that regulators had “discovered a host of perverse incentives in the securitization process.” The confusion and pain were hardly reserved for the stock market. While approximately 1.3 million residential foreclosures took place in 2007, by the second quarter of 2008, such statistics were up 121%, and it was estimated that 1 out of every 171 homes was in foreclosure.

While the Dow Jones Industrial Average continued to exhibit a remarkably consistent fall (ultimately shrinking approximately 40% in 2008), more entities reevaluated their holdings, leading to further write-downs. Tallies of losses at Citibank and Merrill Lynch reached over $80 billion by mid-2008. Simultaneously, the Treasury and the Federal Reserve combined forces to prop up the two GSEs owning half of the mortgages in the country. In October 2008, Congress passed a first bailout (valued at $700 billion), and the government rescued Freddie Mac and Fannie Mae while providing more directed relief to insurance behemoth

AIG, amounting to $75 billion. In February 2009, Congress provided a second, generalized bailout (valued at $787 billion). Ultimately, observers, regardless of political dispositions, agreed on the unprecedented myopia in the economic sector that jeopardized a nation. However, outspoken interests comprehended ahead of time that, when it came to exotic investments and the new derivatives designed to hedge bets thereon, there was much that was dangerously underestimated. In sum, the Crisis was created due to reckless behavior by its architects, had predictable effects, and started with an inordinate amount of attention (and financing) being paid to residential homeowners.

II. WHITE HOUSE HOUSING POLICY: RARELY HAVE SO FEW CONTRIBUTED SO MUCH

A. PERCEPTION

Early in the Crisis, the press highlighted the previous decision by HUD to require GSEs to purchase more loans made to subprime borrowers. That perception posits that the GSEs, ignoring the time-honored dictate of Keynesian economics that there is no true liquidity for markets on the whole, contemplated an ever-increasing source of demand (for both homes and CDOs). They were drastically wrong. By late 2009, the public appeared to overwhelming favor a close, watchful eye over the agencies that both prompted the Crisis and later cost so much to prop up.


54. See, e.g., Laurence Grafstein, The Real Banker Boondoggle, NEW REPUBLIC, Sept. 23, 2009, at 23, 22–23. “[W]e can acknowledge that every major commercial and investment bank in the United States faced a direct threat to its insolvency arising from (a) its level of leverage, (b) its interrelationships with other leveraged institutions—’counterparties’—and (c) its reliance on short-term funding from those counterparties.” Id. at 22.

55. Ip & Miller, supra note 29.

56. Leonnig, supra note 13.


59. See Nick Timiraos, U.S. News: Support Grows for Fan-Fred Plan: Proposals to Reshape Mortgage Firms Call for Retaining Public-Private Structure, WALL ST. J., Dec. 14, 2009, at A7 (“A consensus appears to be growing among academics, investors and housing experts that the federal government should retain a role in the U.S. mortgage market over the long term . . . .”).
B. DETAILS

Upon closer inspection, the ground floor of the baleful “own a home at no cost” strategy had been built by the White House about fifteen years before.\textsuperscript{60} Thereafter, a trifecta of U.S. Chief Executives, from both parties, consistently combined to lower the financial thresholds to home ownership.\textsuperscript{61}

In November 1990, President George H.W. Bush signed the Cranston-Gonzalez National Affordable Housing Act (NAHA) designed to, among other things, provide federal assistance to the planning and financing of conversions of public housing projects from private rental to ownership.\textsuperscript{62} Among other things, NAHA:

(1) proposed a $25.5 billion budget for HUD in 1992,\textsuperscript{63}

(2) established a “National Homeownership Trust” within HUD to provide assistance for first time buyers;\textsuperscript{64}

(3) permitted HUD mortgage insurance up to 98.7% of the appraised value of the property;\textsuperscript{65} and

(4) made permanent the maximum single family mortgage loan limit of $124,875.\textsuperscript{66}

Symbolically, NAHA signaled the start of nearly two decades of assistance for those who failed to meet traditional minimal requirements for mortgages:

[NAHA] puts power in the hands of people. First, it authorizes a major administration initiative: Homeownership and Opportunity for People Everywhere, the HOPE Initiative. HOPE will provide new opportunities for low-income families to buy their own homes—urban homesteaders, if you will—and helps the residents of public housing to buy their own units.

\textsuperscript{60} Leonnig, supra note 13; see also Ann Mariano, Panel Rejects Housing Money Transfer; Kemp Requested Funds for HUD’s Ownership, Rental Initiatives, WASH. POST, Mar. 7, 1991, at A7.

\textsuperscript{61} Leonnig, supra note 13.

\textsuperscript{62} Id.


\textsuperscript{64} NAHA § 302 (codified as amended at 42 U.S.C. § 12851 (2006)).

\textsuperscript{65} NAHA § 324 (codified as amended at 12 U.S.C. § 1709(b)(2) (2006)).

\textsuperscript{66} See generally NAHA, tit. III (codified as amended in scattered sections of 12 and 42 U.S.C.).
Tenant management, control and, ultimately, ownership of public housing is an idea whose time has come.67

Several years later, the torch was relayed by President Clinton’s “National Homeownership Strategy.”68 The National Homeownership Strategy “loosened mortgage restrictions” for first time buyers by insuring loans, eliminating the requirements that borrowers either prove prolonged stable income or be interviewed in person, and allowing lenders to hire their own appraisers,69 thus creating the potential for inflated valuations. The ensuing tactics, which utilized such measures from the 1970s as the Community Reinvestment Act70 and the Home Mortgage Disclosure Act,71 furthered these goals by, respectively, encouraging banks to lend to formerly ineligible customers and penalizing/fining banks that refused to lower credit standards.72 Subsequently, in 1995, President Clinton acquiesced to guidelines that would allow GSEs to receive credit for buying “subprime” securities as packaged products of loans creating affordable housing.73

Then in 2003, President George W. Bush signed the Zero-Down Payment Act.74 Addressing the needs of first time buyers of single family dwellings, this law authorized $200 million in assistance with down payments. The results were dramatic: By 2007, 29% of home mortgages were estimated as originating with absolutely no down payment.75

Additionally, in 2004, HUD guidelines were made even more favorable to financially challenged homeowners and purchases rose dramatically.76 Between 2004 and 2006, GSEs purchased $434 billion in securities backed by subprime loans.77 In hindsight, these guidelines served merely as frightening yardsticks, as neither HUD nor the GSEs possessed the capability of filtering the underlying CDO loan data to inspect individual loans.78

69. Id.
73. Leonnig, supra note 13; see also Moran, supra note 68, at 28.
76. Leonnig, supra note 13.
77. Id.
78. Id.
C. COMMENTARY

Despite the persistent attempts by the press and others to pigeonhole the Crisis as the result of overreaching homeowners, it seems facile to link foreclosure statistics to any burgeoning, disastrous desire for upward mobility. Reliance upon credit had been the hallmark of the middle class for decades, and the last eight years arguably adhered to this discernible trend. Between 2002 and 2007, credit card debt in this country increased over 20%. Between 2002 and 2005, personal bankruptcies shot up about 32%, and only ceased its upward trend because of changes in federal law that made bankruptcy discharges more difficult. By 2008, the length of an average car loan was often extended beyond six years, as buyers saddled themselves with additional payments and interest.

More on point, the decision to employ HUD as the financier of, and repository for, new, untested mortgage-related products far predated any watershed presidential choice in or around 2004. More significantly, to order agencies into lesser standards may be politically popular, but from a regulatory standpoint, such moves risk disjointed implementation and unprepared supervision. For example, banking regulation is notoriously fragmented, with no less than five federal entities sharing duties of setting policy, overseeing operations, and enforcing statutes and rules. The collective presumption that these fiefdoms would maintain order during the prolonged festival thus proved fatal.

D. A MILLION NEW GUNS IN A TOWN WITHOUT A SHERIFF

The notion of the Federal Reserve as a strong banking regulator is misplaced. History recalls the system as originating to preserve banks (as

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85. See Morgenson, supra note 52.

86. See SEC, Banking Regulators, http://www.sec.gov/answers/bankreg.htm (last visited Feb. 20, 2010) (listing the five federal banking regulators); see also COHAN, supra note 19, at 19–20, 49–50 (detailing the role of the Office of the Comptroller of the Currency in attempting to discern the financial condition of Bear Stearns in March 2008 and describing the concurrent efforts of the Federal Reserve and the SEC to obtain the same information).
J.P. Morgan himself had done in the Panic of 1907) and continuing as guarantor of the “elevated risk” game.\textsuperscript{87} The Federal Reserve system is notoriously fragmented, comprised of twelve regional Federal banks, which, per the Banking Act of 1913, have nine member boards made up of leaders in the private sector.\textsuperscript{88} It is safe to say that the system was designed foremost to buoy mortgagees, a goal that is assisted by other federal regulators and their regional subdivisions who, in unison, work to facilitate credit to banks.\textsuperscript{89} For example, in the summer of 2007, it was the Atlanta Federal Home Loan Bank Board that extended its line of credit to Countrywide Financial to the tune of $22 billion. From 2003 to the third quarter of 2007, Countrywide’s SEC filings disclosed that its operating cash flow deficits were a cumulative $38 billion, mostly financed from federal loans.\textsuperscript{90} Moreover, the Federal Reserve and Office of Thrift Supervision (OTS), two of the larger bank regulators, rarely bring disciplinary actions and were reportedly encouraged by the George W. Bush Administration to focus on growth.\textsuperscript{91} Indeed, the effectiveness of the Federal Reserve serving in any role as a regulator has been openly questioned.\textsuperscript{92}

The traditional governmental fragmentation and multiple purposes of those fragmented parts resulted in the opportunistic new residential mortgaging business lines falling across one, several, or no lines of federal supervision. As \textit{The Wall Street Journal} reported:

In 2005, 52\% of subprime mortgages were originated by companies with no federal supervision, primarily mortgage brokers and stand alone finance companies. Another 25\% were made by finance companies that are units of bank holding companies and thus indirectly supervised by the Federal Reserve, and 23\% by regulated banks and thrifts.\textsuperscript{93}

\begin{thebibliography}{99}
\bibitem{90}MORRIS, supra note 27, at 154.
\bibitem{91}Ip & Paletta, supra note 25.
\bibitem{92}Regulators appointed by President Bush often have been more sympathetic to industry concerns about red tape than their Clinton administration predecessors. When James Gilleran, a former California banker and bank supervisor, took over the OTS in December 2001, he became known for his deregulatory zeal. At one press event in 2003, several bank regulators held gardening shears to represent their commitment to cut red tape for the industry. Mr. Gilleran brought a chain saw.
\bibitem{93}See KRUGMAN, supra note 18, at 172–74 (“The Fed is set up to do two main things: manage interest rates and, when necessary, provide cash to banks.”).
\end{thebibliography}
A more granular examination of the government’s liberalized home lending programs perhaps only clouds the issue of detecting the precise problem years. HUD statistics for New York households between 1998 and 2008 disclose that assistance to family households of “very low income” increased 5% to 6% percent annually during the decade, with the exception of 11% in the year 2006, 94 a full three years after the passage of the Zero-Down Payment Act. What does seem readily apparent is that, starting in 1990, HUD’s coffers had been generously opened, leading generically to alternative terms of financing and specifically to a nation of home loan intermediaries actively seeking a plethora of mortgagors.95 Not surprisingly, home ownership among the lower income households soared.

The point to be stressed is that various presidents in the last twenty years wielded the power of promising homes to the tenant masses.96 The more complex notion that investment professionals could turn this well-meaning refrain into lucrative portfolios seemingly separated from those home loans would, of course, need the support of more than just an elected official with a potentially short tenure. Thus, the more exacting study may center on the jurists who, during the key years preceding the crisis, helped to formally signal that Washington, D.C. was a friend and not a foe to expansive notions of capitalism.

III. THE JUDICIARY: SOMETHING IN THE AIR . . .

Scant attention has been paid to the role of the federal judiciary in the nation’s current economic woes. While commentators occasionally noted the difficulty in reaching employers and third parties under the Supreme Court’s holding in the Stoneridge Investment Partners v. Scientific-Atlanta, Inc. case,97 overall, cases from last decade affecting the duties of corporate America have largely escaped scrutiny in the national soul-searching that continues into 2010.

To be sure, the aggressively speculative economy, laid bare in late 2008, neither arose in a season nor originated because of one discreet cause. While it may be impossible to delineate the extent to which such an economy takes direction from the courts, what does seem apparent is that the D.C. Circuit Court of Appeals, a critical federal bench, sounded a series

95. Leonnig, supra note 13.
96. See supra notes 60–95 and accompanying text.
of harmonious notes in the laissez-faire symphony between the years 2003 and 2008.  

A. BACKGROUND – SOME NEW LIMITS ON AN OLD FRIEND TO INVESTORS

In July 2003, a number of securities class actions simultaneously met their dismissal in the District Court for the Southern District of New York.99 Riding on the tail of the monumental “Global Settlement” concluded by then New York Attorney General Eliot Spitzer, the actions sought damages from highly compensated brokerage firm analysts accused of tainting their research in favor of issuers sought by firms.100 The Southern District of New York’s decision rested upon a strict reading of privity, essentially holding that an analyst could not be liable to a stranger.101 The decision marked a new period of strict construction for SEC Rule 10b-5,102 the elastic anti-fraud prohibition outlawing everything from internet securities fraud to insider trading.

The Supreme Court took up the cause of limiting Rule 10b-5 via a number of key decisions between 2005 and 2008. In Dura Pharmaceuticals, Inc. v. Broudo, the Court limited the types of defendants that could be sued in securities class actions.103 In Merrill Lynch v. Dabit,104 the court broke with precedent in accepting a broad definition of securities “purchaser” for purposes of removing a class action against Merrill Lynch to federal court where it could more readily be dismissed under the Uniform Standards Act of 1998.105 As previously noted, also in 2008, the Supreme Court precluded “scheme liability” in private securities actions based upon Rule 10b-5 in Stoneridge.106

Apart from constrictive interpretations of securities fraud cases, the Supreme Court also helped to conserve business assets by limiting penalties. Specifically, in Exxon Shipping Co. v. Baker, the Court

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98. Fin. Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006).
101. See In re Merrill Lynch Co. Research Rep. Sec. Litig., 272 F. Supp. 2d at 262 (“Merrill Lynch and the Fund are not the insurers of Plaintiff’s investment in a highly speculative sector of the market where the omissions complained of are not adequately alleged to have been the proximate cause of the loss.”).
drastically reduced punitive damages in the longstanding dispute over the oil company’s devastating spill in Alaska. 107 Most noteworthy, successful attacks in the D.C. Circuit on the very authority of the SEC to demarcate lines of corporate responsibility put the Commission’s legislative authority under slow but consistent siege. 108

**B. THE LIMITS ON SEC RULEMAKING**

A closer inspection of the decisions of three key circuits within the last decade reveals a curious about-face in a region traditionally favoring regulation. Specifically, while cordial deference to Commission rulemaking has been consistently exhibited in the Second 109 and Ninth Circuits, 110 in the *Goldstein v. SEC* (2006), 111 *Chamber of Commerce v. SEC* (2006), 112 and *Financial Planners v. SEC* (2007) 113 decisions, the D.C. Circuit Court of Appeals dealt rare victories to market voices challenging SEC hegemony. In fact, these unrelated, but equally bold rulings, can be said to have both tilted the battle for business opposition to regulation and helped create the excessively entrepreneurial philosophy now blamed for Wall Street’s myopic risk-taking.

1. *Goldstein (2006)*

In late 2004, the SEC announced its “hedge fund rule,” which required advisers to hedge funds with (1) $30 million in assets and (2) fifteen or more investors, to register with the Commission. 114 Thus, this Rule would have the effect of bringing subject hedge funds onto the SEC radar screen. 115 The Rule, which had been passed on a 3-2, partisan vote among

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109. *See, e.g.*, Schiller v. Tower Semiconductor Ltd., 449 F.3d 286, 302 (2d Cir. 2006) (upholding SEC Rule 3a12-3 by finding that Commission notices and the rule itself satisfied the required “adequate statement of basis and purpose” set forth by § 553 of the Administrative Procedure Act); Gryl ex rel. Shire Pharm. Group PLC v. Shire Pharm. Group PLD, 298 F.3d 136, 145 (2d Cir. 2002) (“[W]e must defer to the SEC’s interpretations of its own regulations in its amicus briefs unless they are plainly erroneous or inconsistent with the regulations.”); *United States v. Cusimano*, 123 F.3d 83, 88 (2d Cir. 1997) ([W]e note that in *O’Hagan* the Supreme Court held, as this Court had held previously, that [SEC] Rule 14e-3 was a valid exercise of the SEC’s rulemaking authority.”) (citation omitted).
110. *See, e.g.*, Dreiling v. Am. Express Co., 458 F.3d 942, 949 (9th Cir. 2006) (finding the creation of SEC Rule 16b-3(d), setting forth three exemptions from the Securities Exchange Act Section 16(b) reporting requirements, was a similar valid exercise); Meyers v. Merrill Lynch & Co., 249 F.3d 1087, 1088 (9th Cir. 2001) (upholding Regulation M as a proper exercise of SEC rulemaking authority).
111. *Goldstein*, 451 F.3d at 884.
112. *Chamber of Commerce*, 443 F.3d at 909.
113. *Fin. Planning Ass’n*, 482 F.3d 481.
115. *See id.*
SEC Commissioners,116 centered on an expanded definition of “clients” advised by the firm. Traditionally, if the number of such clients (or groups of clients) was fifteen or less, no registration was required.117 Petitioners, a hedge fund and investment firm, took issue with the new definition, and the D.C. Circuit Court agreed.118

The D.C. Circuit Court’s criticisms of the SEC stance ranged widely. Noting that the term “hedge fund” had never been adequately defined,119 and that the Rule appeared to be a direct response to the press generated by the failure of notorious Long-Term Capital management,120 the court suggested that the SEC, by seeking to compel registration of individuals affiliated with entities traditionally exempted by both the Investment Advisers Act (IA Act) and the Investment Company Act, had departed from the statutes.121

Additionally, the court’s analysis seized upon the comments of the two SEC dissenter to the Rule’s adoption.122 Ultimately finding the hedge fund rule to be capricious, the court concluded that the, “Commission’s rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the [IA] Act. This is an arbitrary rule.”123

The unanimous court thus struck down the hedge fund rule more than eighteen months after its issuance,124 leaving those hedge funds that had duly registered with the option of continued registered status.125 More globally, a trillion dollar industry which had been publicly faulted for a lack of supervision,126 was left unsure of regulatory expectations either at the government or customer level.

116. See id. at 72,089 (Comm’rs Glassman and Atkins, dissenting).
117. See id. at 72,054.
119. Id. at 874–75 (“The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition.”).
120. Id. at 877.
122. Goldstein, 451 F.3d. at 878.
123. Id. at 884.
124. Id.
125. See Floyd Norris, Court Says S.E.C. Lacks Authority on Hedge Funds, N.Y. TIMES, June 24, 2006, at A1 (noting that “nearly 1,000” hedge fund advisors had registered with the SEC as required by the stricken rule).
126. See, e.g., Dale Oesterle, J. Gilbert Reese Chair in Contract Law at Moritz College of Law, Ohio State University, & David Skeel, S. Samuel Arshl Professor of Corporate Law at the University of Pennsylvania Law School, Debate on Legalaffairs.org: Should Hedge Funds be Regulated (Nov. 8–11, 2005), available at http://www.legalaffairs.org/webexclusive/debateclub_hedgefunds1105.msp.

The same year as *Goldstein*, the Chamber of Commerce (the Chamber), the industry group traditionally speaking for corporate management,\(^{127}\) launched its second challenge in as many years at SEC authority. In *Chamber of Commerce v. SEC*, the famed trade association took aim at the Commission’s response to trading scandals that had tarnished the traditionally non-controversial mutual fund industry.\(^{128}\)

Specifically, the Chamber took issue with the SEC’s revamped “investment company governance” rule\(^{129}\) where it required that (1) the board Chair at all mutual funds be independent of the fund’s adviser, and (2) 75% of the mutual fund board be independent of the fund adviser.\(^{130}\) The Chamber’s three-pronged attack alleged that the SEC (1) had exceeded its rulemaking authority under the IA Act,\(^ {131}\) (2) had offered no justification for the changes, and (3) had failed to abide by § 553 of the Administrative Procedure Act\(^{132}\) in promulgating the amendments.\(^{133}\)

The last argument was adopted by the D.C. Circuit, which, in elevating such details as cost estimates and the recordkeeping attending SEC rulemaking, stated the following:

In sum, the combination of circumstances—inadequate notice that the Commission would base its cost estimates for the two conditions on ‘publicly available’ extra-record materials on which it did not typically rely in rulemakings; the Commission’s acknowledgement that the rulemaking record contained gaps and did not include reliable cost data; the availability of additional implementation data for the period between the close of the rulemaking record and the Commission’s response to *Chamber I* as more funds adopted the conditions; the Chamber’s colorable claim that the Commission’s failure to consider such implementation data harms its investment choices—suffices to show that the Chamber has been prejudiced by the Commission’s reliance on materials not in, nor merely ‘supplementary’ to, the rulemaking record.\(^ {134}\)

By focusing on the mechanics of the process, the D.C. Circuit Court thus vacated the two new conditions implemented by the SEC (i.e., 75%
outside directors and an independent director). 135 The financial services industry thus saw the nearly sacrosanct imprimatur of Commission rulemaking again sullied, and the mutual fund industry returned largely to its prior management protocols.


The next year, Financial Planners Association, the umbrella group for the nation’s investment advisors, successfully challenged the Commission’s rulemaking. 136 Again the D.C. Circuit proved inhospitable to SEC claims, albeit, this time, its written decision spoke more directly to agency legislative authority. 137

For decades, the securities industry, home to both registered “broker-dealers” and the more heavily regulated “investment advisors,” had operated under the SEC guidance that the two groups were separated by considerations of compensation. 138 The traditional dividing line was cemented in 2005 via an SEC rule 139 serving as a minefield for brokers wishing to avoid becoming subject to the IA Act.

The Financial Planners Association challenged the 2005 codification as discriminatory in that its constituency was being held to a higher legal standard despite the inroads upon its services being made by broker-dealers and the accompanying expansion of the traditional notion of “merely incidental” investment advice. 140 In vacating the rule, the D.C. Circuit (by 2-1 vote) held that the statutory language was clear on the topic of exemptions, that the SEC rule was in direct conflict with Congressional intent, and that IA Act subsection (f) was “not a catch-all that authorizes the SEC to rewrite the statute.” 141

The fallout from the decision was considerable. Countless brokerage accounts treated by firms as outside of the dictates of the IA Act faced reclassification, while their handlers faced uncertainty, at best, and

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135. Id. at 909.
136. Fin. Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).
137. Id.
140. Fin. Planning Ass’n, 482 F.3d at 484–85.
141. Id. at 491.
violations, at worst.\textsuperscript{142} The industry’s immediate response was to clamor, unsuccessfully, for the SEC to request a rehearing before the D.C. Circuit.\textsuperscript{143} The long term strategy focused on interim Commission relief to ease the transition from compliance with one law to two.\textsuperscript{144}

\section*{C. MESSAGE AND AFTERMATH}

Thus, in the years that the market engines were revving to unprecedented calibrations, and its chief drivers speeding with an unfathomable amount of gas, the message from the circuit housing the SECs headquarters was clear: Even in expertised matters generally enjoying deference, the agency’s rulemaking is not always legal.\textsuperscript{145} Such ciphers would be mildly dangerous in quiet times; while the market was overextending itself through “toxic” vehicles, they were outright crucial.

As 2010 unfolds, courts occasionally remind observers that the judiciary shall play a role in the resolution of the economic crisis.\textsuperscript{146} However, such considerations of courthouse rebuke may still be a distant second to an examination of the laws written, rewritten, or modified between 1999 and 2002.

\section*{IV. CONGRESS: WHERE LAWS, BAILOUTS, AND MELTDOWNS ARE MADE}

\section*{A. PERCEPTIONS}

A critically popular 2009 film documentary cataloguing the woes of subprime mortgagors commenced with this provocative summary:

To understand why this [market] is like a gambling casino, you have to understand what’s at stake here. On a December evening, December 15,


\textsuperscript{144} Letter from Ira D. Hammerman, Senior Managing Dir. and Gen. Counsel, SIFMA, to Nancy M. Morris, Sec’y, SEC (Nov. 30, 2007), http://www.sifma.org/regulatory/comment_letters/59130958.pdf.

\textsuperscript{145} See generally Fin. Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006).

\textsuperscript{146} See, e.g., Mark Fass, Judge Slashes ‘Fat Cat’ Bank’s Bill for Subpoenaed Documents, N.Y.L.J., Dec. 28, 2009, available at http://www.law.com/jsp/article.jsp?id=1202437287242 (describing the rejection by a Brooklyn, New York, judge of the request by a third party (JPMorgan Chase) for reimbursement of costs attending document production in a case centering on the confirmation of an arbitration award). The judge, noting the President’s reference to “fat cat bankers” during a recent interview on television’s 60 Minutes, wrote “[t]his Court is not a collection vehicle to further enrich already rich bankers.”\textsuperscript{Id.}
2000, around seven o’clock, Phil Gramm, Republican Senator of Texas, then chair of the Senate Finance Committee, walked to the floor of the Senate and introduced a 262 page bill - as a rider to the 11,000 page appropriation bill - which excluded from regulation the financial instruments that are probably most at the heart of the present meltdown.

He not only excluded them from all federal regulation, but he excluded them from state regulation as well, which is important because these instruments could be viewed to be gambling instruments, where you’re betting on whether people will or will not pay off their loans. And he announced at the time that this measure would be a boom to the American economy, and be a boom to Wall Street, because they would be freed of any supervision in this regard. And that lack of supervision freed Wall Street to essentially shoot itself in both feet.\(^{147}\)

The referenced vehicles are known as credit default swaps (CDS), which are non-exchange traded, counterparty agreements which allow the transfer of credit risk from one sophisticated party to another.\(^{148}\) A somewhat novel derivative, the CDS does not fall within the jurisdiction of any relevant federal regulator.\(^{149}\) Indeed, the term itself, “credit derivative,” occasionally invites skepticism. As a noted journalist has written, credit derivatives “are fashioned privately and beyond the ken of regulators—sometimes even beyond the understanding of executives peddling them.”\(^{150}\) These private insurance agreements grew in popularity as nearly unfathomable amounts of investment bank inventory were filled with CDOs, defined generically as asset-backed securities, which were “backed by a pool of bonds, loans, and other assets.”\(^{151}\) Amorphous and ill-understood, the CDO, unlike the CDS, has fallen squarely within SEC jurisdiction as a “security.”\(^{152}\)

\(^{147}\) AMERICAN CASINO (Table Rock Films and Argot Pictures 2009) (quoting Michael Greenberg, Director for Trading and Markets, Commodity Futures Trading Commission) (emphasis added).

\(^{148}\) See generally Credit Default Swap, Investopedia, http://www.investopedia.com/terms/c/creditdefaultswap.asp (last visited Feb. 28, 2010); see also AMERICAN CASINO, supra note 147.


\(^{150}\) Morgenson, supra note 52.

\(^{151}\) JACK GUINAN, THE INVESTOPEDIA GUIDE TO WALL SPEAK: THE TERMS YOU NEED TO KNOW TO TALK LIKE CRAMER, THINK LIKE SOROS, AND BUY LIKE BUFFET (2009); see also SORKIN, supra note 21, at 89–90. Notably, longtime Federal Reserve Chairman Alan Greenspan was quoted as follows:

“I’ve got some fairly heavy background in mathematics,” . . . . “But some of the complexities of some of the instruments that were going into CDOs bewilders me. I didn’t understand what they were doing or how they actually got the types of returns out of the mezzanines and the various tranches of the CDO that they did.”\(^{152}\)

SORKIN, supra note 21, at 90 (quoting Federal Reserve Chairman Alan Greenspan).

Less amorphous is the regulatory zeal with which powerful market regulators embraced the creativity of the private sector to fashion these investments. It has been aptly documented that former Federal Reserve Chairman Alan Greenspan ideologically opposed regulation of credit derivatives.\footnote{153} In the late 1990s, as the SEC gained moderate, indirect ground by requiring that firms include “quantitative disclosure of market risks” in financial statements,\footnote{154} the drive at other agencies to inspire exposure did not lose steam. At a speech in Florida in March 1999, Greenspan openly exhorted the market utility of credit derivatives:

By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives . . . . The fact that [over-the-counter (OTC)] markets function quite effectively without the benefits of [CFTC (Commodity Futures Trading Commission) regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives . . . . These new financial instruments . . . enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it. This unbundling improves the ability of the market to engender a set of product and asset prices far more calibrated to the value preferences of consumers . . . .\footnote{155}

**B. THE LAW**

The ensuing Commodity Futures Modernization Act of 2000 (CFMA)\footnote{156} included various sections aimed at exempting OTC derivatives dealers from CFTC jurisdiction. The most direct of these sections reads as follows:

SEC. 103. LEGAL CERTAINTY FOR EXCLUDED DERIVATIVE TRANSACTIONS.

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\footnote{154}{See Joe Nocera, \textit{Risk Management: Were the Measures Used to Evaluate Wall Street Trades Flawed? Or was the Mistake Ignoring Them?}, \textit{N.Y. TIMES MAG.}, Jan. 4, 2009, at 26.}

\footnote{155}{TETR, \textit{supra} note 1\textsuperscript{Error! Bookmark not defined.}, at 75 (quoting a March 1999 speech by Fed Chairman, Alan Greenspan) (internal quotations omitted).}

Section 2 of the Commodity Exchange Act (7 U.S.C. 2, 2a, 3, 4, 4a) is further amended by adding the following to the end:

(d) EXCLUDED DERIVATIVE TRANSACTIONS.—

(1) IN GENERAL—Nothing in this Act...governs or applies to an agreement, contract, or transaction in an excluded commodity if—

(A) the agreement, contract, or transaction is entered into only between persons that are eligible contract participants at the time at which the persons enter into the agreement, contract, or transaction; and

(B) the agreement, contract, or transaction is not executed or traded on a trading facility.

(2) ELECTRONIC TRADING FACILITY EXCLUSION.—Nothing in this Act...governs or applies to an agreement, contract, or transaction in an excluded commodity if—

(A) the agreement, contract, or transaction is entered into on a principal-to-principal basis between parties trading for their own accounts or as described in section 1a(12)(B)(ii);

...;

(C) the agreement, contract, or transaction is executed or traded on an electronic trading facility.157

When combined with definitions found in § 105 and § 106 of the CFMA,158 the above provisions succeeded in exempting from the definition of futures (and thus, CFTC examination) OTC derivative transactions between sophisticated parties, away from a stock exchange—a category that would later become synonymous with credit default swaps.159 Separate modifications to the two primary securities laws were designed to erase the SEC from the equation.160

Among the authorities not altered by the CFMA were: (1) banking jurisdiction, (2) SEC fraud jurisdiction, and (3) extraterritorial reach (which


158. CFMA § 105, 7 U.S.C. §§ 2–4a (2006); CFMA § 106, 7 U.S.C. §§ 2–4a; see also infra note 180 and accompanying text.


160. See infra note 163 and accompanying text.
was nonexistent both before and after the CFMA). As has been also noted, the exclusion, albeit the incarnation of Greenspan’s dreams, nonetheless successfully precluded oversight of the new vehicles by any single regulator. Professor John Coffee of Columbia University School of Law later testified that the CFMA achieved its goals:

In my judgment, the [current energy derivative] Amendment does not “undo” the desirable legal certainty that the CFMA created. The original uncertainty that led up to the CFMA arose because both the SEC and the CFTC could dispute whether a complex derivatives transaction was more like a futures contract (in which case the CFTC had jurisdiction) or more like an option (in which case the SEC arguably had jurisdiction). Nothing in the . . . Amendment will change the fact that the SEC is now totally out of the picture, as the CFMA amended both the Securities Act of 1933 and the Securities Exchange Act of 193[4] to deny the SEC any authority over OTC derivatives (financial and non-financial).

C. COMMENTARY

Freed from the oversight of both the SEC and the CFTC, market players thus embarked on a course of internecine capitalism. The largest investment houses over-leveraged themselves by stockpiling CDOs, while having the risk of such ventures cushioned through reliance on [unregulated] CDS agreements with third parties.

But the populist view, that any emphasis in the CFMA on imposing legal certainty was subordinated to commercial interests, supposes three things: (1) that derivative businesses sprung up after the CFMA; (2) that SEC and CFTC examiners, if given the chance, would have been able to timely intervene; and (3) that anyone was capable of understanding the exotic instruments at issue. Sources indicate that nary one of these suppositions is reliable.

First, the CFTC crusades to gain sovereignty over the swaps market had repeatedly fallen short in the past. Perhaps overshadowed by a larger, ongoing debate concerning sovereignty over futures, regulation of swaps

162. TETT, supra note 1, at 75 (quoting a lobbyist as declaring that “Congress nailed the door shut in 2000 [on unified regulation], with the passage of the Commodities Futures Modernization Act”).
164. See SORKIN, supra note 21, at 14–15, 156–58.
165. See infra notes 166–90, 205 and accompanying text.
ultimately fell irreparably behind the market, forcing Congress’ hand in 2000 in adopting any feasible measure to address the issue.

Second, the CFMA was hardly a one-sided law. What is often overlooked is the fact that Congress simultaneously (and somewhat inexplicably) expanded the express scope of § 10(b) of the Securities Exchange Act to cover the newly exempted, non-security. Thus, the CDS, while not subject to registration or routine examination, could be the subject of a fraud case. The Commission routinely relies on such cases to deter deleterious market behavior by professionals not subject to registration requirements.

Concurrently, the courts have not blindly applied the CFMA’s blanket exemption. The most frequently cited (and pointed) example is Caiola v. Citibank, N.A., a Second Circuit decision from 2002. In that case, a sophisticated individual specializing in the trading of Philip Morris Co. stock, engaged in synthetic option transactions to offset equity swap agreements. The complex arrangement was motivated by the desire to shield the size of the plaintiff’s positions from the market in general. The defendant bank was alleged to have, at some point, secretly countered the complicated plan by effecting large trades that mirrored the plaintiff’s synthetic transactions.


167. See TETT, supra note 1, at 23–27 (describing, among other things, applicability of outdated “Basel I” banking standards to those engaging in derivatives).

168. The Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338, added the following section to Section 10(b) of the Securities Exchange Act:

\[
\text{Rules promulgated under subsection (b) . . . that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading, and judicial precedents decided under subsection (b) . . . and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section [17(a)] of [the Securities Act of 1933] and sections [9, 15, 16, 20 and 21A] . . . and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.}
\]


171. Id. at 315.

172. Id. at 317.

173. COX ET AL., supra note 161, at 81–84.
The Second Circuit, adhering to the text of the CFMA only insofar as the effective date of the Act and its exemption were concerned, effectively confirmed the uncertainty surrounding application of the securities laws to the exotic products both prior to and after 2000. Finding Caiola’s equity swaps from the late 1990s were not securities (and thus not subject to Rule 10b-5), the court simultaneously concluded, “[h]ad Caiola entered into his synthetic stock transactions after the enactment of the CFMA, they clearly would now be covered under Rule 10b-5” pursuant to the statutory exemption. 175

Moreover, the court simultaneously found the synthetic options to fall within the statutory definitions of securities. 176 Ruling contrary to some federal court precedent, 177 the Second Circuit rejected Citibank’s contention that only an option on a security would be covered by the law, and “not an option based on the value of a security.” 178 Relying upon the language of § 3(a)(10) of the Securities Exchange Act, the court answered the question of “whether a cash-settled over-the-counter option on Philip Morris Stock similar to options commonly traded on the market” was a security in the affirmative. 179

This result is disturbing at best, for applicable § 206 of Gramm-Leach-Bliley Act (GLBA) had expressly defined “swap agreements” to include options “based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to” securities or other assets. 180 Regardless, the end result was that the plaintiff—who was found to have hedged non-security swap agreements with security over-the-counter options—earned a reversal of the dismissal of his complaint and his day in court, despite the contrary goal of the CFMA. 181

Separately and subsequently, the Second Circuit in 2009 both animated the CFMA and reminded observers of one of its purposes in SEC v. Rorech. 182 In that insider trading case, the U.S. District Court for the Southern District of New York refused to grant judgment for the defendants on jurisdictional issues, noting:

In 2000, Congress passed the [CFMA], which amended § 10(b) to extend the rules promulgated by the SEC under § 10(b) to prohibit fraud, manipulation, and insider trading (but not the SEC’s prophylactic reporting requirements), and judicial precedents decided under § 10(b), to

174. Caiola, 295 F.3d at 331.
175. Id. at 327.
176. Id. at 324.
178. Caiola, 295 F.3d at 325.
179. Id. at 325–26.
“security-based swap agreement[s] (as defined in § 206B of the [GLBA]). . . .

. . .

. . .

. . . In this case, the face of the contracts does not reveal whether a material term of the CDS was based on a security. . . . In any event, it cannot be that traders can escape the ambit of § 10(b) and Rule 10b-5 by basing a CDS’s material term on a security, but simply omitting reference to the security from the text of the CDS contract.183

The decision also cited a separate Southern District of New York case for the premise that the “economic reality” of the instruments and the public’s expectations of their nature” govern definitional debates.184 Thus, a key circuit in the battle against securities fraud has on several occasions subjugated the CFMA to larger notions, thus jeopardizing that legislation’s legacy as a purely pro-business advancement.185

Third, it has always been within the authority of both the SEC and CFTC to expand their respective jurisdictions to examine exotic products.186 An example of this can be seen in the March 2008 accord between the two agencies, hastily drawn in response to calls from the Treasury Department to merge the dueling entities. That agreement contained “specific principles to guide future consideration of novel products, with the goal of reviewing product filings expeditiously, providing legal certainty for participants, encouraging market neutrality and choice, and enhancing innovation and competitive growth.”187 In short, the overriding goals of the CFMA could be met at any time with two strokes of agency pens.

Likewise, it bears noting that, even post-catastrophe, a consensus could not be reached that the SEC and CFTC should be merged to end turf wars and solidify jurisdiction. Although the goal was prioritized by the “Treasury

183. Id. at *4–5. But see Sch. Dist. of Erie v. J.P. Morgan Chase Bank, No. 08 CV 07892, 2009 WL 234128, at *1 (S.D.N.Y. Jan. 30, 2009) (finding a swap to not be “security-based” for purposes of §10(b) and Rule 10b-5 because the “only material term” was the floating interest rate based upon the London Interbank Offered Rate).


185. See Caiola, 295 F.3d 312; see also Rorech, 2009 WL 4729921. Class action attorneys have filed federal class action lawsuits alleging violations relating to CDS portfolios. See, e.g., Class Action Complaint at 2, Jacksonville Police & Fire Pension Fund v. Am. Int’l Group, Inc., No. 1:08 Civ. 04772, 2008 WL 2196366 (S.D.N.Y. May 21, 2008) (alleging that the insurer improperly represented the status and health of its CDS portfolio).


187. Id.
Blueprint" for regulatory reform released by the Department of the Treasury in March 2008, the idea fell out of favor in the successor administration as political forces acknowledged that historically distinct Congressional committees would not accede to a loss of oversight power. Simply put, if the turf war between securities and commodities regulators were truly to blame for billions in losses, it would have been remedied by now.

Thus, the perception that the CFMA opened the floodgates to unregulated products is, at best, simplistic. The more edifying examination might then be a study of the GLBA.

D. GRAMM-LEACH-BLILEY ACT

Amidst a relatively tranquil bull market, and a growing concern of foreign competition, Congress moved in the waning months of the Clinton administration to eradicate the last barrier to financial entity consolidation, the Glass-Steagall Act. The barrier had been erected by § 20 of the Glass-Steagall Act which, for over 60 years, forbade affiliation in any manner between a bank and any “organization engaged principally in the issue, flotation, underwriting, public sale, or distribution” of securities.

Exceptions of the statutory, administrative, and judicial nature had reduced the barrier to something less than absolute. Namely, § 16 of Glass-Steagall expressly permitted banks of the 1930s to continue to buy and sell securities “solely upon the order, and for the account of, customers.” Also, litigation later clarified that banks could purchase brokerages that provided only “incidental services” to customers (i.e., that did not render investment advice). Most importantly, government agency guidelines established that bank ownership of securities, capped by a percentage threshold, was permissible.

188. See TREASURY BLUEPRINT, supra note 166, at 11–13.
192. Id. § 20.
193. Id. § 16.
195. See Revenue Limit on Bank-Ineligible Activities of the Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750-01 (Dec. 30, 1996) (amending the interpretation of “engaged principally” as stated in Section 20 of the Banking Act of 1933 to increase “from 10 percent to 25 percent the amount of total revenue that a nonbank subsidiary of a bank holding company . . . may derive from underwriting and dealing in securities . . . “)); see also Frontline: The Wall Street Fix (PBS television broadcast May 8, 2003).
Nonetheless, perhaps primarily as a symbolic gesture, Congress removed all technical barriers to conglomeration. 196 Later on, the statute clarified the presumed breadth of the term “financial” activities by, among others:

I think it’s pretty clear to say that [Citigroup CEO] Sandy Weill forced the hand of Congress. I think it’s equally clear to say that the Fed forced the hand of Congress to do something that they knew full well could not be done. What they said was, ‘At the end of two years, if [Glass-Steagall was not repealed], you [Sandy Weill] will have to disgorge.’ But everyone up here said, ‘Oh my. We can’t do that to our dear friend Sandy Weill.’


196. The operative language of the GLBA, which amended Section 4 of the Bank Holding Act of 1956, reads as follows:

**SEC. 103. Financial Activities**

(a) In general.—Section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1843) is amended by adding at the end the following new subsections:

(k) Engaging in Activities That Are Financial in Nature.—

(1) IN GENERAL.—Notwithstanding subsection (a), a financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the Board, in accordance with paragraph (2), determines (by regulation or order)–

(A) to be financial in nature or incidental to such financial activity; or

(B) is complimentary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally . . . .

    . . .

    . . .

(5) ACTIONS REQUIRED.—

(A) IN GENERAL.—The Board shall, by regulation or order, define, consistent with the purposes of this Act, the activities described in subparagraph (B) as financial in nature, and the extent to which such activities are financial in nature or incidental to a financial activity.

(B) ACTIVITIES.—The activities described in this subparagraph are as follows:

    (i) Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities.

    (ii) Providing any device or other instrumentality for transferring money or other financial assets.

    (iii) Arranging, effecting, or facilitating financial transactions for the account of third parties. . . .

other things, authorizing the Federal Reserve Board to permit banks’ involvement with “[l]ending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities,” 197 “[p]roviding any device or other instrumentality for transferring money or other financial assets,” 198 and “[a]rranging, effecting, or facilitating financial transactions for the account of third parties.” 199

The authority to exempt was thus detailed and replete, and the passage of the law invited universal praise. The press reported that the bill had passed easily and constituted “one of the most significant achievements this year by the White House and the Republicans leading the 106th Congress.” 200 Likewise, Treasury Secretary Lawrence Summers was quoted as saying that the “historic legislation” would “better enable American companies to compete in the new economy.” 201

E. COMMENTARY

Critics of the allocation of blame to the GLBA note that, while the act did formally repeal Glass-Steagall, it was well known within financial circles that the 1987 appointment of Alan Greenspan as Federal Reserve Chairman signaled a move away from the artificial distinctions between commercial and investment banks. 202 Further, a defense of the GLBA has surfaced. This position asserts that, even with the benefit of hindsight, the law is laudable because it has permitted floundering investment banks to continue as commercial banks. 203

What appears undeniable, however, is that the GLBA publicly raised the stakes; the law created a financial world where the largest players had to engage in the most speculative strategies to compete. As one award-winning financial journalist summarized:

The repeal of Glass-Steagall legitimized the concept of combining commercial and investment banking to construct ‘one-stop-shopping’ empires, and many more mergers quickly followed, not just across different sectors of finance but across national borders, too. The formerly stodgy German commercial lender Deutsche Bank announced that it was purchasing the freewheeling Bankers Trust. Deutsche also hired a large chunk of Merrill Lynch’s former trading group, tasking them with creating a derivatives business. Credit Suisse, the once-dull Swiss group, grabbed DLJ, another American broker. The industry was rapidly adjusting to a

197. Id.
198. Id.
199. Id.
201. Id.
203. Id.
new reality that banks needed to be big and offer a full range of services in order to compete at all.\footnote{204}{TETT, supra note 1, at 73.}

Most importantly, the resulting data is unavoidable. Lehman Brothers, in efforts to transform itself from a “second-tier bond trading shop into a full-service investment bank,” took sizeable real estate positions on to its balance sheets (resulting in short-lived but significant profits in years such as 2006).\footnote{205}{Leonard, supra note 20.} Between 2007 and 2008, Lehman raced from twenty-five times leveraged to thirty-five times leveraged.\footnote{206}{COHAN, supra note 19, at 1.} The ensuing market demise has been sublime: A company whose stock traded over $80 a share in 2007 has seen the price ride under $1 a share since mid-September 2008.\footnote{207}{See the company’s historical stock quotes at MarketWatch.com, Lehman Bros. Historical Stock Quotes, http://www.marketwatch.com/investing/stock/LEHMQ (last visited Feb. 25, 2009).} Overall, euphoric visions of rising to the level of a multi-service financial power led the 158-year old firm, like other entities, to hazardously ratchet up its asset-debt ratio to precipitate its own ruin.\footnote{208}{In September 2008, Lehman Brothers filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. See Press Release, Lehman Brothers, Holdings Inc. Announces it Intends to File Chapter 11 Bankruptcy Petition; No Other Lehman Brothers’ U.S. Subsidiaries or Affiliates, Including its Broker-Dealer and Investment Management Subsidiaries, are Included in the Filing (Sept. 15, 2008), http://www.lehman.com/press/pdf_2008/091508_lbh_announce.pdf. Various authors, journalists and critics have posed the unanswered question as to why that entity did not receive a government bailout. See, e.g., Morgenson, supra note 52 (referencing the federal officials who “let Lehman die”).}

AIG remains the most illustrative case in point. The enormous CDS business attributed to that troubled giant was housed in a London subsidiary titled “AIG Financial Products” (AIGFP).\footnote{209}{Morgenson, supra note 52.} AIGFP dates from the late 1990s and is not subject to the jurisdiction of the SEC or any insurance regulator. Most tellingly, since 2004 (i.e., post-GLBA), it has been overseen by the OTS.\footnote{210}{Id.} Such a line of supervision seems obtuse in that, based upon a CDS portfolio of approximately $500 billion, the subsidiary generated $250 million in annual\textit{insurance premiums} by 2007.\footnote{211}{Id.}

\section*{F. AFTERMATH}

In the wake of the Crisis, a wide variety of pending federal remedies attested to the quantifiable change in Congressional mood, as well as the diversity and specificity of that deliberative body’s interest, once adequately provoked. Bills introduced in 2008 and 2009 would have mandated shareholder say in corporate governance,\footnote{212}{Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009).} reinstated the stock exchanges’
“uptick rule” abolished by the SEC in 2007, imposed uniform requirements on mortgage loan originators, legislated registration of hedge funds, expanded the prosecutorial authority of the SEC, created a “systemic risk monitor” to oversee all markets, or clarified the regulation of credit default swaps.

Such legislative solutions offered by the nation’s highest deliberative body may best signal that effective regulation was always within Washington’s grasp. Stated bluntly, there would likely be no AIG bailout in 2008 or 2009 but for the GLBA eradication of business restrictions imposed after the Great Depression in the absence of replacement safeguards.

There is a postscript on the deleterious effects of the GLBA. While it was to be expected that established entities would increase their presence in other markets, the GLBA also created a new type of company on the regulatory scorecard, the Financial Holding Company. Certain of these entities would fall through the cracks of existing lines of federal supervision, leading to one of the most embarrassing of SEC failures in recent years.

V. THE SECURITIES AND EXCHANGE COMMISSION: DECISIONS TOO WEAK TO DEFEND?

A. PERCEPTIONS

The negative perceptions of the SEC seemed to have coalesced in the nation’s recent, trying times. An under-funded and generally inept SEC failed to foresee the dangers in the growing use of leverage and the dramatic alterations in industry relationships. Further, acquiescence to the White House’s conservative views on regulation under George W. Bush

endangered market participants. The dangers hit home when the Madoff scandal broke and it was manifestly clear that red flags had been ignored. As a result, the agency that so often boasted of serving as “the investor’s advocate,” celebrated its 75th birthday by fighting to justify its existence.

Indeed, the perception has been perpetuated, somewhat, by the Commission’s post-President Bush management, which has repeatedly cited growing obligations and scarcity of Congressional funding as largely to blame for the inefficiencies of recent years. As cited by current SEC Chairwoman Mary Schapiro, during the most critical years of the Crisis, the Commission saw its modest staff of approximately 3600 employees reduced by 10%, a decline attributed to “several years of flat or declining budgets.” As has been concurrently noted, even before the agency assumes any proposed registration responsibilities for hedge funds and private equity firms, it already oversees 12,000 public companies; 4600 mutual funds; 11,300 investment advisers; and 5500 broker-dealers. Further, the budgetary defense for the agency’s failures has thus, at times, resulted first and foremost in a polarized debate between Congress and Commission officials, resulting in the delay of significant reform.

**B. DETAILS**

But staffing and budgets in the years 2005-2008 do not appear as stultifying as Commission officials may claim. The SEC’s own numbers, as evidenced in its annual *Performance and Accountability Reports* for 2005 and 2008, showed that when compared to 2005, the SEC was more successful in 2008 for obtaining Enforcement results (92% vs. 91%), reducing the time necessary to review corporate filings (25.2 days vs. 26.1 days), and increasing the percentage of timely resolved Self Regulatory Organizations (SROs) rule filings (86% v. 80%). In addition, the percentage of investment adviser and mutual funds registrants examined in 2008 remained the same as in 2005 (14%). Moreover, while the Commission...
may have continued to evidence its traditionally high attrition rate among employees there was no departmental collapse, as the multi-purposed, widespread structure of the agency remains intact. Further, the Commission is quick to tout its prompt, dedicated responses to the Crisis, all of which belies any budgetary paralysis.

Separately, while the journalistic trend is to lampoon the efforts of the SEC to follow leads or detect overwhelming frauds, the problem runs longer and deeper than any missed tips. Commencing in 2000, and perhaps reaching a crescendo in 2004, the SEC, albeit understaffed and strife with political interference, deliberately and consistently pursued ill-advised courses of action with direct consequence to the market.

Three such questionable interpretations at the Commission warrant the most scrutiny: (1) the easing of traditional net capital restrictions for broker-dealers; (2) the reluctance to impose regulation on credit ratings agencies; and (3) the avoidance of any restrictions on burgeoning margin lending to customers.

1. The Consolidated Enterprise Compromise of 2004

It is now axiomatic that the SEC erred when, in April 2004, it privately agreed to a relaxation of the net capital rules in favor of the largest broker-dealers. The agreement (acquiesced to by all five Commissioners) permitted the nation’s largest financial service firms to legally “upstream” funds to their Bank Holding Companies, thus freeing up millions in funds for purchase of exotic investments. The ugly compromise has received

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230. See John C. Coffee, Jr., Credit Ratings Agencies in Congressional Crosshairs, N.Y.L.J., Jan. 21, 2010, at 5 (comparing the agency to bumbling Inspector Clouseau of the Pink Panther movies).
232. See Stephen Labaton, Agency’s ’04 Rule Let Banks Pile Up New Debt, and Risk, N.Y. TIMES, Oct. 3, 2008, at A1 (discussing the exemption codified in Alternative Net Capital Requirements for Broker- Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004)); see also COHAN, supra note 19, at 448 (referencing the June 2004 changes to net capital rules that permitted “securities firms to increase the amount of leverage they could use on their balance sheets to forty times equity while traditional banks, by statute, had to keep the leverage closer to ten times equity”).
233. See Labaton, supra note 232 (A “senior staff member” was quoted as stating that the compromise would result in meaningful access to holding company ledgers, as the SEC would utilize “people with strong quantitative skills to parse the banks’ balance sheets.”).
far-reaching attention in the years since, even inviting scrutiny from such off-topic popular periodicals as Rolling Stone Magazine.234

i. Purpose of (and Relief From) 15c3-1

Since 1965, SEC Rule 15c3-1 has been in force.235 The Rule serves at least three purposes: (1) avoidance of dependence on customer funds; (2) efficient operation of markets; and (3) deterrence to violative conduct.236 The Rule is generally perceived as establishing “early warning thresholds.”237 Concurrently, even errors in (or omissions of) requisite calculations are disciplinable.238

It was thus no coincidence that the largest financial firms came to the SEC seeking relief from the strict and ubiquitous net capital rule before feeling comfortable with the now notorious rush to unprecedented leveraging.239 The SEC expressly responded, via a formal rule interpretation allowing certain broker-dealers to utilize a “voluntary, alternative method of computing deductions to net capital.”240 In return, this short list of firms agreed to a heightened internal alarms system and to subject its holding company and affiliates to “group-wide Commission supervision” (termed Consolidated Entity Supervision).241

In fairness to the Commission, the hazardous move was made, at least in part, to obtain jurisdiction over investment bank holding companies who were not subject to U.S. bank regulators because they did not own commercial banks,242 and in a climate of urged competitive deregulation. The financial press, in particular, gave much attention to the notions that the

236. See Net Capital Rule, Exchange Act Release No. 27249, 54 Fed. Reg. 40,395, at 40,396 (Oct. 2, 1989) (“Finally, if the liability of a broker-dealer to its customers from violations of state and federal law is to be a deterrent to improper conduct, a firm should be required to maintain a reasonable financial stake in its business.”).
238. See, e.g., Direct Brokerage, Inc., NYSE Hearing Panel Decision No. 05-171 (Sept. 12, 2006), available at http://www.nyse.com/DiscAxn/discAxn_10_2006.html (finding violations of SEC Rule 15c3-1 and NYSE Rule 325 based upon failure to both maintain firm net capital at required levels and to compute net capital as required).
239. See, e.g., Coffee, supra note 230 (noting that mid-decade, five underwriter firms handled “the majority of mortgage-backed securitizations”).
241. Id.
Sarbanes-Oxley Act of 2002 had so encumbered American businesses with red tape that their European counterparts were raising money cheaper and faster. Nonetheless, Consolidated Entity Supervision was, by all accounts, a disaster. With the express blessing of their most immediate regulator, the largest broker-dealers facilitated leveraging at the parent company level that would reach Biblical proportions. Both the ensuing blurred ledgers and billions in losses were unprecedented.

**ii. Aftermath**

Consolidated Entity Supervision was *de facto* terminated via the inevitable and involuntary transformation of its participants: two of the five holding companies filed for bankruptcy, two converted to commercial banks to avail themselves of federal funding, and one merged. As an ongoing concept, the notion was tersely, but resolutely, abolished by the White House’s Financial Reform Plan of June 2009. In view of the massive monies freed for speculation, the consistent criticism thereof, the relatively weak motives for the move and the immediate remedy by the new White House, the variegated form of accounting does seem justifiably blamed for a large share of the Crisis. But SEC inaction in other areas was just as harmful.

2. Unregulated Credit Rating Agencies

Investment banking houses could only grow their CDO inventories to unspeakable proportions if a third party was blessing them. The top three ratings agencies thus served as the seal of approval for an investment that was, at best, misunderstood. As one *Wall Street Journal* writer tersely described the phenomenon: “Rating firms became a crutch.”

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244. See Labaton, *supra* note 232.

245. FIN. STABILITY OVERSIGHT BD., DEPT. OF THE TREASURY, FINANCIAL REGULATORY REFORM A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 12 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (“We propose also eliminating the SEC’s Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve.”).


[[Investors who relied on the ratings agencies—particularly supposedly sophisticated pension funds and other institutions—are at fault, too. Rating firms became a crutch for investors who simply didn't want to spend the time and money required to be prudent investors at a time when low interest rates had everyone reaching for higher returns without contemplating the higher risks.]

*Id.*
Regarding ratings agencies, the SEC was, and still is, the law. Although the statutory responsibility of the Commission to oversee national credit ratings agencies has been sketchy, the fact remains that the Commission has exercised its authority to designate such agencies since at least 1975.\textsuperscript{247}

The SEC floated the idea of formal rating agency registration in 1997, but the idea was received in lukewarm fashion by the industry.\textsuperscript{248} In 2003, the Commission invited public comment on new rules for the agencies.\textsuperscript{249} That SEC Release perhaps begged the question of just how conflicted the rating game had gotten when it asked the industry the following question: “Is it appropriate to require strict firewalls between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production?”\textsuperscript{250}

Nearly fifty commenters weighed in on the release, often in stark terms.\textsuperscript{251} An accounting professor at MIT outright called for the requirement that credit rating agencies disclose the source of their revenues.\textsuperscript{252} State regulators in Texas expressly suggested that agencies be required to adopt procedures addressing issuer and subscriber “influence.”\textsuperscript{253}

Many commentators on the 2003 release expressly opined that the credit rating agency demarcation had outlived its utility;\textsuperscript{254} credit rating agencies needed to be regulated in the same manner as the companies they

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\item[247] See Memorandum from Davis Polk & Wardwell to Interested Persons 2 (June 24, 2008), http://www.davispolk.com/files/Publication/15413a5d-084a-47cc-a8827b7a5371c669/Presentation/PublicationAttachment/1e0c7b8-9b1a-4f61-80c67d96df3349/06.24.08.nrsro.proposals.pdf (“Before the Credit Rating Agency Reform Act [of 2006], the SEC staff followed an informal practice of recognizing certain credit rating agencies as [National Recognized Statistical Rating Organizations] for regulatory purposes through the issuance of no-action letters.”); \textit{see also} Coffee, \textit{supra} note 230 (referencing the “de facto regulatory licenses” long granted the credit rating agencies by the SEC and banking agencies).


\item[249] Id.

\item[250] Id. at 35,259.

\item[251] See id.


\item[254] See Letter from Lawrence White, Professor of Econ., N.Y. Univ. Stern Sch. of Bus., to the SEC (July 25, 2003), available at http://www.sec.gov/rules/concept/s71203/lwhite072503.txt. “I strongly urge the SEC to abolish the regulatory category of ‘nationally recognized statistical rating organization’ (NRSRO) and to cease its use of the NRSRO criterion for deciding which rating company’s ratings can be used for the SEC’s regulatory purposes.” \textit{Id}.
\end{footnotes}
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rate, or under a separate scheme altogether. One commentator exhibited clairvoyance when he suggested that the SEC act “in a timely fashion to provide these answers now, instead of after some (another) financial or stock market calamity.”

Between 2003 and 2006, the SEC did nothing tangible in response to the comments. In 2006, Congress took up the task and passed the Credit Rating Agency Reform Act. That law called upon the Commission to implement new rules, which it did in 2007. The timeline thus edifies that the agency, uneasy with a supervisory role it inherited by default, simply shunned final action until it was ordered by Congress. Of course, the credit rating agencies, unfettered by meaningful regulation in the years preceding the Crisis, profited mightily from the “issuer pays” system that produced so many questionable evaluations of CDOs.

### 3. Unwillingness to Tighten Margin Lending

One area where the SEC’s oversight ability is not subject to claims of vagueness is margin lending. However, the primary purpose of the margin rules (those unique limitations on the initial purchase of stock) has all but been forgotten. The constraints were originally designed to protect Wall Street from itself. Indeed, scholars remain stunned by the fact that brokerage houses in the 1920s were lending customers 95% of the purchase

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261. See THOMAS LEE HAZEN & DAVID L. RATNER, BROKER DEALER REGULATION: CASES AND MATERIALS 554–56 (2003) (“Although the basic purpose of the margin regulations is to restrict stock market speculation, rather than to protect individual customer . . . .”).
value of their securities. If not the incontrovertible cause of the Great Depression, it was most certainly an aggravating factor.

Thus, in 1934, when the Securities Exchange Act was adopted, § 7 therein delegated margin rulemaking authority to one agency: The Federal Reserve Board (the Fed). The Fed adopted famed Regulation T, which, since 1974, has capped the amount that a brokerage house may lend a retail customer for the initial purchase of most stock at 50%. After that day of purchase, margin is regulated by the brokerage houses themselves (who routinely set “house rates” that are stricter than the 25% set by the stock exchanges). The problem, simply stated, is that the more brokerage houses lend, the more money they make, and the temptation has never been eradicated.

In prior crises, regulators worked feverishly to rein in the amount of consumer credit on Wall Street. For example, in the Spring 2000, both the Fed and the Commission publicly questioned the increased amount of margin being afforded American investors. The stock exchanges themselves subsequently threatened to tighten lending rules governing their membership. The scrutiny of broker-dealer lending culminated in SEC approval of an National Association of Securities Dealers (NASD) rule change obligating firms to delivering a uniform disclosure statement on the

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Margins—the cash which the speculator must supply in addition to the securities to protect the loan and which he must augment if the value of the collateral securities should fall and so lower the protection they provide—are effortlessly calculated and watched. Wall Street, however, has never been able to express its pride in these arrangements. They are admirable and even wonderful only in relation to the purpose they serve. The purpose is to accommodate the speculator and facilitate speculation. But the purposes cannot be admitted. If Wall Street confessed this purpose, many thousands of moral men and women would have no choice but to condemn it for nurturing an evil thing and call for reform.

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266. Id.
268. See Gretchen Morgenson, Something Borrowed May Leave Market Blue, N.Y. Times, Jan. 30, 2000, at D1 (stating “lending money to investors is very lucrative for these firms; they reap both margin interest and extra commissions from investors buying twice the stock they would have otherwise”).
270. See Margin Credit Fell in April, N.Y. Times, May 16, 2000 (“The NASD said last month that it would prod the NYSE to join it in trying to toughen margin requirements.”).
dangers of margin investing to all existing and potential margin customers. Whether it was because of the scrutiny, the rule change, or both, margin debt fell at both the New York Stock Exchange (NYSE) and NASD firms in 2001.

But as time passed, so did the scrutiny. Between 2002 and 2006, margin totals increased 60% at NYSE firms and over 200% at NASD firms. Such brokerage houses effect trades for hedge funds and other speculators, all of which were allowed to increase their leverage. For some, the lack of new margin rules or tightened regulations was hardly a surprise. In fact, commentators had casually expected the administration of George W. Bush to effectuate its professed desire to ease up on business regulation. Perhaps more than anywhere else, that drive reached fruition in the everyday world of stock brokerage. Thus, any survey of SEC actions/omissions precipitating the Crisis must note the agency’s reluctance to tighten margin lending, which credit enabled untold market losses.

C. STATUS

The dedicated hesitancy of the Commission to rein in Wall Street’s net capital, credit rating, and lending practices inevitably leads to cries by journalists and practitioners alike of political intervention. The anger has spread to academics, who are quick to also point to the dubious timing of many SEC trial tactics.


272. See Press Release, FINRA, Margin Statistics (Jan. 4, 2010), http://www.finra.org/InvestorInformation/InvestmentChoices/MarginInformation/p005923 (providing a historical, monthly listing of margin totals for both of the major stock exchanges and disclosing a 33% drop at NYSE firms and a 44% drop at NASD firms between 2000 and 2001).

273. See id. (summarily concluding, “[i]ncreasingly, investors are purchasing on margin”).


276. See Velvel on National Affairs: The SEC’s Brief Filed Before Judge Lifland in Madoff, http://velvelonnationalaffairs.blogspot.com/2009/12/secs-brief-filed-before-judge-lifland.html (Dec. 21, 2009, 03:22pm). Lawrence Velvel, Dean of the Massachusetts School of Law, decries the timing and substance of the SEC’s brief filed in a case centering on valuation of Madoff victims’ claims, asserting that the Commission would support the Judge’s decision “if he follows the SEC’s method of partial alleviation.” Id.
Still others steadfastly defend the agency, the abolition or subordination of which does seem to be both premature and impractical.277 The more enlightened approach parses the myriad SEC responsibilities, according high marks for prosecutions and low ones for oversight of financial planning.278

The latest words of reform accentuate the difficulties in detection. Specifically, the Wall Street Reform and Consumer Protection Act of 2009, among many other changes, would create the interagency Financial Services Oversight Council to oversee systemic risk, identify “systemically important companies and activities . . . [and] resolve jurisdictional disputes” between federal agencies.279 Likewise, a new Consumer Financial Protection Agency would focus on consumer financial activities, including mortgage loan practices and disclosures.280 As the inclination to re-tool the government arsenal gets set to weather political storms, the more accurate appraisal (and obtainable result) may posit that the Commission must simply set more consistent priorities and make better choices, or once again find itself fighting for survival.

CONCLUSION: OF LAWS AND SAUSAGES . . .

To be sure, there are regulatory issues to be explored other than the ones detailed herein in an effort to hone the blade of culpability for the two-year economic freefall. The bizarre alliance of private and public flaws that caused the Crisis perhaps serve to isolate any one contributor from blame. One could easily ask whether the 1970 NYSE decision to allow investment firms to go public foretold of the days when management would place quarterly profits above fundamental corporate health.281

Frightfully scarce from critiques to date are detailed studies of the oversight of major firms like Bear Stearns and Lehman Brothers by the stock exchanges—those entities that are only permitted to utilize the

277. See, e.g., Arthur S. Greenspan, Responses and Strategies in Dealing with a Changed SEC, N.Y.L.J., Dec. 10, 2009, at 5 (“It has come under considerable public criticism over the past few years, but the U.S. Securities and Exchange Commission remains one of the most important civil law enforcement authorities for the U.S. financial services industry and for U.S. public companies.”).
278. See John C. Coffee, Jr., Downsizing the SEC?, Nat’l L.J., June 22, 2009, at 22 (“Relatively speaking, the SEC deserves good grades for enforcement and investor protection, but may have flunked the course on prudential financial supervision.”).
280. Id. at 15, 17.
281. See James Surowiecki, Public Humiliation, New Yorker, Sept. 29, 2008, at 30 (describing the most applicable result of two waves of IPO booms among investment banks in recent decades: the ability of the previously private entities to “raise huge amounts of capital, which, in turn, increased the amount of money they could borrow to leverage their bets”).
moniker “national securities exchange” in return for guaranteeing to the government that, in addition to serving as centers of capital formation and transfer, they will simultaneously serve as self-regulatory organizations (SROs).\textsuperscript{282} SRO examination for violations and transgressions is made possible by the separate requirement that exchange member firms file a monthly Financial and Operational Combined Uniform Single (FOCUS) report detailing the firm’s financial condition.\textsuperscript{283} Yet, no cries have been heard for either gross reform at the SRO level, or, alternatively, to eradicate its obsolete warning system. Likewise, while the serious questions and drastic ramifications abound, it is not altogether clear that the public wishes to hold aggressive entrepreneurs accountable via criminal actions.\textsuperscript{284}

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\item \textsuperscript{282} Section 6 of the Securities Exchange Act (“National Securities Exchanges”), 15 U.S.C. § 78f (2006), requires of exchanges as follows:

(5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange.

(6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this chapter, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

(7) The rules of the exchange are in accordance with the provisions of subsection (d) of this section, and in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.
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283. The NYSE web site touts the FOCUS Report as giving the exchange “a complete, detailed picture of member firms’ financial and operational conditions” and goes on to explain that all member firms “must respond quarterly to several hundred questions about financial and operational conditions and activities.” NYSE, Glossary, Financial and Operational Combined Uniform Single Report (FOCUS), http://www.nyse.com/glossary/Glossary.html (last visited Feb. 17, 2010).

284. See Zachary Kouwe & Dan Slater, 2 Bear Stearns Fund Leaders are Acquitted, N.Y. TIMES, Nov. 11, 2009, at A1 (describing the jury acquittal of two hedge fund managers of securities fraud charges based upon their alleged misstatements to investors regarding the health of funds invested heavily in mortgage securities).
The analyses conducted by this Article served to illustrate that any hindsight needs to be a movie reel as opposed to a snapshot, and that the camera needs to focus more on the risk incentives permitted to prosper on trading desks than on any trendy investment vehicles engaged thereby. Clearly, the judiciary and the White House played an often downplayed yet smoldering role in creating that risky climate; clearly Congress and the SEC can bring on a cloudy day in a heartbeat.

Thus, as the GLBA and ill-advised SEC policies emerge as the most damaging contributions to the Crisis, the expedient blame attributed to the growth of the CDO or the CFMA’s exclusion of a sole investment product seems too expedient. In light of management’s commitment to non-traditional structures and profit centers (both in anticipation of and after enactment of the law), a related flaw in recent years appears to be in government failing to commensurately staff and train the agencies. This is supported by the words of Alan Greenspan, who in his speech to Congress in October 2008 outlined the failures of Washington to comprehend the regulatory task at hand, stating:

“...I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms”. . . . “And it’s been my experience, having worked both as a regulator for eighteen years and similar quantities in the private sector, especially ten years at a major international bank, . . . that the loan officers of those institutions knew far more about the risks involved in the people to whom they lent money than I saw even our best regulators at the Fed capable of doing.”

To make Wall Street appreciate the value of regulating itself thus seems ideal. The concept may even be said to be historical. It was FDR himself who, when introducing the first of the federal securities laws, noted that the government could not vet all the nation’s stock offerings: the spirit of that advice bears repeating as regulators scramble to find the cure for malingering economic woes.

Undoubtedly, the government plays a critical role in instilling such diligence. As detailed herein, four vital sectors of government contributed


The Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. . . . There is however an obligation upon us to insist that every issue to be sold in interstate commerce shall be accompanied by full publicity and information.

Id. at 228 (quoting a statement by President Franklin Delano Roosevelt made upon his submission of the Securities Act of 1933 to Congress).
to the atmospheric change attending the Crisis. “The movement to
deregulate the financial industry went too far by exaggerating the
resilience—the self-healing powers—of laissez-faire capitalism,” a pioneer
of the Chicago School of economics recently wrote. \(^{287}\) Maybe so, but, upon
inspection of the verdicts of populist trials, it appears that it was still agents
of the government who often helped to sell us the snake oil. As economist
and journalist Paul Krugman has argued: “Influential figures should have
proclaimed a simple rule: anything that does what a bank does, anything
that has to be rescued in crises the way banks are, should be regulated like a
bank.” \(^{288}\)

This Article sought to test public perceptions of (and consequentially
specifically apportion blame to) an array of government sectors. As the
lingering autopsy of the 14,000 Dow Jones Industrial Average continues,
heightened scrutiny by Washington, D.C. appears mainly to cast blame in
old directions. This author thus suggests that the compass point towards an
amalgamated inquiry: The existing laws and framework failed simply to
instill in sophisticates the need to protect themselves from other
sophisticates. For, if all our scrutiny of financial relationships continues to
sound in metaphors involving sheep and wolves, \(^{289}\) we may never reach the
requisite understanding that the Crisis was caused by the well-heeled
fooling the well-heeled. \(^{290}\)

Despite any controversy about the true author of the “laws and
sausages” quote, no one contests that the great Twain did advise so long
ago: “[N]o country can be well governed unless its citizens as a body keep
religiously before their minds that they are guardians of the law, and that
the law officers are only the machinery for its execution, nothing more.” \(^{291}\)

Clearly, that machinery broke down in recent times, chiefly in keeping
iconic sophisticates from fatal avenues of speculation. Hopefully, a
progressive survey of the lessened defenses that allowed Wall Street to fail

\(^{287}\) John Cassidy, *After the Blowup: Laissez-Faire Economists Do Some Soul-Searching—and
Finger-Pointing*, NEW YORKER, Jan. 11, 2010, at 28 (quoting RICHARD A. POSNER, A FAILURE
OF CAPITALISM, at xii (2009)).

\(^{288}\) KRUGMAN, supra note 18, at 163 (discussing the fall of the “shadow banking system” that
emerged globally in the last decade).

\(^{289}\) See, e.g., GEISST, supra note 286, at 230 (noting that the New Deal Congress was “bent
upon reforming banking so that the poachers and the gamekeepers were kept separate”).

\(^{290}\) As this Article goes to press, the Congressional Financial Crisis Oversight Commission
begins its hearings in Washington, D.C. As a noted Wall Street journalist has pointed out, the
focus has seemingly “shifted to new ground” in view of concerns that Goldman Sachs
simultaneously sold CDOs and hedged against their failure. Andrew Ross Sorkin, *Wall St. Ethos
Under Scrutiny at Hearing*, N.Y. TIMES, Jan. 14, 2010, at A1. In turn, Goldman’s CEO has
defended that such CDO purchasers were “professional investors who want[ed] this exposure.” Id.

\(^{291}\) MARK TWAIN & CHARLES DUDLEY WARNER, THE GILDED AGE 216 (Modern Library
to comprehend the dangers of Wall Street will aid in our collective repair of those engines.
LESSONS LEARNED FROM CSX CORP. V. CHILDREN’S INVESTMENT FUND MANAGEMENT AND PROPOSALS FOR REFORM

Sean M. Donahue*

The federal securities laws governing beneficial ownership do not capture ownership positions in equity swaps or other similar instruments. In the majority of situations these owners do not possess voting or investment power as defined in Rule 13d-3(a) of the Securities and Exchange Act, and thus, they do not have a disclosure obligation. Such persons, however, do have the ability to significantly influence the voting or disposition of the securities of a company. In fact, because their ownership positions remain hidden, these persons can gain an unfair advantage in a proxy contest or engage in a stealth takeover.

Issues related to hidden ownership were litigated in the case of CSX Corp. v. Children’s Investment Fund Management, where a hedge fund acquired long positions in equity swaps giving it the same economic interests as stock ownership, and then, with the help of another hedge fund, launched a proxy contest. An analysis of the facts in this case and the holdings of the court offer great insight into the decoupling of economic interests from voting rights and investment power.

This Article examines CSX and concludes that Rule 13d-3(a) should be amended to require disclosure by beneficial owners of equity swaps and other similar instruments. It further provides a specific disclosure recommendation for the amendment of that Rule. This Article also explores Rule 13d-3(b), reasoning that this Rule should be construed in a manner analogous to the safe harbors contained in Rule 144A and Regulation S, and, therefore, only apply when a person is also a beneficial owner under Rule 13d-3(a). Lastly, this Article demonstrates that sterilization of votes is a necessary remedy under § 13(d) and argues that courts should more frequently enjoin persons who violate this statute from voting at shareholder meetings.

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I. INTRODUCTION

The federal securities laws governing beneficial ownership are such that the owner of a long position in an equity swap or similar instrument (Long Party or Long Parties) that has the same economic interest as a holder of common stock does not have to disclose his ownership position because he does not have beneficial ownership of the securities. This person does not have beneficial ownership because he does not possess voting or investment power. The Long Party has an economic interest in the security because he is entitled to any increase in the value of the underlying stock and any dividends; however, he owns a derivative security.


Although a long position under an equity swap would generally not be treated as beneficial ownership of the underlying security under Rule 13d-3 under the Exchange Act, as the “long” party would not typically have the right to vote or dispose of the underlying shares, Schedule 13D (but not Schedule 13G) requires the disclosure by a reporting person of contracts involving the relevant shares.


Prior to CSX’s lawsuit, the prevailing wisdom was that ‘masked ownership,’ while smacking of gamesmanship, was permissible under the existing proxy rules because a long position in a cash-settled swap, standing alone, constitutes neither actual nor beneficial ownership of the referenced shares. (Section 13(d) requires disclosure only by ‘beneficial owners.’).

Smith & Levy, supra.

[A] person who is a party to a cash-settled swap does not beneficially own the securities subject to the swap if he does not have the right to vote or to sell those securities either pursuant to the swap’s contractual terms or pursuant to another understanding or arrangement with the counterparty to the swap. Thus, a party to a cash-settled swap not possessing such voting or dispositive power has no Section 13(d) reporting duty, no matter how large a percent of the stock is the subject of the cash-settled swap.

JACOBS, supra, § 2.12.

The Division believes that interpreting an investor’s beneficial ownership under Rule 13d-3 to include shares used in a counter-party’s hedge, absent unusual circumstances, would be novel and would create significant uncertainties for investors who have used equity swaps in accordance with accepted market practices understood to be based on reasonably well-settled law.

Breheny Letter, supra, at 4.

rather than physical shares. As such, ownership voting rights and investment power over the security have been decoupled from the economic interest in the security and, rather, are held by the short counterparty (Short Party or Short Parties) to the swap to the extent that the Short Party has hedged by acquiring the securities underlying the swap (Matched Shares).

Where the Long Party has economic ownership of securities that are not required to be disclosed under § 13(d) of the Securities and Exchange Act of 1934 (the Exchange Act), he has “hidden ownership” of the securities. If the person also has informal voting power, then he has “hidden morphable ownership.” Additionally, the Long Party can have investment power where the Short Party has no means to hedge other than by acquiring the security underlying the equity swap, acquiring Matched Shares, and then selling the security upon the unwinding of the swap.

The phenomenon of hidden ownership was litigated in CSX Corp. v. Children’s Investment Fund Management, where a hedge fund, The Children’s Investment Fund Management (UK) L.L.P. (TCI), which owned a long position in a total return equity swap (TRS), was sued by CSX Corporation (CSX), a railroad company, for failing to disclose its beneficial ownership during CSX’s attempt to thwart the hedge fund’s efforts in a

3. See GREENE ET AL., supra note 1, § 14.02[2][a].

An equity swap typically involves an agreement between two parties to exchange a series of payments determined by reference to the change in value of a notional quantity of a single security or group or index of securities (the “reference securities”) over a specified period. In a typical equity swap, one party (the “long party”) will make payments based on the amount of any depreciation in the value of the reference securities during the relevant period, as well as a payment of notional interest based on the notional value of the contract. The other party (the “short party”) will make payments based on the amount of any appreciation in the value of the reference securities during the relevant period, as well as, in some cases, the amount of any dividends or distributions paid with respect to the reference securities during this period.

Id.


A second approach [to decoupling] employs an equity swap, in which the person with the long equity side (the “equity leg”) of the swap acquires economic ownership of shares (but not voting rights) from the short side (the “interest leg”). The short side often hedges its economic risk by holding shares, thus ending up with votes but no net economic ownership.

Id.

5. Id. at 825 (“If a person has economic ownership that disclosure rules do not cover (or can reasonably be interpreted by the person as not covering), we call this ‘hidden ownership.’”).

6. Id. at 825–26. (“If in practice, this hidden ownership includes informal voting rights, we term this ‘hidden (morphable) ownership.’ These ‘morphable voting rights’ will generally not be verifiable by outsiders, and depend on market customs.”).

proxy contest. This Article posits that TCI had hidden ownership of the securities because it possessed economic ownership of swaps that did not have to be disclosed under Securities and Exchange Commission (SEC) regulations. CSX argued, and the court found, that TCI had hidden morphable ownership because, in at least some instances, there was evidence it could influence the voting of the securities by the Short Parties, or obtain voting power by engaging in an exchange unwind. The latter occurs where the Long Party unwinds the swap and acquires the shares used by the Short Party to hedge the swap, either from the Short Party or in the open market. CSX also asserted, and the court found, that TCI had investment power because there was no conceivable way for the Short Party to hedge other than acquiring the Matched Shares; once TCI unwound the swap, the Short Party would be forced to sell the shares either to TCI or in the open market. While the court did not reach the question of whether TCI was a beneficial owner of CSX shares, it stated that “there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties.”

8. Id. at 516.
9. While the court decided that TCI had a disclosable position in the swaps because it met the definition of beneficial owner in Rule 13d-3(b), and inferred, while it did not decide the question that TCI quite probably met the definition of beneficial owner in Rule 13d-3(a), this Article concludes that there was no beneficial ownership under Rule 13d-3, and thus no disclosure was required. See infra Parts IV.A, IV.B.
10. CSX Corp., 562 F. Supp. 2d at 546 (“[T]here . . . 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.”).

When a swap expires, or is terminated early, the dealer, assuming it has hedged, will usually seek to unwind the hedge. If the dealer has hedged with matched shares, it will usually sell most or all of the matched shares.

In some cases, a long equity swap holder will seek to replace that position with full ownership of shares by unwinding the swap and, at the same time or nearly the same time, purchasing shares in the market. I will call this an “exchange unwind.”


TCI patently had the power to cause the counterparties to buy CSX. At the very least, it had the power to influence them to do so. And once the counterparts bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions. Certainly the banks had no intention of allowing their swap desks to hold the unhedged long positions that would have resulted from the unwinding of the swaps.

13. Id. at 545.
However, the court did reach the question of whether TCI should be deemed a beneficial owner under Rule 13d-3(b) of the Exchange Act. The court held that TCI was a beneficial owner because it purchased the swaps with the purpose and effect of preventing the vesting of beneficial ownership of the securities as part of a plan or scheme to evade the reporting requirements of § 13(d). The court further held that TCI and 3G Fund L.P. (3G), another hedge fund that was a party to the litigation, formed a group for the purposes of § 13(d), and violated § 13(d) because they did not file a Schedule 13D until ten months later. In fashioning a remedy for the group’s disclosure violation, the court enjoined the group members from future violations of § 13(d), but chose not to enjoin them from voting in the proxy contest. In the court’s view, sterilization was not an appropriate remedy for the disclosure violation because CSX did not show a threat of irreparable harm, especially given that corrective disclosure had already been made.

The court’s first conclusion is incorrect because Long Parties’ holdings in equity swaps do not have to be reported under § 13(d). The reason is that such parties are not beneficial owners as defined in Rule 13d-3(a) because they do not possess voting or investment power over the securities. While the court’s conclusion was incorrect, given the current state of the law, Rule 13d-3(a) should be amended to require disclosure of Long Parties’ holdings in equity swaps and this Article provides a recommendation as to how the Rule should be revised to require such disclosure. The court’s second holding also was incorrect because TCI did not engage in a plan or scheme to evade the reporting requirements of § 13(d) since it was not a beneficial owner of the securities (as defined in Rule 13d-3(a)). With respect to the formation of a group, the court properly held that TCI and 3G formed a § 13(d) group ten months prior to filing a Schedule 13D in violation of

14. *Id.* at 548–52.
15. *Id.* at 552.
16. *Id.* at 554–55 (“In the last analysis, the question comes down to whether this trier of fact . . . is persuaded that TCI and 3G formed a group with respect to CSX securities earlier than they claim. It finds that they did so no later than February 13, 2007.”).
17. *Id.* at 572 (“This Court holds that a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants’ voting rights and that plaintiff has failed to establish such a threat.”).
18. See infra Part IV.A.
19. See infra Part IV.
20. See infra Part IV.B.
§ 13(d). In determining the proper remedy for the group’s disclosure violation, however, the court incorrectly held that sterilization was not an appropriate remedy because sterilization was not necessary in order to prevent an unfair director election.

This Article analyzes the *CSX* case, advocates proposals for reform, and adds to the current literature on § 13(d) of the Exchange Act in three important ways. First, it provides a specific disclosure recommendation that the Commission can adopt by amending Rule 13d-3(a) to require disclosure of Long Parties’ holdings in equity swaps. While other authors have proposed a recommendation as to how the broad disclosure regime regarding beneficial ownership should be revised, advocated for a judicially imposed solution, or simply argued for Commission action, no other law review article sets forth a specific disclosure recommendation for Rule 13d-3(a). Second, this Article provides an analysis of Rule 13d-3(b), reasoning that it should be construed in a manner analogous to the safe harbors contained in Rule 144A and Regulation S, and thus should apply only when one is a beneficial owner under Rule 13d-3(a). Lastly, it explores the remedy of sterilization of votes in the § 13(d) context by examining the case law and the Commission’s positions in this area and concludes that this remedy should be granted more frequently.

Part II of this Article provides an overview of equity swaps, § 13(d), and the decoupling of economic interests from voting rights and investment power. Part III examines the facts and holdings of the *CSX* case. Part IV critiques these rulings and sets forth proposals for reform. Part V concludes the Article.

21. See *infra* Part III.B.
22. See *CSX Corp.*, 562 F. Supp. 2d at 567–73.
23. See *Hu & Black*, *supra* note 4, at 875–86.
26. This argument does not seem to have been made in any other article. While the Sullivan note analyzes Rule 13d-3(b), it does not provide a conclusion based on the safe harbors contained in Rule 144A and Regulation S of the Securities Act. See *generally id*. 

The ownership disclosure rules can be much simplified and better integrated. Currently, there are five distinct, highly idiosyncratic, complex SEC ownership disclosure regimes. These disclosure regimes apply respectively to large active shareholders (Schedule 13D), large passive shareholders (Schedule 13G), institutional investors generally (Form 13F), insiders and 10% shareholders (Section 16), and mutual funds. Our proposals would significantly simplify this complex scheme, and move toward an integrated system for share ownership disclosure that builds on existing Section 16 and mutual fund disclosure rules.

*Id.* at 820.
II. SWAPS, SECTION 13(D), AND DECOUPLING

A. EQUITY SWAPS

Usually an equity swap entails two parties making payments to one another where at least one set of payments is determined by the return of a stock or a stock index (the Reference Security or Reference Securities). Typically, the Long Party will make payments based on the amount of any depreciation in the value of the Reference Securities and a payment of notional interest based on the interest that accrues at a negotiated rate on an agreed upon principal amount. This payment of notional interest compensates the Short Party for the cost of financing its position hedging the swap, even if it chooses not to hedge, by giving it an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned the Long Party the notional amount. On the other hand,

27. See, e.g., GREENE ET AL., supra note 1, § 14.02[2][a] (“An equity swap typically involves an agreement between two parties to exchange a series of payments determined by reference to the change in value of a notional quantity of a single security or group or index of securities (the ‘reference securities’) over a specified period.”); Don M. Chance, Equity Swaps and Equity Investing, J. ALTERNATIVE INV., Summer 2004, at 75, 75–76.

[A]n equity swap is a transaction between two parties in which each party agrees to make a series of payments to the other, with at least one set of payments determined by the return on a stock or stock index. The return is calculated based on a given notional principal and may or may not include dividends. The payments occur on regularly scheduled dates over a specified period of time.

Counterparty A—the “short” party—agrees to pay Counterparty B—the “long” party—cash flows based on the performance of a defined underlying asset in exchange for payments by the long party based on the interest that accrues at a negotiated rate on an agreed principal amount (the “notional amount”). . . . Counterparty A, referred to as the “total return payer” or “beneficiary,” is entitled to receive from Counterparty B (1) an amount equal to the interest at the negotiated rate that would have been payable had it actually loaned Counterparty A the notional amount, and (2) any decrease in the market value of the referenced asset.

CSX Corp., 562 F. Supp. 2d at 520.

The notional amount typically is the value of the referenced asset at the time the transaction is agreed and may be recalculated periodically. The difference between the reference rate and the negotiated interest rate of the swap depends on (1) the creditworthiness of the two parties, (2) characteristics of the underlying asset, (3) the total return payer’s cost of financing, risk, and desired profit, and (4) market competition.

Id. at 520 n.13 (internal citation omitted).

29. See GREENE ET AL., supra note 1, § 14.02[2][a]. The court in CSX explained:

[The Short Party] is entitled to have the long party place it in the same economic position it would have occupied had it advanced the long party an amount equal to the
the Short Party will make payments based on the amount of any appreciation in the value of the Reference Securities, as well as the amount of any dividends or distributions paid with respect to the Reference Securities. Because equity swaps result in payments based on the return on a stock or stock index, they provide cash flows to the Long Party that mimic equity returns. Therefore, equity swaps can be used as substitutes for direct transactions in equity. These instruments give the Long Party exactly the same economic interest it would have if it actually purchased the stock or stock index.

**B. SECTION 13(D)**

Section 13(d) was enacted as part of the Williams Act. This Act was passed in 1968 to close a gap in the securities laws by requiring disclosure of pertinent information where persons sought to gain corporate control of a company by a tender offer and through open market or privately negotiated purchases. Section 13(d) of the Act was enacted 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.”36 The disclosure required by § 13(d) is aimed to help investors make informed investment decisions based on market prices that reflect an awareness of the required information.37 Section 13(d)(1) provides in pertinent part that:

(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 781 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, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing [certain information].38

Further, Rule 13(d)-1(a), which was promulgated by the Commission in 1978 as a regulation under § 13(d),39 requires any person who acquires, either directly or indirectly, beneficial ownership of greater than 5% of a § 12 registered equity voting security to file and disclose certain information.40 As such, the disclosure mandated by § 13(d) is only required when a person has beneficial ownership of the security. As stated by former Commission Chairman Manuel F. Cohen, “beneficial ownership is the test.

At present, however, some areas remain where full disclosure is necessary for investor protection but not required. The legislation before the subcommittee today will close what I consider to be a significant gap in these last remaining areas. It requires the disclosure of pertinent information to stockholders where persons seek to obtain control of a corporation by: (1) a cash tender offer and (2) through open market or privately negotiated purchases of securities. Disclosure would also be required when corporations purchase their own stock in the open market.

Id. 36. GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972).
37. Id.

(a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D.

Id.
[The acquiring entity] might try to get around it, and that would be a violation of law, but the legal requirement is beneficial ownership.41

The Commission has defined beneficial ownership in Rule 13d-3(a) to include any ownership where the person has voting or investment power over the securities.42 The Rule provides that:

(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.43

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.”44 In this regard, the determination of beneficial ownership requires “[a]n analysis of all relevant facts and circumstances in a particular situation . . . in order to identify each person possessing the requisite voting power or investment power.”45 More than one person can have beneficial ownership of a security and may possess such ownership directly or indirectly.46 For example, if X owns 74% of Y Corporation and Y Corporation purchases 9% of Z Corporation, X is the indirect owner of the 9% interest in Z Corporation, while Y Corporation is the direct owner of the 9% interest.47

Example 1. Rule 13d-3(a), indirect ownership; Rule 13d-3(d)(i), option to acquire. X, an individual, beneficially owns sixty-eight percent of Y Corporation. Y Corporation purchases four percent of a class of securities of Z Corporation and also an option, exercisable within thirty days of the date of purchase, to purchase an additional two percent of the outstanding shares of the same class of Z corporation.

Question. Does X have a filing obligation and, if so, how may it be satisfied?

Interpretative Response. Yes, X has an obligation to file under Rule 13d-1 since under Rule 13d-3 he is the indirect beneficial owner of the Z shares held by Y Corporation due to his power to direct their voting or disposition. It should be noted

42. See 17 C.F.R. § 240.13d-3(a)(1)–(2) (2009).
43. Id.
45. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,344.
46. See § 240.13d-3.
47. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,346.
Beneficial ownership may arise through any contract, arrangement, understanding, relationship, or other means, and “does not require formal documentation of arrangements.” Essentially, a person is a beneficial owner if he has or shares voting rights or investment power. In order to “have” that power, the person must have such authority at the present time without the consent of another party and without another person having that power. A person shares such power if he and at least one other person can make decisions regarding the voting or disposition of the securities. With respect to voting power, it should be restricted to the ability to vote or to direct the vote. The power to vote means the person can vote himself, while the power to direct the vote means the person can instruct others how to vote. Investment power includes the power to dispose of, or to direct

that the operation of Rule 13d-3(d)(1)(i) puts X above the five percent threshold inasmuch as the shares subject to the option will be aggregated with those purchased. X’s reporting obligation may be satisfied with a filing by X disclosing his indirect ownership and the intermediaries involved; alternatively, since Y Corporation also would be subject to a separate filing requirement with respect to the same securities, X may file jointly with Y disclosing the control position and other information required with respect to X pursuant to Instruction C to Schedule 13D.

Id.

49. § 240.13d-3.
50. See Jacobs, supra note 1.

“Has” connotes the present power without the consent of another party and without another person also having that power. Thus, having the power subject to another’s consent is equivalent to not having the power at all. Having the power in the future is not having the present power, but beneficial ownership may exist under Rule 13d-3(d)(1)(i).

Id.

51. Id.

“Shares” the power means that the person in question and at least one other person can make the decision. Thus, each of three trustees of a trust “shares” the power over securities in the trust’s corpus, even though two of them can outvote the third. On the other hand, if one person has the legal power to vote (since he is the record holder) but another instructs him how to vote, the record holder does not share the power. Rather, the other person “has” the sole power. Thus, sharing the power means the person has a meaningful role (although not necessarily a decisive one) in exercising the power to vote or dispose of the security. “Shares” also connotes a present ability; one who in the future will share the power is not the beneficial owner under Rule 13d-3(a), although he may be a beneficial owner pursuant to Rule 13d-3(d)(1)(i).

Id.

52. Id. (“The voting power clause [states] ‘voting power which includes the power to vote, or to direct the voting.’ ‘Includes’ should be construed as ‘means.’ Accordingly, voting power should be restricted to ‘the power to vote or to direct the vote.’”). But see CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 539–48 (S.D.N.Y. 2008), aff’d, 292 F. App’x 133 (2d Cir. 2008) (using the plain language of the statute to set forth a standard whereby it is sufficient that the party has the ability to influence the voting or disposition of the securities).

53. See Jacobs, supra note 1.
the disposition of a security, and it is properly restricted to the words of the statute. The other way in which a person can have beneficial ownership is under Rule 13(d)-3(b). This Rule provides that:

(b) Any person who, directly or indirectly, [1] creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device [2] with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership [3] as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

In adopting the Rule, the Commission gave an example of a transaction that would violate § 13(d) involving stock parking, an arrangement which, according to one court, is “a concealment of stock ownership achieved by placing the stock in an account in the name of a third party.” The Commission provided the following example:

In order to acquire a substantial position in the voting securities of Z Corporation prior to the election of directors which will take place in the near future, X causes ten institutions to each acquire three percent of the outstanding shares of Z Corporation. None of the institutions are aware of the purchases by the other institutions or of X’s control objective. As an attempted means of avoiding disclosure of his beneficial ownership of the Z shares until a short time before the election, X, simultaneously with the purchase of the Z shares, gives an irrevocable proxy to A, which proxy will lapse according to its terms . . . . A is a beneficial owner of the Z shares subject to the proxy due to his power to vote them and therefore he must report such ownership pursuant to Rule 13d-1, as well as information about X under Item 6 of Schedule 13D. In addition, as indicated in Rule 13d-3(b), X is also 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.

Aside from stock parking, Commission pronouncements and court decisions have not focused on Rule 13(d)-3(b) until the CSX decision.

54. Id.
55. See 17 C.F.R. § 240.13d-3(b) (2009).
56. Id.
57. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,348.
59. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,348.
60. See JACOBS, supra note 1, § 2:13.

This provision has received little notice from the cases and SEC pronouncements. Some cases and a series of SEC releases do no more in substance than merely acknowledge its existence. Another case stated that deliberate efforts to conceal legal ownership do not affect the determination of beneficial ownership . . .
C. DECOUPLING AND HIDDEN MORPHABLE OWNERSHIP

Decoupling occurs when the voting rights of a security or the investment power over the security are separated from the economic interest in the security. While there are a number of ways to decouple voting rights and investment power from economic ownership, this Article focuses on the use of equity swaps whereby a person with a long position in the swap acquires economic ownership of the shares while the Short Party retains the voting rights and investment power over the securities (assuming that the Short Party has hedged with Matched Shares). The ownership of the shares is “hidden” in that the Long Party does not have to disclose his economic interest under § 13(d). In this regard, practitioners and the SECs Division of Corporation Finance agree that a Long Party does not have beneficial ownership under Rule 13(d)-3(a) unless he has the power to vote or to sell the securities, either pursuant to the swap’s contractual terms or pursuant to another understanding or arrangement with the Short Party. Consequently, a party to a cash-settled swap that has no § 13(d) reporting obligation may acquire a substantial long position in the security without having to file a Schedule 13D. However, if the person beneficially owns physical shares in excess of 5%, he becomes subject to § 13(d) reporting and disclosure issues regarding the swap under...

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...[The Rule] is a good failsafe but is not an important weapon in a plaintiff’s arsenal.

Id. The only case other than CSX to even discuss the Rule in any detail is Levy v. Southbrook Int’l. Invs., Ltd., 263 F.3d 10, 14–18 (2d Cir. 2001). In that case, “the Second Circuit held that a cap on the right to convert a derivative security to, say, 4.9% of the outstanding stock, is not a sham and will be respected.” Jacobs, supra note 1, § 2:13; see also Levy, 263 F.3d at 18.

61. See Hu & Black, supra note 4, at 811. (“[T]he derivatives revolution and other capital markets developments now allow both outside investors and insiders to readily decouple economic ownership of shares from voting rights.”).

62. Id. at 816.

One method relies on the share lending market, which lets one investor “borrow” shares from another. Under standard lending arrangements, the borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights. Other decoupling strategies are also possible, such as relying on put and call options or, where they exist, single-stock futures.

Id.

63. Id. at 816.

64. Id. at 816, 825 & 868.

65. See Greene et al., supra note 1, § 8.02[1].

66. Id.
several Items of Schedule 13D. Specifically, Item 6 requires the disclosure of equity swap contracts.

A person who avoids § 13(d) disclosure by holding long positions in equity swaps has hidden morphable ownership if such ownership includes the power to direct the voting of the shares by the Short Party, or the ability to conduct an exchange unwind and acquire the Matched Shares. While Long Parties typically do not have the power to direct the voting of the shares, and do not give explicit direction to Short Parties because such instructions would likely trigger disclosure under § 13(d), the Long Party can choose to enter into an equity swap with a dealer whom it believes will vote the shares in the way it desires. For example, a person may enter into an equity swap with a dealer that owns a hedge fund with a large investment in the company subject to the swap and, therefore, has similar investment objectives as the Long Party. Also, dealers have significant economic incentives to vote the shares in the manner the Long Party desires because they want to obtain the client’s business, including potentially receiving large prime brokerage fees. However, the market practice is that dealers make their own voting decisions without consulting the swap counterparties.

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67. See generally 17 C.F.R. § 240.13d-101 (2009) (for example, he would face Item 3—Source and Amount of Funds or Other Consideration; Item 4—Purpose of Transaction; Item 5—Interest in Securities of the Issuer; Item 6—Contracts, Arrangements, Understandings or Relationships with Respect to Securities of the Issuer; and Item 7—Material to be Filed Exhibits); see also GREENE ET AL., supra note 1, § 8.02[1] (discussing disclosure).

68. § 240.13d-101. Item 6 requires the person to:

Describe any contracts, arrangements, understandings or relationships (legal or otherwise) among the persons named in Item 2 and between such persons and any person with respect to any securities of the issuer, including but not limited to transfer or voting of any of the securities, finder’s fees, joint ventures, loan or option arrangements, puts or calls, guarantees of profits, division of profits or loss, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into. Include such information for any of the securities that are pledged or otherwise subject to a contingency the occurrence of which would give another person voting power or investment power over such securities except that disclosure of standard default and similar provisions contained in loan agreements need not be included.

Id.

69. See Hu & Black, supra note 4, at 826 (“These ‘morphable voting rights’ will generally not be verifiable by outsiders, and depend on market customs.”).

70. See Black Letter, supra note 11, at 8 (“Market practice for U.S. companies, which has developed in part because of § 13(d) rules, is for the dealer to make its own voting decisions, without consulting its swap counterparties.”).

71. See Hu & Black, supra note 4, at 815.

72. See Black Letter, supra note 11, at 8.

I am not aware of a market practice with respect to whether it is appropriate for a swap counterparty to contact a dealer and attempt to persuade it to vote in a particular way. Such efforts may exist, especially for non-U.S. companies, but they are not the norm for U.S. companies and did not occur in this case. If such attempts were made, they
For example, dealers simply may vote in proportion to what they understand others’ votes to be or follow the recommendations of RiskMetrics, a proxy advisory firm. Others may aggregate and “net-off” share positions among multiple trading desks such that the dealer actually has a net short position and thus no voting rights. Further, some dealers may have a policy of not voting the shares, at least in contested situations, or they may be unable to do so because they have lent the shares to third parties under an agreement that transfers the voting rights to the borrower. Thus, even though there are circumstances where the Long Party can influence the voting of the Short Party, in the majority of situations, this is not the case.

A Long Party may have voting power because of its ability to conduct an exchange unwind. This can occur when the Short Party hedges its exposure by acquiring the underlying shares. A derivatives dealer who acts as the Short Party for equity swaps often hedges its positions by purchasing shares in the open market. This is especially the case where the swap involves a large number of shares of a thinly-traded company where alternative hedging strategies may be limited. However, there is no guarantee that the Short Party will hedge in this manner, as hedging strategies vary among dealers. In fact, swap dealers’ hedging practices are may fail because there is no direct contact between the dealer’s swaps desk and the persons who make voting decisions, or because the dealer has a policy against responding to such efforts. It is possible that such an effort may backfire by causing the dealer to abstain from voting.


In most cases, the derivatives dealer will hedge its short equity swap position. When hedging occurs, it often (but not always) involves the purchasing of “matched shares.” For example, a dealer might take the short side of an equity swap referencing 1,000,000 shares of CSX, and at or very close to the same time, purchase 1,000,000 CSX shares in the market. If the dealer is fully hedged and CSX shares then rise (fall), the dealer will lose (gain) on the swap exactly the same amount it gains (loses) on matched shares.

Other forms of hedging include acquiring a long position in single stock futures, acquiring a (long call option, short put option) position, and acquiring a long position in
far from uniform and many dealers hedge their exposure on a portfolio basis, rather than swap-by-swap.\textsuperscript{80} Further, while some dealers may be willing to sell the shares to the party via an exchange unwind, some have a policy of not doing so, and, in any case, they are not obligated to do so.\textsuperscript{81} In addition, the International Swaps and Derivatives Association’s equity swap documentation and any dealer-specific supplements, which are used for nearly all swaps, do not give the Long Party any power to direct the actions of the dealer with respect to whether the dealer will hedge with Matched Shares. Furthermore, if the dealer does decide to hedge, no guidance is provided concerning how the dealer will vote or dispose of the Matched Shares.\textsuperscript{82} Thus, while there are circumstances where the Long

\textsuperscript{80} ROBERT L. TORTORIELLO & PAUL E. GLOTZER, GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES § II(E)(3)(c) (14th ed. 2009) (summarizing interpretive letters from the Office of the Comptroller of the Currency describing various hedging practices, including hedging on a portfolio basis).

\textsuperscript{81} See Black Letter, supra note 11, at 9.

Dealers’ practices with respect to exchange unwinds differ. Some dealers, if they have hedged with matched shares, are willing to sell the shares directly to their investor, if the investor requests this. Other dealers, as a matter of policy, will refuse to sell matched shares directly to the swap counterparty.

Investor preferences with respect to exchange unwinds also differ. Some investors may ask their dealer whether the dealer holds matched shares and is interested in selling the shares to the investor. Others may prefer not to even make such an inquiry, partly to limit market knowledge of their positions, and partly to avoid any inference that they had a prior agreement with the dealer with respect to the possible unwind.

\textit{Id.} Moreover,

[market expectation that a dealer will unwind a swap is not a guarantee, as illustrated by a 2006 buyout offer by Sears Holdings for the minority shares in its Sears Canada subsidiary. A hedge fund had previously acquired equity swaps in Sears Canada from Scotiabank. Scotiabank later became the dealer-manager for Sears Holdings’ buyout offer. The offer required approval by a majority of the Sears Canada minority shareholders. Sears Canada’s independent directors opposed the bid; so did many Sears Canada shareholders. The hedge fund asked Scotiabank to unwind the swap so it could vote against the offer. Scotiabank not only refused, but also committed to vote its Sears Canada shares for the offer. Scotiabank thus became an empty voter; perhaps with negative economic interest because it was an agent for Sears Holdings. The hedge fund complained about Scotiabank’s failure to observe swap market conventions and said it was “looking forward to regulatory and legal scrutiny of this transaction.”

\textsuperscript{82} See Black Letter, supra note 11, at 8.

The ISDA equity swap documentation and any dealer-specific supplements do not give a long equity swap holder any power to direct: (i) whether the derivatives dealer will
Party to an equity swap can acquire the underlying shares and obtain voting power, there are situations where this is not the case.

The Long Party may have investment power where the Short Party has no other means to hedge, because by entering into the swap, the Long Party is essentially directing the Short Party to hedge by purchasing the underlying shares. By unwinding the swap, the Long Party essentially has the power to direct the Short Party to sell the shares, as Short Parties typically sell their hedged shares when the Long Party unwinds the swap. The Long Party may have the ability to acquire the physical shares upon the unwinding of the swap, as the dealer may be willing to sell the shares to the Long Party or the Long Party may simply purchase the shares in the open market. Under circumstances where the Short Party has no means to hedge other than by buying the underlying shares, and such party plans to sell those shares upon the unwinding of the swap, the Long Party essentially has investment power over the security. However, market realities are such that the Short Party does not always purchase the underlying shares to hedge its position in the swap and does not always sell the underlying shares when the Long Party unwinds the swap. Further, even dealers that hedge with Matched Shares may sell them prior to the unwinding of the equity swap or may hold on to them after the swap is unwound. Thus, even though there are circumstances where the Long

hedge; (ii) if the dealer hedges, how it does so, with matched shares or in another way; (iii) if the dealer hedges by acquiring matched shares, whether the counterparty will hold those shares on the record date for a shareholder meeting, or will instead lend the shares to others on that date; (iv) if the dealer hedges with matched shares and holds them on a record date, whether the counterparty will vote the shares at the shareholder meeting; or (v) if the counterparty hedges with shares, holds those shares on the record date, and votes the shares, how the counterparty will vote. The dealer-specific addendum will sometimes specifically state that some or all of these matters are in the sole discretion of the dealer.

Id.
83. See CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 546 (S.D.N.Y. 2008), aff’d, 292 F. App’x 133 (2d Cir. 2008).
84. Id. at 542 (“With very minor exceptions, whenever TCI terminated a swap, the counterparty sold the same number of physical shares that were referenced in the unwound swap and it did so on the same day that the swap was terminated.”). However, “[m]arket expectation that a dealer will unwind a swap is not a guarantee.” See Hu & Black, supra note 4, at 839.
85. See Black Letter, supra note 11, at 9.
86. See supra notes 78–82 and accompanying text.
87. See ISDA Brief, supra note 73, at 23. Examples of where this might occur include:

[1] 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

[2] 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.
Party has the power to influence the disposition of the security, there are situations where this is not the case.

III. **CSX CORP. V. CHILDREN’S INVESTMENT FUND MANAGEMENT**

A. **FACTS OF THE CASE**

TCI is an activist\(^8\) hedge fund that buys large enough stakes in companies to bring about changes in the direction of the companies.\(^9\) Likewise, in October 2006, TCI began acquiring long positions in total return equity swaps in CSX because it thought that if it could influence the company to make certain changes, the value of its positions would increase.\(^10\) By the end of 2006, TCI had acquired 8.8% of CSX.\(^11\) Beginning in December 2006, TCI explored the possibility of a leveraged buyout.\(^12\) In February 2007, CSX announced a plan to repurchase some of its stock in an effort to defend itself against a potential takeover.\(^13\) Accordingly, TCI began contacting other hedge funds, attempting to influence them to acquire shares in CSX in order to build support for whatever course of action TCI would decide to take with respect to its ownership in the company.\(^14\) In accordance with this plan, 3G, one of the funds contacted by TCI, began purchasing shares in CSX.\(^15\) As of March 29, 2007, TCI owned equity swaps referencing nearly 14% of CSX stock, but had yet to purchase any of the company’s shares directly.\(^16\)

In March and April of 2007, TCI began to acquire physical shares of CSX.\(^17\) At this point, a leveraged buyout was becoming a less likely

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\(^3\) 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.

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\(^8\) See Dieter G. Kaiser, *Activists*, in *ENCYCLOPEDIA OF ALTERNATIVE INVESTMENTS* 5 (Greg N. Gregoriou ed., 2009). “The investment process of an activist begins with fundamental analysis to identify companies [that are undervalued].” *Id.* The activist will then engage in either a friendly or a hostile strategy. *Id.* A fund using a friendly strategy will have private communications with management in an effort to effect change in the company that will increase shareholder value. *Id.* Alternatively, or after friendly tactics are unsuccessful, the activist may use a hostile strategy, such as waging a proxy contest or threatening and/or engaging in a change in control transaction. *Id.* at 5–6.

\(^9\) See CSX Corp., 562 F. Supp. 2d at 533.

\(^10\) *Id.* at 523.

\(^11\) *Id.* at 524.

\(^12\) *Id.*

\(^13\) *Id.* at 553.

\(^14\) *Id.*

\(^15\) *Id.*

\(^16\) *Id.* at 526.

\(^17\) *Id.* at 527.
alternative because CSX had shown little interest in it. Consequently, TCI explored the possibility of a proxy fight as a means to effect the changes in CSX that it desired. By holding the actual shares as opposed to swaps, TCI had the ability to vote the shares. In August 2007, TCI met with a proxy solicitation firm to discuss the mechanics of a proxy contest, and in October 2007, TCI began to identify potential director nominees. In November 2007, TCI began unwinding its swap positions with six of its eight counterparties and shifted its positions to Citigroup and Deutsche Bank in part because it believed that such firms may vote the same way as TCI in a proxy contest. In this regard, Deutsche Bank owned a hedge fund, Austin Friars Capital, which had a proprietary position in CSX. Austin Friars Capital consulted with TCI on multiple occasions about the direction that CSX should take to maximize shareholder value.

As noted, 3G began purchasing CSX stock in February 2007. By October 2007, 3G owned a combination of physical shares and positions in swaps amounting to 4.2% of CSX. The economic exposure of 3G to CSX never exceeded 4.9% of CSX stock. In anticipation of a proxy fight, 3G began searching for potential nominees to the board of CSX, and two nominees were secured by December 2007. On December 10, 2007, TCI, 3G, and their director nominees (collectively, the Group) filed a Schedule 13D disclosing that they were going to engage in a proxy solicitation. The Group then filed a notice of intent to nominate a minority slate of five directors to the board of CSX, which was comprised of twelve directors. The Group supplemented its notice to include a bylaw that would allow shareholders owning 15% of CSX stock to call a special meeting. CSX filed a preliminary proxy statement in February 2008 and the group filed its proxy statement on March 10, 2008.
B. RULINGS IN THE CASE

CSX filed suit on March 17, 2008 alleging that TCI violated § 13(d) by failing to timely disclose its beneficial ownership of the shares of CSX stock referenced in the total return swaps and claiming that TCI was a beneficial owner of such shares under Rules 13d-3(a) and 13d-3(b). CSX also alleged that TCI and 3G had formed a § 13(d) group ten months prior to filing a Schedule 13D.

The court did not decide the question of whether the ownership of the swaps by TCI constituted beneficial ownership under the definition in Rule 13d-3(a), but did offer its view that such a position likely did. It found that “[i]n the last analysis there are substantial reasons for concluding that TCI is the beneficial owner of the CSX shares held as hedges by its short counterparties.”

With respect to whether TCI had voting power under Rule 13d-3(a), the court found that “[i]n the last analysis, the question whether there was an agreement-explicit or implicit-between Deutsche Bank and TCI with respect to the voting of the shares is a close one.” However, the court explained that “there nevertheless 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.” The court reasoned that TCI moved its shares to Deutsche Bank because it believed it could influence the voting of the Matched Shares. This belief was based in part on the fact that Austin Friars Capital was owned by Deutsche Bank, held a proprietary position in CSX, and, as of March 2007, shared a common interest in taking the railroad private. The court also speculated that Deutsche Bank may have recalled loans of shares around the record date so that it would be entitled to vote them in a manner favorable to TCI, evidenced by the relending of the shares immediately after the record date. The court also found that TCI potentially had the power to influence how the counterparties voted the shares by selecting banks with certain voting policies. While there may not have been an explicit agreement or understanding between TCI and the banks with respect to the voting of the shares, the court found that there was enough evidence, especially with

114. Id. at 538.
115. Id. at 538–39.
116. Id. at 545–48.
117. Id. at 545.
118. Id.
119. Id. at 546.
120. Id.
121. Id. at 544.
122. Id.
123. Id. at 544.
respect to Deutsche Bank, that TCI had the power to influence the voting of the securities, although it did not decide this question.\(^{124}\)

With respect to whether TCI had investment power, the court found that TCI contemplated and intended that the counterparties would hedge the swaps by purchasing shares in CSX and that it was inevitable that the counterparties would hedge in this manner.\(^{125}\) It further reasoned that “TCI significantly influenced the banks to purchase the CSX shares that constituted their hedges because the banks, as a practical matter and as TCI both knew and desired, were compelled to do so.”\(^{126}\) The court reasoned that “once the counterparties bought the shares, TCI had the practical ability to cause them to sell simply by unwinding the swap transactions.”\(^{127}\) Thus, while TCI did not explicitly direct the banks to purchase or sell the hedged shares, the court found that TCI had investment power, although it technically did not decide this question.\(^{128}\)

The court, however, did decide the question of whether TCI was a beneficial owner under Rule 13d-3(b),\(^{129}\) holding that “TCI created and used the TRSs with the purpose and effect of preventing the vesting of beneficial ownership in TCI as part of a plan or scheme to evade the reporting requirements of Section 13(d).”\(^{130}\) The court found that “[u]nder the plain language of Rule 13d-3(b), [TCI] is deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures created by the TRSs.”\(^{131}\) The court reasoned that TCI purposely remained below the 5% disclosure requirement for its ownership of physical shares and made certain that its counterparties stayed below 5% in order to avoid the filing of a Schedule 13D on behalf of itself or its counterparties.\(^{132}\) The court explained that TCI acted in such a manner to avoid paying a higher price for CSX shares.\(^{133}\) It further found that avoiding disclosure allowed

\(^{124}\) Id. at 542.
\(^{125}\) Id.
\(^{126}\) Id. at 543. The court noted that:

[W]hile 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. Indeed, TCI effectively has admitted as much. It did so by spreading its swap transactions among eight counterparties to avoid any one hitting the 5 percent disclosure threshold and thus triggering its own reporting obligation—a concern that was relevant only because TCI knew that the counterparties were hedging by buying shares. And it did so in closing argument, where its counsel said that the banks’ purchases of CSX shares were “the natural consequence” of the swap transactions.

\(^{127}\) Id. at 546.
\(^{128}\) Id.
\(^{129}\) Id. at 552.
\(^{130}\) Id.
\(^{131}\) Id.
\(^{132}\) Id. at 548–49.
\(^{133}\) Id.
TCI to exert pressure on CSX without providing the market or the company with complete information.\(^{134}\)

In interpreting the amicus letter from the SEC’s Division of Corporation Finance, the court easily found that Rule 13d-3(b) applies “when one enters into a transaction with the intent to create the false appearance that there is no large accumulation of securities that might have . . . potential for shifting corporate control by evading the disclosure requirements of § 13(d) or (g) through preventing the vesting of beneficial ownership in the actor.”\(^{135}\) Further, the court dismissed Professor Bernard Black’s argument that, in order for Rule 13d-3(b) to apply, the underlying evasive activity must constitute beneficial ownership under Rule 13d-3(a).\(^{136}\) It reasoned that “[a]s Rule 13d-3(b) is reasonably related to the purpose of the statute, it is a perfectly appropriate exercise of the Commission’s authority even where it reaches arrangements that otherwise would not amount to beneficial ownership” and that “[i]f Rule 13d-3(b) reaches only situations that involve beneficial ownership, then it reaches only situations that are reached by Rule 13d-3(a) [which would] render Rule 13d-3(b) superfluous.”\(^{137}\)

The court also held that TCI and 3G formed a § 13(d) group ten months prior to filing a Schedule 13D.\(^{138}\) Section 13(d)(3) provides that “[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ . . . .”\(^{139}\) The court reasoned that “the existing relationship, the admitted exchanges of views and information regarding CSX, 3G’s striking patterns of share purchases immediately following meetings with Hohn and Amin [partners at TCI], and the parallel proxy fight preparations, all suggest that the parties’ activities from at least as early as February 13, 2007, were products of concerted action. . . .”\(^{140}\) Consequently, the court held that the physical shares acquired by TCI and 3G between February and December 2007 were obtained when the parties should have filed a Schedule 13D, and, thus, the funds were in violation of § 13(d).\(^{141}\) This Article maintains that this holding was correct based on the overwhelming evidence suggesting that the parties formed a group\(^{142}\) and, therefore, provides no further analysis of this particular holding.

\(^{134}\) Id.

\(^{135}\) Id. at 550.

\(^{136}\) See Black Letter, supra note 11, at 5.

\(^{137}\) CSX Corp., 562 F. Supp. 2d at 552.

\(^{138}\) Id. at 555.


\(^{140}\) See CSX Corp., 562 F. Supp. 2d at 554.

\(^{141}\) Id. at 552–54. The court noted that “[d]efendants most recently held 8.3 percent of CSX’s shares. Of that total, 1.9 percent were acquired by 3G before its disclosure obligation arose upon the expiration of 10 days following the formation of a group with TCI no later than February 13, 2007.” Id. at 568 n.314.

\(^{142}\) Id. at 553. This evidence includes that:
As relief, among other requested remedies, CSX sought an injunction prohibiting TCI and 3G from voting any CSX shares at the 2008 annual meeting, including those shares obtained when in violation of § 13(d), which amounted to approximately 6.4% of CSX’s outstanding shares. To obtain an injunction, a moving party such as CSX has to show success on the merits and irreparable harm if the relief is not granted. Furthermore, according to the Supreme Court in Rondeau v. Mosinee Article Corp., for § 13(d) actions the irreparable harm must be caused to those interests that the Section seeks to protect, such as alerting investors to potential changes in corporate control. CSX showed success on the merits because the court found that, among other things, “TCI and 3G failed to file the required disclosure within [ten] days of forming a group.” Thus, the critical issue was whether CSX could show irreparable harm.

In attempting to show irreparable harm, CSX made two arguments. The first was that TCI and 3G should have been foreclosed from voting the

TCI and 3G have had a close relationship for years, in part because 3G’s Synergy Fund is an investor in TCI.

January 2007—Hohn and Behring discuss TCI’s investment in CSX, including its approximate size.

February 2007—3G begins buying CSX shortly after Behring’s January conversation with Hohn.

On or about February 13, 2007—Hohn speaks to his “friend Alex” Behring about CSX as a result of market excitement regarding CSX attributable in whole or part to 3G’s heavy buying.

At about the same time, Hohn begins tipping other funds to CSX, which continues for some time. This is an effort to steer CSX shares into the hands of like-minded associates.

March 29, 2007—Amin and Behring meet.

March 29, 2007—3G resumes CSX purchases after hiatus.

March 29, 2007 through April 18, 2007—TCI increases its overall (shares plus swaps) position by 5.5 million shares, or 1.2 percent of CSX. 3G increases its position by 11.1 million shares, or 2.5 percent of CSX.

August to September 2007—Hohn becomes concerned about possible reregulation. Both 3G and TCI reduce their CSX exposures, although 3G to a proportionately greater extent than TCI.

Late September—October 2007—TCI tells D.F. King it probably will mount proxy contest. Hohn and Behring meet on September 26, 2007. Both TCI and 3G resume increasing their positions in the wake of the meeting. Both begin looking for director nominees.

Id. at 568.

Id. at 567.


CSX Corp., 562 F. Supp. 2d at 568.

Id.
shares they acquired during the period in which they were in violation of § 13(d) because failing to enjoin the votes would result in irreparable injury to shareholders who may have been content with present management.148 The court found CSX’s argument unpersuasive, partly because corrective disclosure had already been made.149 It also reasoned that while the actions of TCI and 3G altered the corporate electorate, their conduct did no more than increase the funds’ likelihood of prevailing in the current contest, and could not be regarded as causing irreparable injury that could be properly remedied by the sterilization of votes.150

The second argument made by CSX was that sterilization was required “to avoid permitted defendants [from] retain[ing] the fruits of their violations and to deter future violations.”151 Some courts have suggested that relief beyond corrective disclosure is appropriate to deter violations, and they typically consider “(1) whether a substantial number of shares were purchased after the misleading disclosures and before corrective disclosure, (2) whether the curative disclosure occurred simultaneously with or on the eve of a tender offer, and (3) whether the violation was egregious.”152 The Commission advanced such a position in its amicus brief in San Francisco Real Estate Investors v. Real Estate Investment Trust of America, suggesting that “[a]bsent a remedy beyond ordering corrective disclosure, a person will have little incentive to comply with the statute.”153 However, the court in CSX did not find such an argument persuasive and ruled that it was foreclosed by Rondeau.154 In doing so, it held that “a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants’ voting rights and that plaintiff has failed to establish such a threat.”155

IV. CRITIQUES OF THE RULINGS IN CSX AND PROPOSALS FOR REFORM

A. LONG PARTIES TO EQUITY SWAPS ARE NOT BENEFICIAL OWNERS UNDER RULE 13D-3(A)

Rule 13d-3 provides that a person beneficially owns a security if he directly or indirectly has or shares voting or investment power through any

148. Id. at 568–69.
149. Id. at 569–71.
150. Id.
151. Id. at 568.
152. Id. at 571 (quoting S.F. Real Estate Investors v. Real Estate Inv. Trust of Am., 701 F.2d 1000, 1009 (1st Cir. 1983)).
155. Id. at 572.
contract, arrangement, understanding, relationship, or otherwise. A holder of a long position in an equity swap does not have beneficial ownership of the security because he has neither voting nor investment power over the security.

The first reason that Long Parties to equity swaps do not have beneficial ownership over the shares held by the Short Party is because the definition of beneficial ownership does not extend to purely economic interests. According to the Staff of the SEC Division of Corporation Finance (the Staff), “economic or business incentives, in contrast to some contract, arrangement, understanding, or relationship concerning voting power or investment power between the parties to an equity swap, are not sufficient to create beneficial ownership under Rule 13d-3.” Moreover, practitioners share the same view. In this regard, a standard cash-settled swap does not give the Long Party voting or investment power over the Matched Shares, absent a contract, arrangement, understanding, or relationship concerning voting or investment power. The Long Party merely has “an economic interest in the market performance of the referenced security, including any dividends or other distributions associated with it.” Thus, even though the Short Party may have economic or business incentives to vote the shares as the Long Party wishes, or to sell the shares upon the unwinding of the swap, the Long Party does not have actual authority to direct the voting or disposition of the securities. In this regard, the Long Party essentially owns the economic equivalent of nonvoting shares, which are not required to be disclosed under § 13(d).

Further, “when the counterparty chooses to act in these areas in circumstances where it is unconstrained by either legal rights held by the other party or by any understanding, arrangement or restricting

157. See generally GREENE ET AL., supra note 1. A long position is the “purchase of securities by an investor with the hope there will be an increase in price allowing an investor to recognize a profit from the eventual sale of the securities.” MODERN DICTIONARY FOR THE LEGAL PROFESSION (3d ed. 2001).
158. See Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15,348, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,762 (Nov. 22, 1978). In the adopting release, the Commission declined to include “traditional economic interests in securities, i.e., the right to receive dividends and the right to receive proceeds upon sale” as “criteria for defining beneficial ownership for purposes of Regulation 13D-G.” Id.
159. See Breheny Letter, supra note 1, at 2.
160. See JACOBS, supra note 1, § 2:13.
161. See Breheny Letter, supra note 1, at 2.
162. Brief of Amicus Curiae Managed Funds Association in Support of Neither Party 4, CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 292 F. App’x 133 (2d Cir. 2008) (No. 08 Civ. 2764) [hereinafter Managed Funds Association Brief].
163. Id.
164. See Black Letter, supra note 11, at 17.
relationship with the other party, it is acting independently and in its own economic interests.165

Because the swap agreement between TCI and its counterparties contained no contract, understanding, arrangement, or relationship concerning voting or investment power, TCI is not the beneficial owner of the Matched Shares under Rule 13d-3(a). Further, since the mere presence of economic incentives to vote or dispose of securities does not fall within the definition of beneficial ownership contained in this Rule, TCI did not possess voting or investment power over the securities. As most swap agreements are similar to those entered into by TCI, most Long Parties to equity swaps do not have beneficial ownership under Rule 13d-3(a).

The second reason that a Long Party to an equity swap does not have beneficial ownership over the shares held by the Short Party is because the mere ability to influence another party is insufficient to establish beneficial ownership.168 In this regard, the court in CSX is incorrect in its view that Rule 13d-3(a) extends to persons who can merely influence the voting or disposition of the securities.169 Beneficial ownership requires control over

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166. Managed Funds Association Brief, supra note 162.
167. See Black Letter, supra note 11, at 7.

Equity swaps are in theory privately negotiated contracts. However, the principal terms of the vast majority of equity swaps are based on documentation published by the International Swap Dealers Association (ISDA). Some dealers use supplements to the standard ISDA equity swaps form, but the principal terms of these supplements are standardized and not individually negotiated with each client.

Id. (footnote omitted).
168. ISDA Brief, supra note 73.
169. See CSX Corp., 562 F. Supp. 2d at 548–49. ISDA’s amicus brief explained:

In the 1978 Release, the SEC stated that “[t]he legislative history of [§ 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 . . . .

ISDA Brief, supra note 73, at 17. The brief further stated:

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 [adopted release].

Id. at 18 n.5.
Lessons Learned

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the voting or disposition of the shares because “the terms ‘voting power’
and ‘investment power’ as used in the Rule . . . are based on the concept of
the actual authority to vote or dispose or the authority ‘to direct’ the voting
or disposition [of the securities].” 170 Moreover, in adopting the beneficial
ownership rules, the Commission chose not to extend the rules to relatives
living in the same household because “such a standard was totally
inapposite to the voting/investment power approach,” 171 even though such
persons may have significant influence over the voting or disposition of the
securities by the beneficial owner. 172 Further, the beneficial ownership rules
were adopted “to provide more objective standards” for the rules defining
beneficial owner, 173 and an influence standard is based on subjectivity,
which could lead to substantial uncertainty for persons attempting to
comply with Rule 13d-3(a). 174 Because the Long Party to an equity swap
merely has the ability to influence the voting or disposition of the securities,
he does not have voting or investment power as defined in Rule 13d-3(a). 175
Consequently, such person or entity, including TCI, does not have to
disclose his long position in an equity swap.

The third reason that holders of long positions in equity swaps do not
have beneficial ownership of the Matched Shares is because this judicial
interpretation of Rule 13(d)-3(a) incorrectly assumes that the Short Parties
always hedge by purchasing the referenced security, and/or that the Long
Parties always have the ability to direct the voting and/or disposition of the
securities, and such assumptions would lead to substantial uncertainty in
applying the Rule. With respect to dispositive power, the argument for
beneficial ownership is that the Short Party has to hedge with Matched
Shares, and that he will sell the shares when the Long Party unwinds the
swap. 176 However, the Short Party does not always purchase the underlying
shares to hedge its position in the swap, as hedging practices vary widely
among dealers. 177 Further, even where it does hedge with such shares, it
may sell them prior to the unwinding of the equity swap or may hold on to
them even after the swap is unwound. 178 Consequently, even assuming that
there are situations where the Long Party has the ability to direct the
disposition of the security by causing the Short Party to purchase the

170. See Breheny Letter, supra note 1, at 2 (emphasis added).
171. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,348.
172. See ISDA Brief, supra note 73, at 15–16.
173. Id. at 16 (quoting Adoption of Beneficial Ownership Disclosure Requirements, Securities
1977) (emphasis in original).
174. Id. at 19.
175. See 17 C.F.R. § 240.13d-3(a) (2009).
(S.D.N.Y. 2008), aff’d, 292 F. App’x 133 (2d Cir. 2008).
177. See TORTORELLO & GLOTZER, supra note 80; see also Black Letter, supra note 11, at 7
(“when hedging occurs, it often (but not always) involves purchasing ‘matched shares.’”).
178. See supra part II.C.
underlying shares or by causing the Short Party to sell the shares when the Long Party unwinds the swap, there are circumstances where this is not the case. With respect to voting power, the argument for beneficial ownership is that Long Parties can direct or influence the voting of the securities by the Short Parties and/or that they can acquire the Matched Shares upon an exchange unwind and obtain voting rights. However, market realities are such that dealers make their own voting decisions without consulting with the swap counterparties, or may have a policy of not voting their shares. Therefore, while there may be situations where the Long Party has the ability to direct the voting of the shares, or at least has the ability to influence the voting (assuming arguendo that influence is the correct standard), there are situations where this is not the case. Further, as explained with respect to dispositive power, because the Short Party does not always purchase Matched Shares—and even when the Short Party purchases the Matched Shares—there is no guarantee that it will sell the shares to the counterparty upon the unwinding of the swap. Thus, there is uncertainty as to whether the Long Party can obtain voting rights.

The uncertainty created by the judicial interpretation of a Rule requiring disclosure of beneficial ownership by Long Parties whose counterparties’ hedge with Matched Shares would be difficult for the SEC to administer, since beneficial ownership would be determined solely based upon whether, and in what manner, the Short Party hedged the swap. Further, because “there is no economic difference to an investor between an equity swap hedged by the derivatives dealer with [M]atched [S]hares, and an equity swap hedged in another way, one cannot logically say that the former conveys § 13(d) beneficial ownership and the latter does not.” Moreover, parties could simply contract around the Rule by stating in the swap contract that Short Parties cannot hedge with physically Matched Shares, and thus, the Rule would not capture all long positions in equity swaps. Parties seeking to avoid § 13(d) may simply start to use cash-settled single stock futures that have very similar economic characteristics to equity swaps, but that according to a Commission interpretation, do not confer beneficial ownership.

180. See Black Letter, supra note 11, at 8.
181. See Sullivan, supra note 25, at 1317.
182. See Black Letter, supra note 11, at 16.
183. Id. at 12.
184. Id. at 13. The following interpretation is from an Exchange Act Release:

Q18: Would the equity securities underlying a security future that requires cash settlement be counted for purposes of determining whether the purchaser of the contract is subject to the Regulation 13D beneficial ownership reporting requirements?

A18: No. A purchaser of a cash-settled security future (i.e., a security future that, by its terms, must be settled by a cash payment) would not count the equity securities underlying the contract for purposes of determining whether he or she is subject to the
Because the standard posited by the court depends on specific market practices, it will not lead to uniform results. This will make compliance and administration difficult. For example,

[i]f an investor who holds matched shares is the beneficial owner (in the 13(d) sense) of the matched shares which its dealers holds as a hedge, but the dealer retains the power to hedge in any way it wants, to change the form of its hedge over time, and to potentially not hedge at all, how is the investor to know how many shares it beneficially owns?185

In this regard, “it would seem strange to decide ex post that equity swaps with dealer 1, which follows one set of practices, count as beneficial ownership of shares; while swaps with dealer 2, which follows a different set of practices, do not.”186 Such a vague, uncertain, and subjective standard is unworkable. As such, Long Parties should not have to disclose their ownership positions in equity swaps under a judicial interpretation of Rule 13d-3(a).187 The Commission should amend this rule to capture these ownership positions.

Regulation 13D reporting requirements, because he or she does not have the right to acquire beneficial ownership of the underlying security.


185. See Black Letter, supra note 11, at 11. In addition, among other potential consequences, market participants –

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.

ISDA Brief, supra note 73, at 25–26.

186. Black Letter, supra note 11, at 17.

B. RULE 13D-3(A) SHOULD BE AMENDED TO REQUIRE THE DISCLOSURE OF LONG POSITIONS IN EQUITY SWAPS

The Commission is currently “evaluating whether persons using equity derivatives, such as an equity swap, should be subject to the beneficial ownership reporting provisions of the Exchange Act when accumulating substantial share positions in connection with change of control transactions.”\(^\text{188}\) The Commission should amend Rule 13d-3(a) to require such persons to be subject to the beneficial ownership rules. Other regulators have already adopted similar reforms,\(^\text{189}\) including the Financial Services Authority (FSA), which regulates financial markets in the United Kingdom (U.K.).\(^\text{190}\) Similar to the FSA rules for contracts for difference, which are the U.K. equivalent of equity swaps, the Commission should amend Rule 13d-3(a) to require the disclosure of Long Parties’ holdings in equity swaps and other similar instruments. Disclosure should be required regardless of whether the instrument is physically settled in cash or in shares.\(^\text{191}\) Just like the U.K. rules, there should be an exemption for dealers that hold long positions in equity swaps as the result of client-servicing transactions (i.e., transactions that are not made on a proprietary basis, such as where a dealer writes a short equity swap for a client, resulting in the dealer holding a long position in the swap).\(^\text{192}\) According to the FSA, “[t]he principle behind [such an] exemption is that firms holding a position purely to facilitate a client position, with no interest in the performance of underlying equity, should not need to make a disclosure.”\(^\text{193}\)

Rule 13d-3(a) should be expanded to capture economic ownership by using concepts found in the definition of beneficial ownership in § 16 of the Exchange Act.\(^\text{194}\) Specifically, Rule 13d-3(a) should be amended to include a new category of beneficial ownership for any “[d]irect or indirect


\(^{189}\) Henry T.C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. PENN. L. REV. 625, 684–86 (2008). Hong Kong and Switzerland have adopted such reforms, and other countries are in the process of considering whether to implement changes to their rules. Id. at 684.


\(^{191}\) See FSA, Disclosure and Transparency Rules, § 5.3.3.

\(^{192}\) Id. § 5.3.1.


\(^{194}\) See Hu & Black, supra note 4, at 882.
pecuniary interest in such security.”195 “Pecuniary interest” should have the same definition as it does in Rule 16a-1.196 The definitions of “derivative instrument” and “immediate family” should have the same meaning that they have under this Rule.197 The definition of “indirect pecuniary interest” should also have the same definition that it has in the Rule; however, the provision regarding derivative securities should be expanded to capture long positions in equity swaps and long ownership positions in similar instruments.198 To this end, the definition of indirect pecuniary interest should be revised to include, among other things, “[a]ny derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit . . . from the [subject security’s value increasing], including a person’s right to acquire the . . . security through the exercise or conversion of any derivative instrument, whether or not presently exercisable.”199 In addition, there should be an exemption for dealers holding long positions in equity swaps or similar instruments where these positions were acquired to facilitate client transactions. This exemption would apply to a client-serving intermediary (as defined in the Rule), which “(a) fulfill[s] orders received from clients otherwise than on a proprietary basis; (b) respond[s] to a client’s requests to trade otherwise than on a proprietary basis; or (c) hedge[s] positions arising out of dealings [described] in (a) or (b).”200

Amending Rule 13d-3(a) in this manner would require disclosure of persons’ long positions in equity swaps, which would prevent them from using such positions to influence the voting or disposition of a company’s

195. Memorandum of Theodore N. Mirvis et al., Wachtell, Lipton, Rosen & Katz, Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century 6 (Mar. 3, 2008), http://www.wlrk.com/webdocs/wlrknew/FirmMemos/WLRK/WLRK.15395.08.pdf (proposing amendments to Rule 13d-3). The Rule would read as follows with the proposed amendments:

(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; and/or,

   (3) Direct or indirect pecuniary interest in such security.

Id. (emphasis in original).

196. Id. at 13d-3-2. Rule 13d-3(e) should read: “The term pecuniary interest in any security shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject security.” Id.

197. Id. at 13d-3-3.

198. Id. at 13d-3-2 to 13d-3-3.

199. Id. at 13d-3-2.

securities, or engaging in an exchange unwind for the purposes of voting at the annual meeting, conducting a proxy contest, or making a tender offer. Currently, Long Parties have the ability to exert significant influence or control over a company, without public disclosure, in the following ways: First, when a Long Party enters into an equity swap, he, in certain instances, has the ability to influence the disposition of the underlying shares because the Short Party at times has no other effective means to hedge other than purchasing the Matched Shares (e.g., in the case of thinly traded stock). 201 Further, where the Short Party does hedge with Matched Shares, the Long Party has the ability to influence the disposition of the securities through unwinding the swap, regardless of whether he acquires the shares from the Short Party or the shares are sold in the open market. 202 With respect to voting power, the Long Party has the ability to influence the voting of the securities by choosing a counterparty that has a similar voting interest. 203 Additionally, a Long Party may acquire a large amount of a company’s securities prior to an annual meeting of shareholders by engaging in an exchange unwind and then vote the newly obtained shares at the meeting. A Long Party could also engage in an exchange unwind and then launch a proxy contest. Moreover, Long Parties may conduct stealth takeovers, several of which have occurred in Switzerland, where the Long Party could acquire a large amount of securities through an equity swap, conduct an exchange unwind, and then launch a tender offer. 204 In addition, equity swaps can be used to conduct a “street sweep” tender offer, where a bidder “can acquire [shares], cross the 5% threshold for 13D disclosure, and . . . before the 13D must be filed, buy up to 9.9% of a target’s shares (stopping short of the 10% level that would trigger . . . Exchange Act § 16) and then use decoupling strategies to jump to a much higher level,” prior to ever filing a Schedule 13D. 205 Because Long Parties to equity swaps currently can exert significant influence or control over a company without making public disclosure, Rule 13d-3(a) needs to be amended to require these persons to disclose their ownership positions. Such an amendment will alert investors and the marketplace to the accumulation of these large economic positions in a company’s stock.

Amending Rule 13d-3(a) would promote investor protection because it would give investors information regarding persons with large economic positions in the securities of a company that have the ability to influence or control the company. It would also preserve market integrity because it assures that a large economic position in a company’s stock, the disclosure

201. See Hu & Black, supra note 4, at 837.
202. See supra Part II.C.
203. See Hu & Black, supra note 4, at 837–38.
204. See Hu & Black, supra note 189, at 655–59 (contains examples and the Swiss regulatory response).
205. Id. at 736.
of which often results in an increase in the stock price, reaches the marketplace. Regarding the CSX opinion, while the court in the case was correct in reasoning that there should be disclosures of long positions in equity swaps, reform should not be made through judicial interpretation because such interpretation leads to substantial uncertainty in the application of the Rule. Moreover, because the Rule was written in the 1970s, before equity swaps or other over-the-counter derivatives existed, it is more appropriate to amend the beneficial ownership rules than try to come up with a meaningful interpretation of an antiquated law. Thus, while the court in CSX reached the correct conclusion from a policy standpoint, the optimal way for long positions in equity swaps to be disclosed is to amend Rule 13d-3(a).

Investors are not the only ones who need information about Long Parties’ holdings in equity swaps, as this information is also critical to issuers. Presently, companies are engaging in private ordering by adopting second generation advance notice bylaws and poison pills that include a definition of beneficial ownership that encompasses equity swaps and other similar instruments. They are doing so to fill a regulatory gap in the definition of beneficial ownership in Rule 13d-3(a). The private ordering that is occurring in this context can simply be defined as the coming together of non-governmental parties in voluntary arrangements to adopt rules in an area where the government has not yet regulated.

One way that private ordering is occurring is through the insertion of provisions in advance-notice bylaws. Advance-notice bylaws are bylaws “regulating the ability of shareholders to nominate directors or place items on the agenda for consideration at a company’s annual or special meeting or by consent.” Such bylaws obligate shareholders to provide a specific amount of notice to the company of their proposed directors or agenda items prior to the meeting date. Regarding these bylaws, “[t]ransparency

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206. Contra Bertaccini, supra note 24 (providing opposing view).
207. See Black Letter, supra note 11, at 11.
208. Please note that § 13F, which requires disclosure of holdings by institutional money managers, including hedge funds, may need to be amended for the amendment of Rule 13(d)-3(a) to have a sufficient impact on the market.
210. See id.
212. See Nathan & Amdur, supra note 209, at 1.
214. Id.
and accountability for decoupled equity and voting interests in the context of actual or potential proxy contests was the first problem addressed by private ordering [in the area of decoupling]. Right around the time of the CSX decision, companies began to insert provisions in their advance-notice bylaws that define beneficial ownership in a way that captures Long Parties’ positions in equity swaps and long ownership positions in other similar instruments.

Another way that private ordering is occurring is through the adoption or renewal of second generation poison pills. These anti-takeover devices are being adopted or renewed to include a definition of beneficial ownership that encompasses long ownership positions in equity swaps and other similar instruments. The rationale for adopting these shareholder rights plans is the ease at which such instruments can be converted to traditional equity by activist investors attempting a proxy contest, or others interested in a change of control transaction.

The private ordering that is occurring in the adoption of advance notice bylaws and poison pills to capture long positions in equity swaps and other similar instruments shows that companies need information about parties’ ownership positions in these securities. Companies should not have to fill the regulatory gap in Rule 13d-3(a) by drafting provisions that create a

215. See Nathan & Amdur, supra note 209, at 3.
216. Id.

Law firms began recommending that their clients insert requirements in their advance notice bylaws calling for proxy contest proponents to include in their required advance notice of matters they proposed to bring to a shareholder meeting information concerning their decoupled equity and voting interests, whether consisting of synthetic equity without votes, or votes decoupled, in whole or in part, from the economic exposure of traditional equity investment. These provisions have now been inserted in over 550 second generation advance notice bylaws, a number that will likely grow significantly over the next few years.

Id.

Such increased disclosure requirements should not be problematic for shareholder proponents, or objectionable. While such disclosures may provide a company with more information than it would have based on SEC filings alone, the overall consequence of companies learning more about the holdings of proponent shareholders should not significantly affect the ability of proponents to nominate directors or propose business for shareholder meetings.

218. See Nathan & Amdur, supra note 209, at 3.
219. See Gerstein et al., supra note 217, at 2.
220. See Nathan & Amdur, supra note 209, at 2.
definition of beneficial ownership capturing these ownership positions. Rather, such a definition is properly the subject of Commission rulemaking. Consequently, the Commission should amend Rule 13d-3(a) to assure that the definition of beneficial ownership includes Long Parties’ holdings in equity swaps and other similar instruments.

C. PERSONS DO NOT HAVE BENEFICIAL OWNERSHIP UNDER RULE 13D-3(B) UNLESS THEY ARE BENEFICIAL OWNERS UNDER RULE 13D-3(A)

As previously mentioned, Rule 13d-3(b) provides that any person who (1) uses a contract, (2) with the purpose or effect of preventing the vesting of beneficial ownership of a security, (3) as part of a plan or scheme to evade the reporting requirements of § 13(d) is deemed a beneficial owner of the security. Since equity swaps are contracts and TCI entered into such agreements with the counterparties, the first element is met. Regarding the second element, TCI acted with the purpose and effect of preventing the vesting of beneficial ownership by entering into equity swaps because one of its motives in purchasing the swaps was the avoidance of reporting under § 13(d), and because it monitored its counterparties to assure that they stayed below the 5% ownership threshold that would require disclosure. However, TCI did not violate Rule 13d-3(b) because in order to engage in a plan or scheme to evade the reporting requirements of § 13(d) a person has to be a beneficial owner under Rule 13d-3(a). Since TCI is not a beneficial owner under Rule 13d-3(a), it cannot be deemed a beneficial owner under Rule 13d-3(b).

The first reason that TCI should not have been deemed the beneficial owner of the shares under Rule 13d-3(b) is because the ownership of long positions in equity swaps does not constitute beneficial ownership under § 13(d) or Rule 13d-3(a), and thus, the swaps were not used to create the false appearance of non-ownership of a security. Absent unusual circumstances or an egregious situation, the “plan or scheme to evade” language requires a showing that there was intent to enter into an arrangement that creates a false appearance. While Long Parties to equity swaps, including TCI, often purchase swaps to exert control over a company while avoiding disclosure under § 13(d), this conduct does not comport with the meaning of the terms unusual circumstances, or egregious

221. 17 C.F.R. § 240.13d-3 (2009).
223. See id.
224. See Black Letter, supra note 11, at 5.
225. See supra Part IV.A.
226. See id.
227. See Breheny Letter, supra note 1, at 3.
228. See Hu & Black, supra note 189, at 630.
situation. Therefore, the issue is whether the arrangement created a false appearance. The term "false appearance" refers to the false appearance of the non-ownership of a security, rather than, as the district court found, the "false appearance that there is no large accumulation of securities that might have a potential for shifting corporate control." According to the SEC Division of Corporation Finance, for the transaction to fall within the "plan or scheme to evade" language, it must be a sham where the equity swap is being used to create a false appearance or illusion that is contrary to the actual situation (i.e., the person is not actually the owner of the shares). However, it is the contention of this Article that in order to have the intent to enter into an arrangement that creates a false appearance of non-ownership, one must in fact be the beneficial owner of the security in the first place. In this regard, it is impossible to use an equity swap to create the false appearance that the person is not a beneficial owner where the person’s ownership position does not meet the definition of beneficial ownership under Rule 13d-3(a). Simply put, entering into an equity swap to avoid the reporting and disclosure requirements is not necessarily a violation of § 13(d). While acting with such a purpose satisfies the second element of Rule 13d-3(b), it does not attest to whether the person had a plan or scheme to evade the reporting requirements. Thus, a person’s actions do not come within Rule 13d-3(b) when his ownership position does not constitute beneficial ownership under § 13(d) or Rule 13d-3(a).

This conclusion is best explained by reference to the interpretation of a similar safe-harbor rule in Rule 144A of the Securities Act of 1933 (the Securities Act) which reads that “this section is not available with respect 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 [Securities] Act. In such cases, registration under the [Securities] Act is required.” This safe-harbor, as well as a correlative provision in Regulation S of the Securities Act, was interpreted by the Staff to not apply when a person engages in a sham transaction to create the illusion that the transaction should be exempt from registration.

229. See Breheny Letter, supra note 1, at 3.
231. See Breheny Letter, supra note 1, at 3.
232. See GREENE ET AL., supra note 1, § 8.02[1].
under the Securities Act.\textsuperscript{235} On the other hand, where the person simply enters into a transaction that is not covered by the Securities Act, the safe harbors are inapplicable.\textsuperscript{236} For example, a person conducting a private placement of equity swaps does not engage in a plan or scheme to evade the Securities Act because swaps are not securities under it.\textsuperscript{237} Consequently, the person has simply complied with the Securities Act by not issuing securities and the safe harbor is inapplicable.\textsuperscript{238} Similarly, the owning of long positions in equity swaps does not constitute beneficial ownership under § 13(d). Moreover, the Exchange Act generally does not apply to equity swaps, but rather to voting shares.\textsuperscript{239} The holder of a long position in equity swaps has simply complied with the Exchange Act by entering into a transaction that does not trigger disclosure under § 13(d), and thus, Rule 13d-3(b) and its “plan or scheme to evade” language does not apply. Consequently, “a person that does nothing more than enter into an equity swap should not be found to have engaged in an evasion of the reporting requirements.”\textsuperscript{240} In other words, “[o]ne does not evade a statute by complying with it.”\textsuperscript{241}

The second reason why long positions in equity swaps do not come within the purview of Rule 13d-3(b) is because the only statement by the Commission regarding violations of this rule is an example of “stock parking,” an activity which includes several elements that differentiate it from hidden ownership through the use of equity swaps.\textsuperscript{242} In the Commission Release giving an example of a violation of Rule 13d-3(b), X caused 10 institutions to each purchase 3% of Z Corporation for X and gave A an irrevocable proxy, which will lapse.\textsuperscript{243} Under these facts, the Commission concluded that X is deemed a beneficial owner under Rule 13d-3(b).\textsuperscript{244} In this example, X had beneficial ownership of the shares, but it was hidden because he “parked” his voting rights with a third party by giving such party an irrevocable proxy.\textsuperscript{245} Thus, this example stands for the proposition that a beneficial owner who attempts to conceal his ownership

\begin{footnotesize}
\textsuperscript{236} See Black Letter, supra note 11, at 5.
\textsuperscript{237} Id.
\textsuperscript{238} Id.
\textsuperscript{239} Id. at 6.
\textsuperscript{240} See Breheny Letter, supra note 1, at 4.
\textsuperscript{241} See Black Letter, supra note 11, at 5.
\textsuperscript{244} See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,347.
\textsuperscript{245} Id.
\end{footnotesize}
of the shares by transferring voting control to a third party is deemed a beneficial owner under Rule 13d-3(b).246 Like person X in the stock parking example, a person that purchases a long position in an equity swap may do so to avoid disclosure. Such person has essentially transferred voting control to a third party, provided that the third party has hedged with Matched Shares. More importantly, however, unlike person X, a Long Party to an equity swap is not a beneficial owner attempting to conceal his beneficial ownership, as there have been no purchases of physical shares.247 Rather, he has engaged in an investment that is not subject to § 13(d).248 In addition, there are two other material distinctions between shares parked with another party and shares purchased by a Short Party for hedging purposes.249 In this regard, “[p]arking involves an understanding that the client will buy the stock back at a later date and protect its counterparty against loss.”250 With an equity swap, there is no such understanding and the dealer must protect itself against loss.251 Thus, hedging with Matched Shares is distinguishable from conventional stock parking. Consequently, a holder of a long position in an equity swap should not be deemed a beneficial owner under Rule 13d-3(b).

The third reason that Long Parties to equity swaps should not be deemed beneficial owners of the shares held by Short Parties under Rule 13d-3(b) is because the Commission did not intend for the Rule to capture purely economic interests. When the Commission issued the proposing release regarding the beneficial ownership rules, the definition of beneficial ownership included “the right to receive or the power to direct the receipt of dividends from or the proceeds from the sale” of equity securities.252 These economic interests are nearly identical to those received by the Long Party in an equity swap.253 The Commission, however, ultimately decided not to include these economic interests in the definition of beneficial ownership.254 Instead, the Commission decided to include Item 5 of Schedule 13D, which required disclosure by actual beneficial owners of “any other person . . . known to have an economic interest,” such as the right to receive dividends or sale proceeds.255 Thus, the Commission distinguished beneficial

246. See Opening Brief, supra note 233, at 33–34 (discussing “parking schemes” and beneficial ownership).
247. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,347.
248. See Greene et al., supra note 1, § 8.02[1].
249. See Hu & Black, supra note 4, at 869.
250. Id.
251. Id.
253. See ISDA Brief, supra note 73, at 7.
254. See Beneficial Ownership Disclosure Requirements Release, supra note 34, at 12,348.
255. Id. at 12,352 (note this is now Item 6 of Schedule 13D).
ownership from economic ownership by drafting rules where economic only interests do not create beneficial ownership, but requiring that such interests be disclosed by actual beneficial owners. In promulgating Rule 13d-3(b), the Commission surely “did not intend that an arrangement it had expressly concluded should not fall within the definition of beneficial ownership [i.e., arrangements where the party only has economic interests] would result in its participants being ‘deemed’ beneficial owners under the ‘scheme to evade’ provision.” Consequently, Rule 13d-3(b) should not be used to deem holders of long positions in equity swaps beneficial owners of the shares held by Short Parties.

D. THE NEED FOR STERILIZATION AND COURTS WILLING TO ENJOIN THE VOTING OF SHARES

The court in CSX should have sterilized the votes for the shares illegally obtained by TCI and 3G because failing to do so results in irreparable harm to CSX shareholders since the voting of the shares resulted in an unfair director election. In addition, courts should more readily grant this remedy in § 13(d) proceedings. While the court in CSX rightly stated that “a threat of irreparable injury is essential to obtain an injunction sterilizing any of defendants’ voting rights,” it incorrectly held that CSX did not establish such a threat. Consequently, TCI and 3G should not be able to succeed in a proxy contest by voting shares that they obtained in violation of the securities laws to the detriment of CSX’s other shareholders.

The failure to sterilize votes leads to an unfair election of directors, as demonstrated when TCI and 3G obtained the shares at a reduced price, giving them an ill-gotten voting position in the securities. In this regard, “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.” If TCI and 3G had to pay a greater price for the securities, their ownership position would likely have been smaller, and the positions of other CSX shareholders would probably have been more significant. Under these circumstances, TCI and 3G would have had to obtain a larger amount of support to prevail in the proxy contest

256. See ISDA Brief, supra note 73, at 6–8.
257. Id.
259. Id. at 572.
261. See CSX Corp., 562 F. Supp. 2d at 549.
than was necessary at the time of the contest.\textsuperscript{262} By purchasing these shares at a reduced price, the funds were able to gain an unfair advantage in their efforts to exercise control over CSX.\textsuperscript{263} Specifically, they accumulated an economic interest requiring disclosure and failed to disclose such interest, while tipping selective third party funds and encouraging them to acquire CSX.\textsuperscript{264} Obtaining the shares at a reduced price increased the voting power of TCI and 3G, allowing them to manipulate the corporate electorate and giving them a significant advantage in the proxy contest.\textsuperscript{265} As a result, their votes should have been sterilized to prevent an unfair director election.\textsuperscript{266}

The court’s failure to sterilize votes will lead to an unfair election of directors because it improperly tilts the playing field in favor of activist hedge funds. In drafting the Williams Act, the drafters commented upon the “extreme care” which was taken “’to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid.’”\textsuperscript{267} In violating the Williams Act, TCI and 3G changed the composition of CSX’s shareholder base to the detriment of those CSX shareholders who may not have shared their vision for the company.\textsuperscript{268} Specifically, many activist hedge funds, including TCI and 3G, attempt to maximize the stock price over a short time period and realize quick profits.\textsuperscript{269} However, other shareholders are often focused on long-term growth.\textsuperscript{270} In this regard, the court should not have allowed TCI and 3G to employ a scheme to avoid disclosure as a means of gaining an unfair advantage over shareholders who do not share their investment goals. By allowing the funds to vote shares in a proxy contest that were obtained when other shareholders did not possess complete information about the

\begin{itemize}
\item \textsuperscript{262} See WLF Brief, \textit{supra} note 260, at 10.
\item \textsuperscript{263} \textit{Id.} at 12.
\item \textsuperscript{264} \textit{Id.} at 28–29 n.13.
\end{itemize}

Indeed, TCI’s and 3G’s efforts to enlist the support of other hedge funds was just one more part of their effort to tilt the playing field in their favor and against the interests of other, longer-term shareholders. Given the Williams Act’s well-recognized goal of maintaining a “level playing field” among all participants in contests for corporate control, the tilt caused by TCI’s and 3G’s resort to a “wolfpack” strategy provides just one more reason why the injunctive relief requested by CSX is essential to restoring a level playing field and preventing CSX’s shareholders from suffering irreparable harm.

\begin{itemize}
\item \textsuperscript{265} \textit{Id.} at 29 n.13.
\item \textsuperscript{266} Further, other persons that violate § 13(d) should be enjoined from voting their shares for the same reason.
\item \textsuperscript{268} See WLF Brief, \textit{supra} note 260, at 8.
\item \textsuperscript{270} \textit{Id.}
\end{itemize}
funds’ ownership positions or intentions, the court improperly tilted the playing field in favor of activist hedge funds. Therefore, such entities, including TCI and 3G, should have been enjoined from voting shares obtained when in violation of § 13(d).

The third reason that the failure to sterilize votes results in an unfair election of directors is that corrective disclosure does not cure the harm caused by TCI and 3G. In this regard, the court acknowledged that

> [the] actions [of TCI and 3G] may have contributed to creating a corporate electorate that is materially different today than it was before [TCI and 3G] made [their] purchases. Those who are content with present management and unconvinced by [TCI’s and 3G’s] blandishments may be in a weaker position than they might have occupied had [TCI and 3G] made full and timely disclosure. That all of the facts now have been disclosed does not alter this prospect.

Further, the court expressly acknowledged that the conduct of TCI and 3G increased the funds’ likelihood of prevailing in the proxy contest. Yet, one of the court’s rationales for not sterilizing the votes was that corrective disclosure had already been made. Corrective disclosure is simply not sufficient to remedy the unfair advantage gained by TCI and 3G in the proxy contest. “An injunction against future violations [and corrective disclosure], without more, not only leaves defendants their ill-gotten gains but also permits them to add to those gains every time they vote their shares.”

While corrective disclosure gives shareholders the ability to make a decision after reading all the Schedule 13D information, it does not prevent TCI and 3G from voting shares obtained at a reduced price in violation of § 13(d). It also allows activist hedge funds to gain an unfair advantage in contests for corporate control. Consequently, the votes of TCI, 3G, and other violators of § 13(d) should be sterilized.

Fourth, the votes should have been sterilized because, in the actual proxy contest, two of the directors selected by the funds were elected by

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272. Id. at 569.
273. See id.
274. Id. at 570.

Conceptually, an injunction against voting the shares therefore differs little from an injunction against future violations; sterilization merely forbids voting which, though legal in itself, is made possible by the illegal acquisition. In this respect sterilization resembles many remedies granted in other areas of administrative law. It does not interfere with corporate governance in a way contrary to the intent of Congress.

Id.
less than 6.4% of the vote, which is the percentage of shares for which there were disclosure violations. In a very close election contest, CSX announced in July 2008 that “[i]f the Court decides in favor of the CSX position, [two of the TCI directors] will not have the votes needed to be elected to the Board.” After the Second Circuit issued a summary order affirming the decision to not enjoin the voting of the shares, the two TCI directors joined the board of CSX. Thus, two of the directors elected to the Board were elected with shares that were illegally obtained when TCI and 3G were in violation of § 13(d). This outcome shows the impact that the votes of illegally obtained shares can have on director elections and other agenda items at shareholder meetings. Consequently, the votes of TCI, 3G, and other shareholders that violate § 13(d) should be sterilized.

The fifth reason why the votes should have been sterilized and why courts should more readily enjoin votes in future § 13(d) litigation is that, in certain circumstances, the Commission has recognized equitable relief as necessary to remedy intentional violations of § 13(d). In 1981, the Commission stated that a court’s equitable powers to remedy violations of § 13(d) include “the authority to order any relief appropriate under the circumstances.” In this regard, “equitable remedies in addition to corrective disclosure . . . may be necessary or appropriate to remedy violations of the Williams Act, particularly in cases where the defendant deliberately violated Section 13(d). Absent a sufficient remedy, shareholders could be irremediably harmed and the defendant would be permitted to benefit from his wrongful conduct. Further, where the remedy is limited to corrective disclosure, shareholders are not adequately protected from the harm flowing from the violation. Equity requires that violators of § 13(d) be prevented from taking advantage of the shares obtained while they were in violation of the statute.

277. See CSX Corp., 562 F. Supp. 2d at 568.
282. Id.
283. Id.
284. Id.
286. Id. at 7.
By allowing TCI and 3G to vote in the proxy contest, the CSX court deprived other shareholders of adequate protection against the harm flowing from the violation of § 13(d). In this regard, the group should not have been permitted to take advantage of the shares it obtained while in violation of the statute. TCI and 3G should have been enjoined from voting their shares in the proxy contest. In addition, other courts addressing this issue should not hesitate in sterilizing the shares of parties that violate § 13(d).

The sixth reason why the votes should have been sterilized and why future courts should enjoin violators of § 13(d) from voting at shareholder meetings is that such a remedy is supported by the case law. In Rondeau, the Supreme Court held that a showing of irreparable harm is necessary for a private litigant to obtain injunctive relief in a suit under § 13(d). In that case, the purchaser acquired less than 10% of the issuer’s stock while unaware of the then recent amendment to § 13(d) lowering the triggering level of disclosure from 10% to 5%. The shareholder subsequently filed a Schedule 13D disclosing all of the required information and chose not to proceed with a tender offer. Further, the Court found that there was no evidence that the shareholder would fail to comply with § 13(d) in the future. Unlike Rondeau, where the defendant chose not to proceed with a tender offer, the defendants in CSX were attempting to take control of the company by engaging in a proxy contest. The other shareholders were put at a disadvantage in the contest because they did not have adequate information during the period in which TCI and 3G were preparing for the proxy fight. Further, TCI and 3G obtained their shares at a reduced price altering the corporate electorate of shareholders with votes at the meeting. There is also evidence that TCI and 3G may engage in this conduct in the future, as this proposition was the reason the court enjoined them from future violations of § 13(d). The parties’ conduct was not a mere technical violation like the shareholder’s actions in Rondeau, but displayed a willful disregard of the disclosure requirements of § 13(d). TCI and 3G

288. Id. at 57.
289. Id. at 55.
290. Id. at 59.
291. Id. (“[T]here has been no suggestion that he will fail to comply with the Act’s requirement of reporting any material changes in the information contained therein.”).
293. See CSX Corp., 562 F. Supp. 2d at 572–73.
failed to file a Schedule 13D for ten months in order to acquire the stock at
a reduced price and to avoid SEC disclosure requirements. Because the
facts in CSX are distinguishable from Rondeau, the court should have
sterilized the shares.

Other district court opinions support a finding that the shares should
have been sterilized. For example, in Champion Parts Rebuilders, Inc v.
Cormier Corp., several shareholders violated § 13(d) by failing to timely
file a Schedule 13D. The violation was for failing to disclose their group
formation and/or omitting material facts in the Schedule 13D regarding
their control intent. These shareholders had agreed to acquire control of
the company through a proxy fight. The court neutralized the shares

294. Id. at 552–55, 573.
295. See generally Champion Parts Rebuilders, Inc v. Cormier Corp., 661 F. Supp. 825 (N.D.
Ill. 1987).
296. Id. at 832, 834, 836–37.
297. Id. at 838–39. The reorganization plan was as follows:

Management Reorganization and Corporate Strategy

I. Management Reorganization

A. 13-D Holders call for Special Shareholders Meeting

1. Groups calling for special shareholders meeting
   a. Hodes-Gray 8%
   b. Robinson 5%
   c. Cormier 10%
   d. Gross 12%

2. Proceed to arrange for meeting
   a. obtain shareholders list
   b. go to court to force meeting if necessary
      1. 13D groups excluding Gross meet to arrange cost sharing if and when a
         fight breaks out
      3. Upon presentation of demand for shareholders meeting, try to get Schwartz to
         peacefully agree to reorganize management i.e. have directors resign to be
         replaced by 13D nominees

B. Should Schwartz not immediately agree to a change

1. Initiate proxy fight 13D groups meet to agree on a full slate of directors

C. The Proxy battle

1. Nominees for reorganized board should include following characteristics
   a. stock ownership in size
   b. broad range of business disciplines
   c. automotive experience

2. areas of weakness for 13D groups proxy battle
acquired by these persons in violation of § 13(d) ruling that all such shares had to be voted in proportion to the votes cast by all other shareholders.\(^{298}\) It reasoned that the “group’s conduct in failing to make proper disclosure [when] they were acquiring control . . . deprived Champion’s present shareholders of the opportunity to make a full range of different decisions as to Champion’s future course . . . [an] injury [that is] both irreparable and cognizable in equity.”\(^{299}\) The CSX court stated that the Champion decision “relied on considerations that are inappropriate in light of Rondeau.”\(^{300}\) However, the Champion court relied on the fact that the company’s other shareholders suffered irreparable harm, which is precisely the standard for a preliminary injunction set forth in Rondeau.\(^{301}\) Further, Champion is distinguishable from Rondeau for the same reasons set forth above upon which CSX can be distinguished.

In addition, Champion is analogous to CSX because both cases involved a disclosure violation for failing to timely disclose the formation of a § 13(d) group, and each case related to a proxy contest.\(^{302}\) Moreover, like the shareholders in Champion, CSX shareholders were deprived of the opportunity to make informed decisions regarding CSX for the ten months during which TCI and 3G were acquiring the stock in violation of § 13(d).\(^{303}\) Specifically, some of CSX’s shareholders may not have shared the hedge funds’ views regarding the future of the company, and, like the shareholders in Champion, such shareholders were deprived of the opportunity to make a reasoned investment decision regarding the company’s stock.\(^{304}\) Similar to the defendants in Champion, TCI and 3G

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\(^{a\text{. Sheldon Gray-bankruptcy}}\)

D. Assuming Victory

1. Board reform so that nominees of 13D groups replace principals of 13D groups
2. The 13D groups agree upon working nominees who will be responsible for implementing a corporate strategy to attain asset value
3. Active board – for at least one year after victory have monthly board meetings.

\textit{Id.}

298. \textit{Id.} at 851.
299. \textit{Id.} at 847. The court further reasoned that:

[D]efendants’ blocking position in Champion’s shares causes substantial and irreparable adverse effects. Champion’s shareholders now face an illiquid market for Champion’s shares. Champion’s ability to raise equity capital, or to find investment bankers willing to manage placements of its shares, has been substantially impaired.

\textit{Id.} at 847–48 (defendants held 42% of Champion’s shares).

301. \textit{Id.} at 571–72; see also Rondeau, 422 U.S. at 64–65.
302. See Champion, 661 F. Supp. at 832–46; see also CSX Corp., 562 F. Supp. 2d at 511.
303. See CSX Corp., 562 F. Supp. 2d at 511.
304. See WLF Brief, \textit{supra} note 260, at 12.
were able to increase their control position by 6.4% during the ten month period without the other CSX shareholders being aware of these parties’ acquisitions. As such, the corporate electorate of CSX may have been much different on the record date for the proxy contest had TCI and 3G disclosed their ownership positions. Consequently, the court in CSX should have followed the court in Champion and sterilized the shares of TCI and 3G.

Another case involving the sterilization of shares in the 13(d) context is Committee for New Management of Butler Aviation v. Widmark. In that case, the former CEO of a company initiated a proxy contest and acquired shares in anticipation of the meeting. The court found that he violated § 13(d) by failing to timely file a Schedule 13D. The former CEO, just like the shareholder in Rondeau, argued that this was merely a technical violation. The court rejected this argument, reasoning that “[i]f [§] 13(d) means anything, [the former CEO] should not be permitted to gain advantage from a course of action pursued in clear violation of law.”

To put teeth in Section 13(d)(1), the court enjoined the shareholder from voting at the annual meeting all shares purchased during the twelve-month period in question in excess of 2 percent of the outstanding stock—in effect, all shares purchased after the Schedule 13D statement should have been filed with the Commission and sent to the issuer.

In Water & Wall Associates v. American Consumer Industries, several shareholders failed to timely disclose their formation of a group in violation of § 13(d). The court, relying on Butler Aviation, issued a preliminary

305. See CSX Corp., 562 F. Supp. 2d at 572.
307. Id. at 149, 154.
308. Id. at 154–55.
309. Id. at 154.
310. Id. at 155.
injunction restraining the voting of the shares beneficially owned by such persons. 313

While both of these cases were decided prior to Rondeau, both courts found that the shareholders would suffer irreparable harm if the shares were not sterilized. 314 Just like the courts in Butler Aviation and Water & Wall Associates, the court in CSX should have enjoined TCI and 3G from voting the shares because failing to do so allows these shareholders to benefit from a course of action pursued in violation of § 13(d) to the detriment of the other shareholders of CSX. Moreover, based on the precedents in Rondeau, Champion, Butler Aviation, and Water & Wall Associates, courts should more frequently sterilize shares for violations of § 13(d) to prevent irreparable harm to shareholders.

Lastly, the votes of TCI and 3G should have been sterilized, and other violators of § 13(d) should be enjoined from voting at shareholder meetings, in order to deter future violations by other parties. While deterrence cannot be an independent basis for an injunction under § 13(d), it is an important factor for courts to consider when determining whether to enjoin the voting of shares. 315 In Rondeau, the Court acknowledged that the “usual basis for injunctive relief” is the “danger of recurrent violation” and such relief is designed “to deter, not to punish.” 316 The Court further stated in Piper v. Chris-Craft Industries, Inc., that deterrence may be “a meaningful goal” in fashioning relief for “the most flagrant sort of violations” of the Williams Act. 317 Moreover, according to the Commission

[absent a remedy that deprives the defendant of his wrongfully obtained shares [or the ability to vote such shares], a person will have little incentive to comply with the statute. On the one hand, the potential benefits to be gained from a violation can be quite substantial . . . [o]n the other hand, corrective disclosure is no real deterrent, since it merely requires compliance with the original statutory disclosure obligation and leaves the violator with the profitable fruits of his illegal conduct. 318

By failing to sterilize votes in cases like CSX, hedge funds and others will continue to have an incentive to avoid § 13(d) disclosure obligations to gain an advantage in a proxy contest or to obtain control in a stealth fashion by use of another takeover method. In this regard, the other shareholders of the company are not being afforded the protection of the federal securities laws, as hedge funds and others have the ability to gain an unfair advantage

313. Id. at *11.
317. Id.
by hiding their ownership positions until they decide to engage in a control contest. Moreover, market integrity is damaged when investors deliberately flout the § 13(d) disclosure requirements, but are still able to vote their shares. Consequently, the shares of TCI and 3G and other violators of § 13(d) should be sterilized to prevent further abuses of the Williams Act.

V. CONCLUSION

This Article has explained that while holders of long positions in equity swaps have the ability to significantly influence the voting or disposition of the securities of a company, they do not have beneficial ownership under Rule 13d-3(a). It went on to provide a specific recommendation for how Rule 13d-3(a) should be amended to capture Long Parties’ holdings in equity swaps and other similar instruments. It showed that Rule 13d-3(b) should be construed in a manner analogous to the safe harbors in Rule 144A and Regulation S, and thus, the Rule should only result in a person being deemed a beneficial owner where the person holds an interest in the security that is considered to constitute beneficial ownership under Rule 13d-3(a). Lastly, the Article demonstrated that sterilization of votes is an appropriate remedy in a § 13(d) action to prevent unfair director elections and that such remedy should be granted more frequently to enjoin violators of § 13(d) from voting at shareholder meetings.

If the Second Circuit decides to write an opinion on the CSX case, it should adopt the positions articulated in this Article: that TCI did not have beneficial ownership under Rule 13d-3(a) and that it should not be deemed a beneficial owner under Rule 13d-3(b). Future court rulings on whether votes should be sterilized for violations of § 13(d) should enjoin violators of the statute from voting at shareholder meetings. Furthermore, the Commission should act quickly to require disclosure of Long Parties’ holdings in equity swaps and other similar instruments by amending Rule 13d-3(a). More research may be necessary to determine whether a complete overhaul of the beneficial ownership regime is needed, and if so, how such change should be accomplished.

319. See WLF Brief, supra note 260, at 27.
320. See Hu & Black, supra note 4. While Hu and Black have already undertaken this inquiry to a certain extent, others could look more deeply into the issue of whether such change is actually needed, and if so, whether their suggested approach is adequate.
UNREGULABLE:
WHY DERIVATIVES MAY NEVER BE REGULATED

Alireza M. Gharagozlou*

In this Article I explore various methods of regulating financial derivative contracts, including (a) regulation by judicially created case law, (b) regulation as gambling, (c) regulation as insurance, (d) regulation as securities, (e) regulation via a clearinghouse and (f) oversight by a super financial regulator. After discussing the drawbacks of each approach, I conclude that derivatives may be beyond the reach of the law, and indeed may be a trend whose prevalence rises and falls based only on the zeitgeist of society.

INTRODUCTION

Derivatives are under severe scrutiny. They are thought to have caused catastrophic financial losses. Numerous law review articles have been published calling for the regulation of this “11-letter dirty word.” Proposals include capital requirements, the use of clearinghouses, and heightened disclosure requirements. The Treasury Secretary is shocked by the havoc caused by derivatives, stating that as a result of their use, “the world is now experiencing its worst financial crisis in 50 years.” The Federal Reserve Chairman has never seen anything in his lifetime that compares to the terror of this crisis. Financier George Soros has derided derivatives, claiming their instability will “destroy society.” Michael Lewis, a Wall Street

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2. See, e.g., Booth, infra note 9, at 507–08.
3. See, e.g., Markham, infra note 9, at 61–66.
4. See, e.g., Motes, infra note 9, at 614.
5. See Lewis, infra note 10.
6. Id.
7. See Partnoy, infra note 12.
muckraker and author of the book *Liar’s Poker*, has written a long article describing how derivatives have destroyed Wall Street.8

But the previous paragraph does not refer to the financial crisis of 2009. The aforementioned law review articles were not written in the past year; they were written in the mid 1990s, after derivatives trading caused numerous financial catastrophes, including the collapse of Barings Bank and the bankruptcy of Orange Country.9 The statements of the Treasury Secretary and Federal Reserve Chairman were not made by Timothy Geithner and Ben Bernanke, but by Robert Rubin and Alan Greenspan in the late 1990s, after the collapse of Long Term Capital Management.10 George Soros did not make the destabilizing claim in his widely read 2009 critique of derivatives;11 he said it in 1997.12 The Michael Lewis article does not refer to the one he wrote in 2008,13 but rather the one he wrote in 1999.14

The controversy surrounding derivatives is not a new thing. Professionals have been wringing their hands over these instruments since their ascendance in the late 1980s.15 It must be asked why derivatives are not regulated? How many massive financial collapses have to be attributed to these instruments before they are corralled? In this Article, I argue that derivatives may be beyond the reach of regulators. Because the decision to regulate is predicated, to a large extent, on the societal zeitgeist, and

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8. See Lewis, infra note 10.
15. Tracy Corrigan, *Survey of Derivatives*, FIN. TIMES, Oct. 20, 1993, at 1 (“ONLY three years into the decade, the 1990s are already being dubbed the decade of derivatives.” (emphasis in original)).
because derivatives are contracts—a fundamental human activity—whose growth was fueled by popular demand, derivatives may not be regulable.”

In Part I of this Article, I look at the reasons why case law cannot be an effective regulator. Parts II, III, and IV explore why derivatives cannot be regulated by calling them gambling, insurance, or securities. Part V explains why a clearinghouse solution would be equally ineffective. Finally, Part VI discusses the possibility of regulation by a new super financial regulator.

I. USING THE COURTS AND CONTRACT CASE LAW TO REGULATE DERIVATIVES

The first thing to note about derivatives is that they are indisputably contracts. They satisfy all of the common law requirements of contract

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However, this wasn’t necessarily so: Prior to 2000, most derivatives were unregulated. See The Commodities Futures Modernization Act of 2000: Hearing on S. 2697 Before the Comm. on Agriculture, Nutrition, and Forestry and the Comm. on Banking, Housing and Urban Affairs, 106th Cong. 31 (2000) [hereinafter Hearings on Commodities Act] (comment of Lawrence Summers, Secretary, United States Department of the Treasury) (characterizing pre-CFMA derivatives regulation as an “an extremely remote risk [that a derivatives contract could be] . . . arbitrarily unwound [by regulators]”); Thomas Lee Hazen, Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance, 24 ANN. REV. BANKING & FIN. L. 375, 390 (2005); Allen D. Madison, Derivatives Regulation in the Context of the Shingle Theory, 1999 COLUM. BUS. L. REV. 271, 276 (1999) (“Indeed, most derivatives transactions fall into this category that is either devoid of regulation or subject to ill-defined regulation. These derivatives are called over-the-counter (‘OTC’) derivatives.”). The [2000 Commodities Futures] Modernization Act sought to solidify changes that had been in the making for years. In the latter part of the twentieth century, there was erosion of the [Commodity Exchange Act’s ability to regulate], due to increased use of forward contracts and swap transactions that were pigeon-holed into existing exemptions to the [Commodity Exchange Act].

Hazen, supra, at 390.


In the early days of the swaps market, active participants often developed their own in-house forms, with each differing from company to company. Lack of uniformity in definitions and basic terminology made negotiations difficult and time-consuming . . . .
formation, such as offer, acceptance, consideration, statute of frauds, and so on. So why not let the court system regulate them through case law in the same way they regulate other contracts?

A. DEFINITIONAL PROBLEM

The first challenge in regulating derivatives is definitional—when is a contract a derivative? In other words, which contracts are categorized as derivative contracts, requiring special regulation, and which are not? While there is no widely accepted definition of the term “derivative”, for illustrative purposes, the International Accounting Standards (IAS) definition is a good place to start. According to IAS No. 39, ¶ 9, a financial instrument or other contract is considered a derivative if:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit ratings or credit index, or other variable, . . .

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts . . . [that] have a similar response to changes in market factors; and

(c) is settled at a future date.

The movement to develop standardized documents for general industry use received a major boost from the efforts of a small group of industry representatives who subsequently in 1985 organized themselves as ISDA . . . . Today, in a typical derivatives transaction between a dealer and end-user, the dealer will provide its preferred form of master agreement (usually an ISDA agreement) to the counterparty soon after discussions have begun about a possible trade. The ISDA master agreement involves a preprinted master agreement (either local jurisdiction single currency or multicurrency-cross-border), a schedule, and a form of confirmation. Generically, these three documents are often referred to together as an ISDA master. The schedule is used to make certain elections and any modifications (additions and deletions) to the standard terms in the preprinted form. Confirmations provide the specifics of each trade between the two parties. Together with various definitional booklets (incorporated by reference), these documents form a single agreement between the parties. If appropriate, credit support documents (guarantees and pledge agreements) are also annexed to the master agreement.

Id.

18. For the basic elements of contracts, see RESTATEMENT (SECOND) OF CONTRACTS (1981), § 17 (discussing the requirement of mutual assent and consideration for contract formation), § 22 (discussing how mutual assent can be satisfied by offer and acceptance), § 24 (defining offer), § 50 (defining acceptance), and § 110 (discussing the Statute of Frauds, which requires that certain contracts must be in writing to be enforceable).

19. The term “financial instrument” has a complex definition under accounting rules, but it includes contracts which give one the right to receive cash. FINANCIAL INSTRUMENTS: PRESENTATION, International Accounting Standard (IAS) No. 32, ¶ 11 (Int’l Accounting Standards Bd. 2008).

20. FINANCIAL INSTRUMENTS: RECOGNITION & MEASUREMENT, Int’l Accounting Standard (IAS) No. 39, ¶ 9 (Int’l Accounting Standards Bd. 2008). There is an additional qualifier to this
There are four general types of derivatives: (a) forward contracts—agreements to buy something at a specified price on a specified future date; (b) futures contracts—generic types of forward contracts executed at an exchange; (c) swap contracts—agreements to exchange future cash flows, where the amounts to be exchanged are based on a future variable; and (d) option contracts—agreements granting the holder the right, but not the obligation, to buy or sell something at a specified price on or before a specified future date.\(^{21}\)

The above definition, however, may encompass every contract for which the remedy for nonperformance is monetary damages.\(^{22}\) One could easily categorize every such contract in a contract law casebook as a derivative if they are defined as instruments whose value changes based upon a variable and which are settled at a future date.\(^{23}\)

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22. As opposed to non-monetary remedies, such as specific performance (i.e., requiring the other party to perform the act they were obligated to do under the contract). Please note, non-monetary remedies are a disfavored remedy and are only granted in rare circumstances. See, e.g., Bowen v. Massachusetts, 487 U.S. 879, 925 (1988) (“[E]ven though a plaintiff may often prefer a judicial order enjoining a harmful act or omission before it occurs, damages after the fact are considered an ‘adequate remedy’ in all but the most extraordinary cases.”). But see DOUGLAS LAYCOCK, THE DEATH OF THE IRREPARABLE INJURY RULE 5–6 (1991) (arguing that courts grant non-monetary remedies more often than they did in the past).

23. IAS No. 39, ¶ 9. The accounting industry attempts to distinguish derivative from non-derivative contracts via the following language: “[D]erivatives do not include [contract]s that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.” IAS No. 39, ¶ 5; see also DELOITTE TOUCHE TOHMATSU, FINANCIAL INSTRUMENTS: APPLYING IAS 32 AND IAS 39 32 (2001). Further, not every “contract that requires settlement at a future date in which neither party has performed” is a derivative. DELOITTE TOUCHE TOHMATSU, supra. “Normal
Take, for example, the famous contracts case of *Smith v. Hughes*. Smith showed Hughes a sample of oats which Hughes mistakenly thought were oats fit for feeding a racehorse. They entered into a contract for delivery of 40 quarters of such oats, at a set price. After Smith delivered some of the oats, Hughes realized his mistake and refused to pay. Because of the doctrine of caveat emptor, Hughes’s mistake was immaterial, and so the contract gave Smith the right to recoup payment.

This comports with the definition above. In Hughes’s hands, the contract is worth nothing if Smith delivers oats that match the sample, but its value increases if Smith does not deliver the oats. In Smith’s hands, the contract is worth nothing if Smith fails to make delivery, but its value increases if Smith does make delivery. Thus, the contract is an instrument whose value changes based upon a variable and which is settled at a future date.

One could rewrite this contract using any number of derivative forms, but they would all have the same financial result. One can understand this contract as a forward—an agreement by Hughes to buy oats for a specified price on a future date. Alternatively, one can understand it as a swap—an agreement to exchange future cash flows. Hughes pays the purchase price in exchange for an amount which is the function of a variable—the variable being whether Smith delivers the oats. If delivery is made, Hughes gets zero. If delivery is not made, Hughes receives a sum of money in compensation. That sum of money could be the market value of oats on the delivery date, which Hughes could then use to purchase oats on the market. So, if they had agreed on a $100 purchase price, Hughes would pay Smith $100 on delivery. If the oats are not delivered, Smith would pay whatever extra Hughes requires to buy the oats on the market. If the open market oats cost $110 on the delivery date, Smith would pay Hughes $10. Once one identifies the variables that trigger payment obligations under a contract, one can rewrite the contract as a derivative. Indeed, Hughes and Smith have the same intention as modern derivatives counterparties: the allocation of risk. Hughes transfers the risk of price increases to Smith, who, in exchange, transfers the risk of price decreases to Hughes.

If the courts were to create special rules for derivative contracts, how would they avoid applying those rules to other contracts? For example, the commitments to purchase and sell non-financial assets and regular-way purchase contracts that require delivery of a financial asset are not defined as derivatives under IAS 39. 

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25. *Id.*
26. *Id.* at 597–98.
27. *Id.*
28. *Id.*
30. In the end Hughes would receive $10 and then pay $100 to purchase the oats on the market. The oats would cost him $100, the originally agreed purchase price.
courts could refuse to enforce rights under a derivatives contract in which one has failed to previously set aside adequate capital to support one’s obligations under the contract. The goal here would be to move such “freeloaders” out of the derivatives market by showing that courts will not enforce these types of contracts. While this may be a sensible rule, it leaves open the question as to which types of contracts it would apply. Would all contracting parties now need to maintain capital to support their obligations?

Courts are currently struggling with this definitional problem. For example, in *CSX Corp. v. Children’s Investment Fund Management*, Judge Kaplan stated that ownership of a total return swap derivative was equivalent to ownership of the underlying share for purposes of Securities and Exchange Commission (SEC) Rule 13d-3. In that case, hedge funds purchased derivatives from brokers. These derivatives mimicked the return of a stock. The brokers then purchased that underlying stock to hedge their position. When exercising their voting rights under the stock, the brokers were influenced by the hedge funds. Thus, the hedge fund

31. This author defines freeloaders as those who enter into derivatives contracts expecting to be paid if they win the bet, but who have neither the intention nor capital to pay if they lose. One might assume that freeloaders do not exist in a market because rational participants would not enter into a contract with a freeloader. In other words, before one enters into a contract they would make sure their counterparty has the capital to meet their obligations. However, there is controversy as to whether the market is able to set the correct capital requirements without government intervention. See Alan Greenspan, Chairman, Fed. Reserve, Remarks on Financial Derivatives Before the Futures Industry Association (Mar. 19, 1999), available at http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm. But see Gary Gensler, Chairman, Commodities Futures Trading Comm’n, Remarks at the OTC Derivatives Reform Conference (Mar. 18, 2010), available at http://www.cftc.gov/ucm/groups/public/@newsgroup/documents/speechandtestimony/opagensler-35.pdf. For example, Alan Greenspan believes capital requirements should be set by counterparties because capital requirements set by a regulator will be necessarily simplistic, thereby allowing sophisticated parties to manipulate them. Greenspan, supra.

Regulatory risk measurement schemes are simpler and much less accurate than banks' risk measurement models. Consequently, they provide banks with the motive and the opportunity to engage in regulatory arbitrage that seriously undermines the regulatory standard and frustrates the underlying safety and soundness objective. Specifically, they induce banks to reduce holdings of assets where risks and regulatory capital are overestimated by regulators and increase holdings of assets where risks are underestimated by regulators.

*Id.*

However, other regulators believe that the government needs to determine the amount of required capital. Gensler, *supra* (“Capital requirements are essential so that dealers – rather than the taxpayers – are on the hook for the risk they undertake in the derivatives markets.”).


33. *Id.* at 531–32.

34. *Id.* at 524.

35. *Id.* at 521.

36. *Id.* at 526.
effectively owned the underlying share. The hedge fund received the return of the underlying share, and effectively controlled how the share was voted. For this reason, the court treated the hedge funds as owning the shares.

Judge Kaplan has thus identified derivatives that require special regulation because they mimic stock ownership. It remains unclear, however, which contracts fall under Judge Kaplan’s definition. For example, what if the hedge funds sold a large number of “puts” on the underlying shares, and these were sold to dealers, who, having avoided downside risk, purchased the underlying share and voted them based on instructions from the hedge fund? What if the hedge funds had purchased shares of an investment fund which held the underlying share, and again the investment fund voted the shares based on instructions from the hedge fund? These questions illustrate the definitional problem. Furthermore,

37. Id. at 523–25.
38. Id. at 546.
39. Id. at 517.
40. Brief of Amici Curiae for International Swaps and Derivatives Ass’n, Inc. and Securities Industry and Financial Markets Ass’n at 3, CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) L.L.P., 292 F. App’x 133 (2d Cir. 2008) (No. 08-3016) (arguing that Judge Kaplan’s definition would create “substantial uncertainties for the equity derivatives and capital markets . . . .”).
41. A “put” is “[a]n option that conveys to its holder the right, but not the obligation, to sell a specific asset at a predetermined price until a certain date.” DAVID L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY’S INVESTOR 295 (Houghton Mifflin Co. 3d ed. 2003) (1997).
42. This issue was recently litigated: In October 2008, Microchip Technology Inc. and ON Semiconductor Corp. offered to acquire the company Atmel. Jef Feeley & Phil Milford, "Atmel Defeats Court Challenge to 'Poison-Pill' Takeover Defense," BLOOMBERG, May 20, 2009, http://www.bloomberg.com/apps/news?puid=20060103&sid=ahGoAe3XXIt8&refer=us. However, “Atmel’s board rejected that offer and amended the company’s poison-pill plan to make it harder for potential suitors to use so-called derivative contracts to amass shares in a takeover fight.” Id. Some of Atmel’s shareholders, however, did not like this amendment. Id. On February 2, 2009, the shareholders sued for an injunction invalidating the new poison-pill language on the grounds that “the language of the Amendment regarding ‘Derivatives Contracts’ is unenforceably vague and the Individual Defendants’ adoption of the Amendment constituted a breach of fiduciary duty.” Atmel Corp., Current Report (Form 8-K), exhibit 99.2, at 4 (Nov. 17, 2009) [hereinafter Atmel 8-K].

One of the plaintiff’s arguments was that it was unclear whether shares of an investment fund holding Atmel shares fell under this definition of derivative. See Defendants’ Memorandum in Opposition to Motion for Injunctive Relief at 27, In re Atmel Corp. S’holders Litig., No. 4161-CC (Del. Ch. Mar. 11, 2009) (“Equally unpersuasive is plaintiff’s assertion that the definition of ‘Derivatives Contract’ is so vague as to potentially encompass an investment in a mutual fund or an exchange traded fund that holds Atmel common stock.”). On May 19, 2009, the court ruled from the bench that the definition was not vague enough to meet the high standard of “fatally vague” required for an injunction. Akin, Gump, Strauss, Hauer & Feld L.L.P., Corporate Alert: Top 10 Topics for Directors in 2010, Dec. 21, 2009, at 1, 23 n.76, http://www.akingump.com/files/upload/091218_Top_10_Topics_for_Directors_in_2010.pdf [hereinafter Akin Gump]; see also Feeley & Milford, supra.

The judge, however, decided the case should proceed to trial regarding whether the language was vague enough to justify invalidating the amendment. Akin Gump, supra. A few months later Atmel settled the case, amending the poison pill language to narrow the definition of
here we are only trying to identify derivative contracts that equate to share ownership; imagine how hard it would be to identify contracts that are “derivatives” in general.

Possibly the most important thing to note about derivatives is that although they are characterized as unusual and bizarre creations,\textsuperscript{43} they are simply contracts.\textsuperscript{44} Parties enter into them for the same reason they have always entered into contracts—to allocate the risks posed by an uncertain future.\textsuperscript{45}

\textbf{B. RESPONSIVENESS}

Another problem with allowing the courts to regulate the derivatives industry is that courts do not act quickly.\textsuperscript{46} Under the case law system, citizens may not know whether a derivative is legal until the arrangement sours and a party sues.\textsuperscript{47} Only after a long appeals process may the question of a derivative’s legality be settled.\textsuperscript{48} Furthermore, courts can only decide the cases before them.\textsuperscript{49} They cannot monitor an entire industry and make changes on the fly.\textsuperscript{50}

derivative contracts to (a) exclude certain investment funds and (b) require that the contract make specific reference to the number of notional shares. See Atmel 8-K, supra, at 8–9.


\textsuperscript{44} PEDERSEN, supra note 17; Karol, supra note 17.

\textsuperscript{45} Townsend Walker, Managing Risks with Derivatives 4 (1996).

\textsuperscript{46} See Hearings on Commodities Act, supra note 16, at 24 (testimony of Lawrence Summers, Secretary, United States Department of the Treasury).

I basically share the impulses behind your question, Senator Kerrey. I do not think that waiting until particular lawsuits have wended their way through the courts is a good way to make public policy in this area. I think case-by-case litigation is probably, as a general proposition, a poor way to make public policy in this type of issue . . . .

\textit{Id.} (responding to Sen. J. Robert Kerrey of Nebraska).

\textsuperscript{47} See id.

\textsuperscript{48} See id.

\textsuperscript{49} See id. at 25 (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

\textsuperscript{50} Id. The inability of courts to respond to a “rapidly evolving financial industry” is of particular concern. \textit{Id.}

\textbf{MR. GREENSPAN.} Senator, I think, without commenting on the particular suit that you are raising, in this type of issue it is a mistake to leave it to the courts to decide. The reason basically is that what we are dealing with at this point is a changing economy and the changing necessary regulatory structure that would be required with it . . . .

. . . [I]t strikes me that it is terribly important when dealing with an issue such as this in a rapidly evolving financial industry that the Congress should address it from scratch in a sense, to take a look at it de novo and make judgments of an appropriate type to determine what is the structure because there is no way that the courts can do that; nor should they. They are there for a fundamentally different purpose and to abandon a decision of this nature to [the courts], in my judgment, is a mistake.
As described above, derivatives are contracts and the court system has the authority to regulate them.\textsuperscript{51} While the judiciary could develop case law to address and fix the problems posed by derivatives, the courts are not ideally suited for this task.\textsuperscript{52} But this is nothing new. There are many other types of contracts for which case law was deemed an insufficient regulator, such as gambling, insurance contracts, and securities.\textsuperscript{53} Each of these approaches will be discussed next.

**II. REGULATING DERIVATIVES AS GAMBLING**

The law has always struggled to distinguish legitimate risk taking from gambling. Because there is risk in every activity, every activity can be seen as a gamble. As such, society cannot ban all risk taking. At the same time, certain risk taking is considered harmful enough to be rightfully prohibited.\textsuperscript{54} The question is where to draw the line? Generally, it is thought that society arrives at an answer through cultural negotiation.\textsuperscript{55} There is no objective and timeless answer. Rather, society decides generation-by-generation, on a case-by-case basis, which risk taking behavior to prohibit and mark as “gambling” and which to allow.\textsuperscript{56}

So, will contemporary society—which includes businesses—decide to categorize derivatives as a prohibited form of risk taking? The likelihood of that happening seems very slim. Today, large businesses use derivatives to hedge interest rates, currency, weather, and other risks.\textsuperscript{57} This is thought to be beneficial because it allows them to focus on their core businesses.\textsuperscript{58}

\textsuperscript{Id.} (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System & Sen. J. Robert Kerrey of Nebraska).

\textsuperscript{51} See supra Part I.A.

\textsuperscript{52} Hearings on Commodities Act, supra note 16, at 25 (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

\textsuperscript{53} See RESTATEMENT (SECOND) OF CONTRACTS, supra note 18, § 178 cmt. a.

\textsuperscript{54} See, e.g., CAL. BUS. & PROF. CODE § 19801 (West 2008) (“(a) State law prohibits commercially operated lotteries, banked or percentage games, and gambling machines [because] . . . (d) Unregulated gambling enterprises are inimical to the public health, safety, welfare, and good order.”).

For a compendium of state and federal gambling prohibitions, see National Gambling Impact Study Commission, Gambling Statutes Database, http://govinfo.library.unt.edu/ngisc/reports/statutes.html (last visited Apr. 9, 2010).


\textsuperscript{56} Id. (“[T]he conflict over what was gambling and what was allocation of risk was handled, and settled, not according to an analytical formula that successfully distinguished between them, but rather through a more complex and less decisive cultural negotiation and displacement of the question.”).


\textsuperscript{58} See generally Jan Barton, Does the Use of Financial Derivatives Affect Earnings Management Decisions?, 76 ACCT. REV. 1 (2001).
Because derivatives are so engrained in modern business practice, it seems highly unlikely that society would prohibit them as gambling. The country went through a similar exercise in the 19th century, as it struggled to determine whether commodities trading constituted illegal gambling. On the one hand, these contracts served the legitimate purpose of allowing producers to lock in prices. On the other hand, some parties were using the contracts to speculate. Ultimately, the country decided that commodity futures were too integral to commerce to be banned as gambling.

But what about purely speculative derivatives (i.e., those entered into for reasons other than hedging)? What about the hedge fund who buys derivatives on energy, not to lock in prices for a key material used in manufacturing, but rather to speculate that energy will appreciate in value? What about the trader who buys credit default swap contracts on General Motors (GM), not because he holds GM bonds and wants to hedge his risk, but rather to speculate that GM will go out of business? Such speculators are not protecting against a business risk or any other risk to which they were previously exposed. They have no connection to the underlying assets—energy or GM’s profitability—except through the derivative. Thus, the argument that they need access to derivatives to manage their risks does not hold. Could society label that category of derivative transactions gambling? This would be the equivalent of regulating derivatives as insurance, which is discussed next.

59. See Kreitner, supra note 55, at 1102–13 (showing how between the late 1800s and the mid 1900s, such instruments went from being referred in court opinions as a “gigantic evil and blighting curse” to “necessary to the commerce of the people of the United States in their domestic interstate economy”) (quoting Cothran v. Ellis, 16 N.E. 646, 648 (Ill. 1888) and Albers v. Lamson, 42 N.E.2d 627, 630 (Ill. 1942)); see also J. Patrick Raines & Charles G. Leathers, Financial Derivative Instruments and Social Ethics, 13 J. BUS. ETHICS 197 (1994) (arguing that if the ethical precepts of the late 1800s prevailed today, modern derivative trading would be indicted as a form of gambling).

60. See Kreitner, supra note 55, at 1102–03 (discussing how people would enter into futures transactions to “prevent losses resulting from swing[s] in the price of the commodity”).

61. Id. at 1099–1102.

62. Id. at 1102–13.

63. Some commentators argue that these are the problematic derivatives that require regulation. See, e.g., James Rickards, How Markets Attacked the Greek Piñata, FIN. TIMES, Feb. 12, 2010, at 13.

For over 250 years, insurance markets have required buyers to have an insurable interest; another name for skin in the game. . . .

. . . .

. . . .

Until the [credit default swap] market is confined to buyers who have an underlying interest in the risk being covered, and sellers who are regulated as insurance companies with adequate reserves, this market will remain a reckless enterprise bent on arson.

Id.
III. REGULATING DERIVATIVES AS INSURANCE

Insurance is a form of risk taking that society finds acceptable. Law distinguishes insurance from gambling by using the concept of “insurable interest.”64 For an interest to be insurable “there must be some significant relationship between the insured and the person, the object, or the activity that is subject to the risks covered by the insurance arrangement.”65 Without an insurable interest an insurance contract is void.66

Absent this requirement, insurance contracts could devolve into the sort of risk taking of which society disapproves. For example, before the insurable interest requirement was established, people would gamble on the lives of public figures and other events by purchasing insurance.67 The requirement solved this problem as, for instance, a speculator could no longer purchase “graveyard” insurance on the life of a stranger she thought would pass away because she lacks an insurable interest in the stranger’s

64. ALAN I. WIDISS, INSURANCE: MATERIALS ON FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND REGULATORY ACTS 123 (1989); see also Franklin L. Best, Jr., Defining Insurable Interests in Lives, 22 TORT TRIAL & INS. PRAC. L.J. 104, 105 (1986).

65. Id. at 123.


No contract or policy of insurance on property made or issued in this state, or made or issued upon any property in this state, shall be enforceable except for the benefit of some person having an insurable interest in the property insured. In this article, “insurable interest” shall include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage.

N.Y. INS. LAW § 3401.


London underwriters issued policies on the lives of celebrities like Sir Robert Walpole, the success of battles, the succession of Louis XV’s mistresses, the outcome of sensational trials, the fate of 800 German immigrants who arrived in 1765 without food and shelter, and in short served as bookmakers for all and sundry bets.

Daston, supra, at 244.

In the minds of many, life insurance was simply a new speculative fund-raising device to substitute the floundering lotteries and the unsuccessful tontines. Its alleged lottery spirit became a major source of prejudice against it, forcing life insurance advocates to insist upon the differences between the two . . . .

The history of life insurance reinforced the credibility of these accusations. Early forms of life insurance were outright bets on human lives. . . . In eighteenth-century England, insurance and wagering went hand in hand, and it has been alleged that no form of gambling became “so varied, so universal, so wasteful or so demoralizing” as insurance.

ROTMAN ZELIZER, supra, at 68–69 (citation omitted).
life. Furthermore, the insurable interest concept has the added benefit of dissuading policyholders from destroying the thing insured so as to collect the insurance proceeds.

So would carrying this concept into derivatives regulation have prevented the financial crises allegedly caused by derivatives? The answer seems to be “No.” Many of the derivative contracts thought to be responsible for the recent crisis were held by parties with insurable interests.

For example, after weaving through the complicated Collateralized Debt Obligation (CDO) structure, one finds that the “super senior” insurers, such as AIG, were the only parties with naked exposure. The intermediaries in between were doing “negative basis” trades in which they would both write protection and purchase offsetting protection at the same time.

Market intermediaries did not speculate on

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68. Rotman Zelizer, supra note 67, at 70 (“Another form of gambling with life, known as ‘graveyard insurance,’ briefly flourished in the United States in the early 1880s with speculators insuring the lives of old people, preferably paupers who were likely to die soon.”).


70. See sources cited infra note 74.

71. “Super senior” refers to super senior tranche, which is defined as “the layer of credit risk senior to a risk layer that has been rated AAA by the credit rating agencies, or if the transaction is not rated, equivalent thereto.” William K. Sjostrom, Jr., The AIG Bailout, 66 Wash. & Lee L. Rev. 943, 955 (2009) (citing AIG, 2007 ANNUAL REPORT (FORM 10-K) 11 (Feb. 27, 2008)). But, note that this was arguably an illusory rating, as the practice of tranching could create AAA rated securities from low-rated assets. Id. at 955 n.73 (“[A] BBB-rated corporate bond portfolio could be tranched so that 90% of the debt securities would be rated AAA.” (citing Arvind Rajan et al., The Structured Credit Handbook 2 (2007))).


73. See Exhibit 1; see also ISDA, AIG and Credit Default Swaps 1 (Nov. 2009) (unpublished discussion paper), http://www.isda.org/c_and_a/pdf/ISDA-AIGandCDS.pdf (“AIG was unique among large credit default swaps participants in that it ran a ‘one way’ book consisting almost entirely of sold protection; credit default swap dealers, in contrast, maintain ‘matched books’ that balance sold with bought protection so net exposure is low.”).

the underlying risk, but rather made money by purchasing protection and then writing that same protection for a higher amount.75

This can best be illustrated via an example.76 Imagine Sam wants to buy insurance on a bond he owns. This insurance would pay him any lost principal and interest payments if the bond defaults.77 He goes to an insurance company and buys this coverage. This is fine, as Sam has an insurable interest in his bond.78 After selling protection to Sam, the insurance company buys protection from a hedge fund to cover its position.79 This is also fine because the insurance company has an insurable interest (its obligation to Sam).80 This chain continues until there are ten
such contracts. The parties involved are Sam, the insurance company, and nine hedge funds. If Sam’s bond defaults, hedge fund 9 will pay hedge fund 8, which will pay hedge fund 7 and so forth down the line, all the way to the

the insurance company may default, but Sam perceives it to be risk-free and so has reason to make the trade.

Another way to describe this is to state that Sam is buying a product and selling it for a higher price. This is no different than what one sees in other segments of the economy, from fruit stores buying strawberries from farms and selling them for a higher price to customers, to professional services firms buying employees’ services and selling them for higher prices to their clients. So what product is being purchased and sold here? This product can be viewed as insurance on the company’s operations. When Sam buys the company’s bond, he is in effect insuring XYZ’s operations for a fee. The fee—or “insurance premium”—Sam receives is the interest rate provided by the bond, and the amount of coverage he provides is the face value of the bond plus the fee. Sam is, therefore, providing $1,050,000 of insurance on the company’s operations, for a $50,000 fee to be paid at the end of the year. If the company succeeds, Sam receives $50,000 for the insurance he provided. If the company fails, Sam receives the $50,000 fee and pays a claim of $1,050,000 (he loses the $1 million he paid for the bond). Playing with this perspective a bit more, when a business issues a bond they are in effect purchasing coverage on their operations for a fee. So from this perspective, Sam sold XYZ insurance for $50,000, and then purchased that same insurance for $40,000. Because Sam doesn’t perceive any risk of default by the insurance company, he has locked in a $10,000 profit. Then, perhaps, the insurance company will find someone willing to provide this coverage for only $35,000. Now the insurance company will buy that coverage and lock in a perceived $5,000 profit.

To carry this example further, imagine that a month after Sam buys coverage from the insurance company, XYZ’s fortunes change. The XYZ bond now has a greater risk of default and the insurance company changes the price they charge to insure it. Now it requires $80,000 for the coverage. This is the same coverage they previously sold to Sam for $40,000, but now it costs more because circumstances have changed. At this time, another party is willing to sell coverage on the XYZ bond for only $70,000. The insurance company will buy this coverage, even though they are paying $70,000 for something they sold for only $40,000 to Sam. This is because they believe the coverage should cost $80,000, and so it makes sense to buy it for $70,000.

The hypotheticals above are a few examples of situations in which a party has reason to buy and sell the exact same coverage. The above trades are sometimes called “negative basis” trades. MOORAD CHoudhry, THE CREDIT DEFAULT SWAP BASIS 132–37 (2006) (providing a detailed explanation of such trading).

This section ends with one last example, which may illustrate a cause of the financial crisis. Imagine that Sam buys a large pool of low-rated bonds (bonds with a relatively high likelihood of default). See Investopedia, Definition of Bond Rating, http://www.investopedia.com/terms/b/bondrating.asp (last visited Apr. 21, 2010). Next, imagine that Sam combines and then slices these bonds, and turns them into a new set of bonds that somehow have a higher rating than the bonds that went into his stew. See, e.g., RAJAN ET AL., supra note 71, at 2. Since these new bonds have a higher rating, it will cost less to insure them. To provide numbers, perhaps Sam is earning 12% ($120,000) on these junk bonds, but insuring them for only 5% ($50,000). Sam’s financial engineering provided him a $70,000 profit. How could Sam improve the credit rating assigned to bonds simply by combining them and then tranching them into a new set of bonds? This was a well reported phenomenon. Id. (discussing how BBB rated bonds could be combined and “tranched so that 90% of the [debt securities] constructed would likely be rated AAA”); Elliot Blair Smith, Bringing Down Wall Street as Ratings Let Loose Subprime Scourge, BLOOMBERG, Sept. 24, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=ahb39JWLPPb (“S&P outlined the alchemy of structured finance in a March 2002 paper for clients entitled ‘Global Cash Flow and Synthetic CDO Criteria.’ . . . [T]he authors said ‘the goal was to create a capital structure with a higher credit rating than the underlying assets would qualify for without financial engineering.’”).
insurance company which pays Sam.\textsuperscript{81} Since the intermediaries are both receiving payment and making an equivalent payment, they have no exposure.\textsuperscript{82} The only party with naked exposure is the last party in the chain—hedge fund 9.\textsuperscript{83}

Because there are now ten contracts, the total, or “notional,” amount of protection is now ten times that purchased originally by Sam.\textsuperscript{84} This example illustrates how the notional value of outstanding derivative contracts can explode. And indeed, the total amount of risk has increased. Although the intermediaries have seemingly covered themselves by entering into offsetting positions, they are still exposed to the risk of their counterparty defaulting.\textsuperscript{85} Imagine that every third person in this chain is Lehman Brothers (Lehman), and the same economic forces that caused the underlying bond to default also caused Lehman to go out of business.\textsuperscript{86}

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81. See Wallison, supra note 74, at 4.
82. See id.
83. Id. A real world chain may be one where a hedge fund buys the bond, and then purchases coverage from an investment bank, who then buys coverage from an insurance company. But for the purposes of this section, the identity of the parties does not matter. This example seeks only to illustrate a chain of parties buying and selling protection.

While using notional amount as a measurement tool for the size of the privately negotiated derivatives business has its benefits, it also has a major drawback. Notional amount greatly overstates the actual exposure represented by the CDS business. One reason for this is because a seller of protection often seeks to hedge its risk by entering into offsetting transactions. Using the example above, if the counterparty that sold $10 million of protection wished to hedge its risk and buy protection, it too would enter into a $10 million CDS contract. Thus, there are now two CDS contracts outstanding with a total notional amount of $20 million. The reality is, however, that only $10 million is at risk.

Hearings on Investor Protection, supra, at 130.
85. Wallison, supra note 74, at 3 (“[E]ach of the parties in the chain has two distinct risks—that its counterparty will be unable to perform its obligation either before or after A defaults.”).
86. EUROPEAN UNION TESTIMONY, supra note 74, at 2 (testimony of Lee C. Buchheit).

**Q5 Lord Browne of Madingley:** Going back to credit default swaps, did they contribute to the financial crisis that we have today? If so, in what way?

**Mr. Buchheit:** They contributed in this sense. First, they did not cause it, by any means. If you think about the risks of a credit default swap, the first risk is that the underlying borrower goes into default, and that is, of course, the risk that the seller takes. But there is a second risk. Many institutions that operate in this market will run what they call matched books, which is to say that they will not pay protection on a certain debtor without trying to buy corresponding—congruent is the theory—protection from someone else. Therefore, at any given time, the prospect that the underlying borrower may not perform has been hedged, because it is true they will pay out to their buyer but they will collect from their seller. The fly in the buttermilk as it relates to that scenario is one in which the institution for whom they have bought this offsetting protection itself
Three parties in this chain were relying on Lehman for coverage, but they now have to take a loss. Restating the payment chain under this scenario, hedge fund 9 pays hedge fund 8, which pays hedge fund 7 (Lehman), but then Lehman doesn’t pay hedge fund 6. This causes a loss to hedge fund 6. Hedge fund 6 still has to pay hedge fund 5, which pays hedge fund 4 (Lehman), but again Lehman doesn’t pay hedge fund 3, causing another loss. Then, hedge fund 3 pays hedge fund 2, which pays hedge fund 1 (Lehman), but Lehman does not pay the insurance company, causing the insurance company a loss. Originally, only one person, Sam, would have taken the loss as a result of the bond defaulting, but now three parties will take losses.87

Since all the parties above had an insurable interest, requiring one would not have solved the problem. If such trading was, in fact, responsible for the financial crisis, an insurable interest requirement would not have prevented it. In fact, some of the key culprits, the monoline insurers, participated in the market by writing financial guaranty insurance contracts.88

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87. A clearinghouse system would solve this problem, but may create equally insuperable obstacles. See infra text accompanying note 109.


Though themselves no giants, monolines have guaranteed a whopping $2.4 trillion of outstanding debt. The two largest, MBIA and Ambac, cut their teeth “wrapping” municipal bonds, in effect, renting their AAA rating to the securities for a fee. For a long time this business, though staid, was nicely profitable.

But, as competition grew, the monolines—with two honourable exceptions, FSA and Assured Guaranty—were seduced by the higher returns of structured finance, especially the stuff involving subprime mortgages . . . . As mortgage delinquencies rose, so did paper losses. Ambac and MBIA wrote assets down by a combined $8.5 billion in the past quarter.

Monoline insurers are insurance companies that insure only financial products. Investopedia, Definition of Monoline Insurance Company, http://www.investopedia.com/terms/m/monolineinsurance.asp (last visited Apr. 21, 2010). The name “monoline” comes from the fact that they can only insure one line of business. See N.Y. INS. LAW § 6902(a)(1) (McKinney 2008) (“[A] corporation organized for the purpose of transacting financial guaranty insurance may . . . be licensed to transact only the following additional kinds of insurance . . . [residual value insurance, surety insurance, and credit insurance] . . . .”).

Id. at 2–3 (emphasis added).
It would be helpful, at this time, to summarize the preceding two sections. Part II discussed how one cannot ban derivatives used by businesses to hedge their operational risks. But this does not explain why one cannot stop speculators from entering into derivative arrangements. Part III proceeded to discuss how many of the trades thought to be the work of speculators are, in fact, done by parties who are not speculating on the underlying risk. Thus, the main tool for regulating speculators, the insurable interest requirement, would not diminish such trading. But this still does not address speculators—those who are not protecting against a business risk, and who have no insurable interest. Is there any reason not to ban them from the derivatives market? While this Article will not address the question exhaustively, a few problems are apparent from the outset. First, it will be difficult to carve out this sub-group. The term insurable interest is vague.  

Second, and possibly more importantly, such speculators are thought to be necessary to a well-functioning market.  


The CDO squared bonds are made up of middle or mezzanine tranches of the CDO asset-backed securities and are also sold in tranches. . . . At this point there have been two levels of tranching, and it becomes much more difficult to accurately determine the risk of these securities. 

We are considering whether bond insurers should be prohibited from guaranteeing CDO squareds.

Id.

89. Graydon S. Staring & Christopher P. Staring, Law of Reinsurance § 6:1 (Supp. 2009) (“In limited space we can talk around insurable interest but never talk it through. A standard text confesses that ‘[i]t is very difficult to give any definition of an insurable interest,’ and then discusses it for about 70 pages.” (citation omitted)).

90. Although it is not clear how such a standard would be applied in regulating derivatives, other areas of the law generally read business purpose very broadly. See Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 Vand. L. Rev. 83, 88–90 (2004). For example, under the “business judgment rule” doctrine, a corporation’s board of directors is given tremendous leeway in determining whether a decision has a business purpose. Id.

91. If the business judgment rule does anything, it insulates directors from liability for negligence. The rule does so by providing a presumption that the directors or officers “of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” As a result, even clear mistakes of judgment will not result in personal liability.

Id. at 88–89 (citations omitted).
marketplace, accept risks that no one else may be willing to accept, and add to the information content of the marketplace.92

IV. REGULATING DERIVATIVES AS SECURITIES

After the Great Depression, policymakers debated two different approaches to securities regulation.93 The first approach, merit regulation, would have had a regulator review the substance of every security offering and decide which ones would be allowed or prohibited.94 The idea was that the regulator would know which were good investments and which were not.95 Under the second approach, disclosure regulation, the regulator did not care about the substance of the investment,96 but only whether sufficient information was disclosed such that the other party could make an informed decision on the investment’s merits. The nation ultimately chose disclosure-based regulation,97 believing that “sunlight is the best disinfectant.”98

But was lack of disclosure the root problem in the current crisis? It is hard to imagine an investment firm’s highly educated and talented professionals claiming that they were misled or deceived. They were sophisticated enough to know what questions to ask their counterparties. The problem was not a lack of information.99

First, speculators add liquidity to the market. Their willingness to buy or sell based only on price makes it much easier and cheaper for hedgers to hedge when they need to. When the order from a pure hedger arrives at the market, chances are there is not an exactly opposite counter-order from another hedger waiting to trade with it. For example, when the farmer goes to sell wheat in advance with a futures contract, chances are there is not a buy order waiting there from a flour mill. The speculators help to fill in the gaps. They profit by providing a smoothing service . . . .

Second, speculators bring risk-bearing capacity to the markets . . . .

Third, speculators bring their information to the market.

Id. (emphasis in original).

92. Id.

93. Hazen, supra note 16, at 382 (“Congress debated but rejected a merit approach to regulation that would examine the substance of the investment product being offered and sold.”).

94. Id. at 382–83 n.19 (“Merit regulation is a regulatory system under which a securities administrator has the power to evaluate the merits of an investment before allowing it to be sold.”).

95. See id. at 383.


98. Hazen, supra note 16, at 383 (quoting LOUIS D. BRANDeIS, OTHER PEOPLE’S MONEY ch. 5 (1914) (“The focus of disclosure was based on the determination that ‘sunlight is the best disinfectant.’”)).

99. See Markham, supra note 9, at 41 (“[T]he SEC style regulation for broker-dealers that deal with the public seems unnecessary. Institutional investors simply do not need such a protective
While there may be no benefit to regulating the information coming from derivative counterparties, what about the information from independent third parties, such as rating agencies? Rating agencies have taken a lot of the blame for the current crisis.\textsuperscript{100} The rating industry suffers from a systemic flaw: agencies can make more money by copying each other’s ratings than by making accurate ratings.\textsuperscript{101} There are also a host of other concerns including conflicts of interest and poor methodologies.\textsuperscript{102} The SEC could address these problems by regulating third party rating agencies. In this author’s opinion, the only way to regulate the agencies effectively would be to judge the merits of the ratings themselves. So long as regulators do not judge their ratings, they can shield themselves by copying each other and pointing to the lack of an opposing viewpoint. However, judging the merit of a rating means determining the merit of the underlying investment, effectively turning the SEC into a merit-based and expensive regulatory shield. They have the ability to manage their own risks. A different regulatory model, therefore, appears appropriate.”).

\textsuperscript{100} See, e.g., Posting of Cyrus Sanati to DealBook Blog, http://dealbookblogs.nytimes.com/2009/02/12/greenspan-says-he-was-mystified-by-subprime-market/ (Feb. 12, 2009, 07:50 EST) (New York Times website blog edited by Andrew Ross Sorkin) (“Mr. Greenspan also lays the blame on the ratings agencies and the people that trusted their judgment for the proliferation of the mortgage derivatives that were a major part of the current financial crisis.”).


Even with the so-called “reputation” effect, the incentives of the rating agencies can be such that it may be more important to them to produce essentially the same forecasts (ratings) as their competitors than to be accurate in their forecasts. . . . [A] rating agency that produces a correct prediction when its competitors are wrong may stand to gain less than it stands to lose by producing an incorrect prediction when its competitors are right.


In August 2004, Moody’s Corp. unveiled a new credit-rating model that Wall Street banks used to sow the seeds of their own demise. The formula allowed securities firms to sell more top-rated, subprime mortgage-backed bonds than ever before.

A week later, Standard & Poor’s moved to revise its own methods. An S&P executive urged colleagues to adjust rating requirements for securities backed by commercial properties because of the “threat of losing deals.”

Smith, supra.

\textsuperscript{102} Roger Lowenstein, \textit{Triple-A Failure}, N.Y. TIMES MAG., Apr. 27, 2008, at 36 (providing an exhaustive critique of the ratings industry, from their alleged conflicts of interest, to their excessive use of inaccurate models).
 regulator. As described earlier, this was not a role envisioned for the SEC.\textsuperscript{103}

\section*{V. USING A CLEARINGHOUSE}

One proposed solution to the problem of derivatives is to require all such contracts to be executed at a clearinghouse.\textsuperscript{104} A clearinghouse would work as follows: As soon as two parties enter into a derivatives contract, a new counterparty (the clearinghouse) would interject itself between them. The two parties would no longer have a contract with each other, but rather each would have a contract with the clearinghouse.\textsuperscript{105} The clearinghouse’s credit would be backed by its members.\textsuperscript{106}

One of the biggest benefits of the clearinghouse is that its netting feature would solve the problem in the example described in Part III.\textsuperscript{107} In that example, Sam, the insurance company, and hedge funds repeatedly wrote coverage and purchased offsetting coverage, which increased the

\begin{footnotesize}
\begin{itemize}
\item[103.] Hazen, \textit{supra} note 16, at 382--83. However, it should be noted that Europe has experimented with new ways of regulating agencies and became “the world’s most stringent regulator” of such agencies. Knowledge@Wharton.com, \textit{Reforming the Ratings Agencies: Will the U.S. Follow Europe's Tougher Rules?}, May 27, 2009, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2242.


\item[106.] Id. at 46. ("The clearing members provide the financial resources for the clearinghouse to cover the losses that result from a default of another member.").

\item[107.] See infra text accompanying note 109 (further discussing netting).
\end{itemize}
\end{footnotesize}
notional value of outstanding contracts and thus the risk. A clearinghouse would cure this problem. Another benefit is greater transparency. Since all derivatives trades would have to be conducted via the clearinghouse, the regulator would see all derivative contracts entered into.

108. See supra text accompanying note 84.
109. Pirrong, supra note 105, at 46–47. Continuing from the hypothetical in the text accompanying note 87, which described a daisy chain: If a clearinghouse were used, then immediately after Sam buys coverage from the insurance company, Sam’s contract with the insurance company would be replaced with a contract with the clearinghouse, which would now be responsible for paying Sam if his bond defaults. Id. at 45–46. If the bond defaults, the clearinghouse would pay Sam and then recoup payment from the insurance company. Id.

If, before the bond defaulted, the insurance company purchased coverage from a hedge fund, again the clearinghouse would interject. See id. The insurance company would then have two contracts with the clearinghouse. Now, if the bond defaults, the clearinghouse would pay Sam, recoup payment from the insurance company, pay the insurance company, and then recoup payment from the hedge fund. Since upon default, the clearinghouse’s exchange with the insurance company would net to zero, the insurance company drops out of the picture. See id. at 47 (discussing netting transactions). Similarly, if the hedge fund purchased protection from another party, the hedge fund would drop out. Id. Thus, no matter how many times the protection is sold, there are still only two parties with any obligation: the clearinghouse and the final seller of protection. Id. Compare this to the example provided earlier, where there were ten parties with an obligation to pay. See supra text accompanying note 87.

But some commentators argue that such netting does not in fact reduce total risk in the market. Pirrong, supra note 105, at 49. As applied to the example above, they would note that although the clearinghouse prevented Lehman’s downfall from causing losses to the parties in the chain, Lehman’s downfall still caused losses to some other party. See id. In other words, when Lehman’s contracts with the clearinghouse dropped out, it would replace these contracts with new contracts of the same magnitude. Id.

The reduction in replacement losses incurred by derivatives counterparties incurred in the event of a dealer default as the result of netting is widely touted as a source of reduced systemic risk. . . . [B]ut recall that this is due to the fact that netting transfers wealth in the event of a default from the bankrupt dealer’s other creditors . . . . [T]he existence of [central clearing] does not affect the total losses from a default, but just the distribution of those losses. The systemic effect of this redistribution is ambiguous.

Id.
110. At this point I would like to add some precision to the terminology and distinguish between an exchange and a clearinghouse.

An exchange is essentially a place (physical or virtual) where members of the exchange enter into the contracts or exchange (trade) contracts previously entered into. Jerry W. Markham & Daniel J. Harty, For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs, 33 J. CORP. L. 865, 867–87 (2008) (describing the history of financial exchanges in the United States). However, the central clearing and novation features described in note 105 are provided by a clearinghouse. See Pirrong, supra note 105, at 45–46. In addition, the exchange and clearinghouse can be separate entities. BANK FOR INT’L SETTLEMENTS, CLEARING ARRANGEMENTS FOR EXCHANGE-TRADED DERIVATIVES 1 (1997) [hereinafter CLEARING ARRANGEMENTS REPORT] (“An exchange's clearing house may be a department of the exchange or a separate legal entity. In several cases a single clearing house provides clearing services to more than one exchange.”); see also Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve, Remarks at the European Central Bank and Federal Reserve Bank of Chicago Joint Conference on Issues Related to Central Counterparty Clearing (Apr. 6, 2009) (explaining that exchanges often “engage unaffiliated [clearinghouses] to clear their trades”). The terms “exchange” and “clearinghouse” are often used interchangeably, although they are distinguishable, because most derivatives exchanges use a clearinghouse that clears most of the
The problem is that derivatives trading exchanges already exist that employ clearinghouses to do the exact same thing.111 They are not used, however, because some derivatives are so customized that the clearinghouse refuses to accept the contract.112 A critical component of the clearinghouse concept is the fungibility of the traded contracts, which “allows the clearinghouse to net out its risks from offsetting contracts.”113 If a contract is too unique, the clearinghouse will be unable to net its risk.114 Therefore, a clearinghouse will reject deals that are too unique.115 In addition, the clearinghouse may reject a deal simply because it dislikes its substance or one of the parties involved.116

If the clearinghouse turns down some derivatives contracts, would the counterparties give up on the deal? These are two willing parties who want to enter into a contract, but government regulation will not let them.

111. Pirrong, supra note 105, at 45 (“Clearing houses have been a part of the derivatives landscape for well over a century. The Minneapolis Grain Exchange established the first modern clearing house for futures in 1891, and other futures exchanges in the United States adopted clearing in the years between 1891 and 1925.”); see also Memorandum from Shearman & Sterling to Clients, Ice Launches Credit Default Swap Clearinghouse (Mar. 12, 2009), http://www.shearman.com/fia-031209-ice-launches-credit-default-swap-clearinghouse.112. Kroszner, supra note 110 (explaining “not all OTC derivatives are sufficiently standardized to be cleared”); see also Glenn Somerville & Charles Abbott, Geithner Sees Case for Some Derivatives Exemptions, REUTERS, Dec. 2, 2009, http://www.reuters.com/article/idUSTRE5B133C20091202 (“Some derivative products are traded on exchanges and centrally cleared while other, customized transactions are made over-the-counter or between individual parties, and are not centrally cleared . . . .”)(“We . . . should require that regulators carefully police any attempts by market participants to use spurious customization to avoid central clearing,’ Geithner said.”).

113. Markham, supra note 9, at 63 (“The problem is that it is difficult to create a clearinghouse for over-the-counter derivatives. A critical component of the clearinghouse concept is the fungibility of the exchange traded contracts.”); see also Daniela Russo et al., The Evolution of Clearing and Central Counterparty Services for Exchange Traded Derivatives in the United States and Europe: A Comparison 11 (European Central Bank Research Paper Series, Occasional Paper No. 5, 2002), available at http://ssrn.com/abstract_id=748968 (“Where fungibility of contracts exists across exchanges, as is the case in US markets for options on equities, the clearing of those markets by a single clearing house is workable.”).

114. See Pirrong, supra note 105, at 49.

115. See id.

116. Members are required to meet collateral and creditworthiness requirements, so not everyone will be allowed to join a clearinghouse. See id. at 46 (“The clearinghouse’s guarantee extends only to its members; non-member customers have to trade through members, who guarantee the contracts.”).
However, since business entities and capital are both highly mobile, they can always choose to make the deal in a country that will honor it. This has happened before. In the early 1990s, Japan tried to restrict futures and Over-the-Counter (OTC) derivatives, which led to the futures market relocating to Singapore, and the OTC market moving to New York and London. This could happen again, with derivatives trading leaving the United States in search of more hands-off regimes.

At the opposite end of the spectrum, if the clearinghouse chooses to accept every derivatives contract, even those that seem like a terrible idea, then it could turn into a concentrated center of risk. This risk could

117. See Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 HARV. L. REV. 1573, 1575 (2000) (“This increased mobility of capital is the result of such technological advances as the electronic transfer of funds and the relaxation of exchange controls.”).

118. Hearings on Commodities Act, supra note 16, at 29 (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) (“[I]f the Congress cannot work it out, foreigners will. It is not a question of whether or not there will be single-stock futures out there it is only: traded where?”).

[T]he failure to pass this bill would create a situation where derivatives contracts entered into in the United States would be subject to more risk, to be sure, an extremely remote risk, but more risk of being arbitrarily unwound because of a regulatory action than in Europe.

And in a world where it is easy to change the location at which contracts are booked, that residual uncertainty could become an important feature of competitive disadvantage.

Id. at 31 (testimony of Lawrence Summers, Secretary, United States Department of the Treasury).

119. Booth, supra note 9, at 523 (“When Japan tried to restrict both listed futures and OTC derivatives tied to the Tokyo stock exchange, the futures business moved to Singapore and the OTC business moved to New York and London.”).


“There’s a fairly significant risk that if a regulator decides they have to clear something and can set capital or otherwise determine how to appropriately clear a product, we have succeeded in just pushing risk to clearing corporations and raised the risk that they
become so large that even the combined creditworthiness of its members will not be enough to cover the bets. \footnote{122} This would function, then, to simply mimic the kind of enormous risk that led to the 2009 crisis, when the highly margined financial industry was unable to cover its exposure and had to ask the government for a bailout. \footnote{123}

**VI. USING A SUPER FINANCIAL REGULATOR**

One other proposal is for a super financial regulator. \footnote{124} This governmental division would collect real-time data on every financial transaction performed by every entity. It would analyze this information, and spot and correct problems. Something like this was proposed by Treasury Secretary Paulson in 2008. \footnote{125} While it is conceivable that such an approach could work, it is hard to imagine any governmental agency successfully handling such an enormous task.

**CONCLUSION**

Derivatives are contracts entered into by willing and informed parties, for the age-old purpose of risk allocation. Parties have entered into such

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\footnote{122}{Id.}

\footnote{123}{Id. Pirrong, supra note 105, at 49.}

\footnote{124}{See generally Dep’t of the Treasury, Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure 13–22 (2008), \url{http://www.treas.gov/press/releases/reports/Blueprint.pdf} (proposing the elimination of all prior financial regulation in favor of three new regulatory bodies, a prudential regulator to address problems specific to explicit government guarantees (such as deposit insurance), a business conduct regulator to regulate business practices (for example, to ensure consumer protection standards) and a market stability regulator to address the market overall (the super financial regulator)).}

\footnote{125}{Id. at 15 (“In terms of its recast regulatory role focusing on systemic risk, the Federal Reserve should have the responsibility and authority to gather appropriate information, disclose information, collaborate with the other regulators on rule writing, and take corrective actions when necessary in the interest of overall financial market stability.”).}
arrangements in one form or another for millennia.\textsuperscript{126} The late 20th century saw a greater demand for optimal risk allocation and the financial industry satisfied this demand by writing the contracts, many of which are now known as derivatives. This effort has proven to be a rocky one with derivatives thought to be responsible for numerous financial crises over the past two decades.\textsuperscript{127} There is, however, very little the law can do about this problem. The desire to allocate risk by contract has always been a part of human culture, and its prevalence rises and falls based only on the spirit of the time.

\textsuperscript{126} DON M. CHANCE, ESSAYS IN DERIVATIVES: RISK-TRANSFER TOOLS AND TOPICS MADE EASY 7 (2008).

To start we need to go back to the Bible. In Genesis Chapter 29, [around the year] 1700 BC, Jacob purchased an option costing him seven years of labor that granted him the right to marry Laban’s daughter Rachel. . . . Around 580 BC, Thales the Milesian purchased options on olive presses and made a fortune off a bumper crop in olives.

Exhibit 1

Synthetic CDO

128. This diagram was taken from a presentation on derivatives in the Spring of 2009 at New York University School of Law, by professors James B. Carlson and Joel S. Telpner.
INTRODUCTION

In late 2007, brothers Brian and Basil Maher lost access to approximately a quarter of the massive fortune the two had entrusted with various financial firms, including the now defunct Lehman Brothers. The Maher brothers had recently sold their almost fifty-year-old shipping business to one of Deutsche Bank’s investment units for more than $1 billion. Hoping to “[p]reserve capital” and maintain “sufficient liquidity” with the profits made from the sale, the Mahers spread their cash among three separate financial firms to deal with their short-term investments. However, when Lehman Brothers invested about $400 million of the Mahers’ account in investments known as “auction rate securities,” the Mahers became alarmed because they did not think that these investments fit into their prescribed investment objectives. It turns out the Mahers’ concerns were justified.

2. Id. Michael Maher, the father of Brian and Basil, created a shipping terminal in Port Elizabeth, N.J. in the 1950s, and the company quickly expanded into a massive shipping empire. Id. In the 1960s, Michael “invested heavily in building a facility that could load and unload ‘containers’—the giant metal boxes that are now the main building block of the global shipping trade.” Id. In the early 1990s, Brian was named chief executive of the company, and Basil took the position of president. Id. In July of 2007, the brothers completed the sale of their company, Maher Terminals, to Deutsche Bank’s RREEF Infrastructure. American Shipper, Maher Brothers Make $1.1 Billion Claim Against Lehman, Jan. 21, 2008, http://www.americanshipper.com/SNW_story.asp?news=82206.
3. Frank, supra note 1.
4. Id.
5. Id.
6. Id. The Maher brothers and their financial advisor had a list of three financial objectives: (1) “[p]reserve capital”; (2) “provide sufficient liquidity”; and (3) “capture a market rate of return based on [the brothers’] investment policy parameters and market conditions.” Id. (quoting a “letter the family sent the banks”). These financial objectives were laid out to Lehman Brothers, UBS AG, and JP Morgan Chase & Co., the three investment firms the Mahers entrusted their money with. Id.
Over the next several months, the Mahers’ funds, tied up in these auction rate securities, become extremely inaccessible, losing any sense of liquidity they might have once possessed. Auction rate securities are known in the financial world as long-term corporate or municipal bonds “with interest rates . . . that are periodically re-set . . . typically every 7, 14, 28, or 35 days.” First developed in 1984, these investments were marketed to potential investors as short-term, safe, highly-liquid alternatives to money market funds. Auction rate securities differ from normal types of bonds, with the “interest rate [for each security being] set through an auction (commonly referred to as a ‘Dutch’ auction) in which bids with successively higher rates are accepted until all of the securities in the auction are sold.” However, when there is not enough demand for the securities, an auction failure results. An auction failure means that few, if any, of the securities change hands, resulting in an inability on the part of the investors to sell the investments. Over the last few decades, broker-dealers and investment banks have intervened in order to prevent auction failures, by acting as “buyers of . . . last resort,” keeping the rate of failed auctions at a very low level.

However, in late 2007, the market for auction rate securities froze up, preventing investors from liquidating their investments in the market. When demand for these securities declined substantially, broker-dealers and investment bankers ceased acting as “buyers of . . . last resort,” refusing to bid on the excess of auction rate securities available. The departure of broker-dealers and investment banks from the market has resulted in devastating illiquidity for thousands of investors in the United States. It has also caused a massive flood of litigation and investigation aimed at financial institutions, with investors claiming that they were not fully

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7. See id.
9. Id.
10. Frank, supra note 1.
14. John Carney, Did Auction Rate Securities Ever Have a Natural Success Rate?, DEALBREAKER, Feb. 27, 2008, http://dealbreaker.com/2008/02/did_auction_rate_securities_ev.php. While there had been very few failures of auctions throughout the past few decades in the auction rate securities market, eighty-seven percent of all of the auctions in the market experienced failures on Thursday, February 14, 2008. Johnston, supra note 13.
appraised of all of the risks of these so-called highly-liquid and safe investments.17

To understand how the market, once advertised as a safe alternative for investors with a low-risk appetite, collapsed and froze-up, it is necessary to analyze the history and development of auction rate securities. Part I of this note summarizes the creation and expansion of the auction rate securities market.18 Part II examines how the market collapsed, including the effect that the subprime mortgage meltdown and the ensuing credit crisis had on the breakdown of these investments.19 Part III explores the practice of broker-dealers in “stabilizing” certain markets in order to facilitate liquidity and how this practice differed from the “manipulation” practices that the financial institutions used in the auction rate securities market.20 Part IV argues that the market was doomed to fail because of the irrational and irresponsible actions of the broker-dealers in propping-up the market in order to fuel their desire for larger investment fees.21 This note will further argue that the broker-dealers never should have played such a large role and that in order for the market to have followed on its natural path there needed to be much less intervention by the broker-dealers. Part V offers solutions as to how to restore confidence in the markets by prohibiting the creation of products such as auction rate securities in the future.22 Part VI concludes this note by summarizing the importance of these issues.23

I. THE AUCTION RATE SECURITIES MARKETS

A. THE CREATION AND DEVELOPMENT OF THE MARKET

Auction rate securities were first introduced in 1984,24 and further developed in 1988, when Goldman Sachs introduced the first “‘periodic auction asset securities’[,] through a $121,400,000 offering for the Industrial Development Authority of Pima County, Arizona.”25 While auction rate securities may seem to be extremely complex investment alternatives, they “are far simpler than the mysterious name suggests.”26

18. See infra pp. 299–305.
26. Id. at 361.
Auction rate securities are long-term debt instruments,\textsuperscript{27} with “interest rates that reset monthly or weekly according to a scheduled auction process.”\textsuperscript{28} These bonds are normally issued by state and local government agencies, corporations,\textsuperscript{29} and college student-loan programs.\textsuperscript{30} “The principal difference between typical debt instruments and [auction rate securities] is how interest rates are set.”\textsuperscript{31} Instead of having an interest rate that is fixed at the time of issuance, auction rate securities have interest rates that fluctuate on a weekly or monthly basis, depending on the interest rate that investors are willing to accept at the time of auction.\textsuperscript{32}

This trait makes auction rate securities attractive not only to investors, but also to the corporations, government agencies, and municipalities who issue these securities because of the lower interest rate that is normally paid on them as compared to long-term bonds.\textsuperscript{33} In recent years, the popularity of auction rate securities “has ballooned . . . amid low interest rates as investors look for short-term investments that offer better [interest rates] than Treasury bills, certificates of deposit, or money-market funds.”\textsuperscript{34} Therefore, the issuers of these securities have “the ability to raise long-term money at short-term rates and retain the right to change the [frequency at which interest rates are set].”\textsuperscript{35}

\textbf{B. HOW THE AUCTIONS WORK}

The issuer of auction rate securities hires broker-dealers “such as Goldman Sachs, . . . Citicorp, Lehman Bro[thers], etc., as well as many regional brokers” to issue the bonds and run the auctions.\textsuperscript{36} The broker-
dealers, while receiving fees from the issuers, are also responsible to the
investors purchasing the securities. The broker-dealers have an obligation
to the issuer “to solicit bids on the regularly scheduled auction dates, and
[an] obligation to the investors of the securities . . . to manage the auction
process [according to the securities’ guidelines].”

On the specified dates, the securities are auctioned at par value with
the broker-dealers submitting bids for investors, or on their own behalf, for
“$25,000 . . . [blocks of the securities] they are willing to buy at a given
interest rate.” Therefore, in the auction rate market, it is “the interest rate
that fluctuates, not the value of the debt instrument.” In an auction,
investors can submit the following types of orders to their broker-dealer:

1) [A] “hold” order, which is the default order for current investors (i.e.,
the order that is entered for a current holder if the holder takes no action),
where a current investor will keep the securities at the rate at which the
auction clears; 2) a “hold-at-rate” bid, where a current investor will only
keep the securities if the clearing rate is at or above the specified rate; 3) a
“sell” order, where a current investor will sell the securities regardless of
the clearing rate; or 4) a “buy” bid, where a prospective investor, or a
current investor who wants more securities, will buy securities if the
clearing rate is at or above the specified rate.

The broker-dealers then submit these bids to an auction agent, who is
hired by the issuer of the securities. The auction agent then calculates the
“Clearing Rate,” “which is the highest rate bid at the point that there are
sufficient bids to purchase all shares offered for sale.” The auction agent is
then responsible for allocating the securities to the proper investors.

In essence, the investors “submit the lowest [interest rate that] they are
willing to accept, and the auction manager fills the bids with the available

“Investors can only submit orders [for the auction] through the selected broker-dealers,” making
this a very lucrative market for those broker-dealers who are lucky enough to be the lead

38. Id.
39. Bear Stearns & Co., 88 SEC Docket 259, at 260. The “securities are auctioned at par so the
return on investment to the investor and the cost of financing to the issuer between auction dates is
determined by the interest rate or dividend yield set through the auctions.” Id.
40. Gitomer, supra note 12, at 362. “Typically, the minimum investment [in auction rate
securities] is $25,000.” Bear Stearns & Co., 88 SEC Docket at 260.
41. Gitomer, supra note 12, at 362.
42. Bear Stearns & Co., 88 SEC Docket at 260. In most auctions, the disclosure documents
related to the auctions “often state that an investor’s order is an irrevocable offer.” Id.
43. Risks & Rewards, supra note 28.
44. Gitomer, supra note 12, at 362. “The final rate at which all of the securities are sold at is
[known as] the ‘clearing rate’ that applies to all of the securities in the auction until the next
45. Risks & Rewards, supra note 28.
securities starting at the bottom until all the securities are allocated.”

Through this auction process, the auction agent is able to determine the lowest interest rate necessary (the Clearing Rate) to sell all of the securities available in that auction. “[Every investor] who bids [an interest rate that is] lower than the clearing rate receives the value of securities desired and earns the clearing rate.” Bids, starting “with the lowest rate and then [moving] successively [to the] higher rates[,] are accepted until all of the sell orders are filled.”

When allocating the securities among the investors, the auction agent distributes the securities based on the orders the broker-dealers submitted on behalf of themselves and other investors. “When there are more bids for securities at the clearing rate than securities remaining for sale, the securities are allocated on a pro-rata basis first to the hold-at-rate bidders and then to the buy bidders.” “If there are no sellers of [the securities at a particular auction] the result is an ‘all hold’ outcome where interest rates are set at a default rate that is generally lower than the current rate.”

However, the opposite situation could arise where there is a lower demand for the securities being auctioned, resulting in an overabundance in the supply of these securities at a given auction. “If there are not enough investors willing to purchase . . . all shares of a particular issue offered for sale, the auction fails and no securities change hands.” Essentially, “[a]uctions fail if there aren’t enough interested bidders,” or buyers, on a specific auction date. There can be major ramifications for both the investors and issuers of these securities when an auction fails, including a

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46. Warren & Grant, supra note 36, at 1.
47. Id.
48. Id.
50. Id. at 261.
51. Id.
52. Warren & Grant, supra note 36, at 2.
53. See Daniel Rockey, Auction-Rate Securities: The Next Frontier in Subprime Litigation or a Dead End for the Plaintiffs’ Bar?, 22 NO. 23 ANDREWS DEL. CORP. LITIG. REP. 13 (June 2, 2008).

For example, suppose $100,000 of securities were for sale and the auction received four buy bids. Bid A was for $50,000 at 1.10%, Bid B was for $50,000 at 1.15%, Bid C was for $50,000 at 1.15%, and Bid D was for $25,000 at 1.20%. Under these circumstances, the “clearing rate” would be 1.15%, meaning all of the securities in the auction would pay interest at a rate of 1.15% until the next auction. Bid A would be allocated $50,000, Bids B and C would receive pro-rata allocations ($25,000 each), and Bid D would receive no allocation [due to the fact that the interest rate bid in Bid D was higher than the ultimate “clearing rate”].

Id. at 260 n.4.
loss of liquidity for those particular securities. “In the event of a failed auction, a fail rate,” is then paid to the holders of the securities by the issuer of the securities.

The fail rate, defined in the securities’ prospectus, can range “anywhere from a few percentage points to as high as 20%,” and “is often some percentage above comparable commercial paper or LIBOR (London Interbank Offered Rate) rates.” If investors in auction rate securities have no pressing liquidity needs, a failed auction may result in a fairly profitable occurrence because they would now be reaping the benefits of higher interest payments. However, if investors require liquidity in their investments, they are faced with the unenviable position of holding the securities until liquidity opens up, or possibly selling the auction rate securities in “a thin secondary market for less than par value.” There are also damaging consequences for issuers of auction rate securities if an auction for their securities fails, with the issuer having to pay substantially higher interest rates on their debt.

C. BROKER-DEALERS’ ROLE IN THE AUCTIONS

Broker-dealers such as Goldman Sachs, Morgan Stanley, and Merrill Lynch play a significant role in the sale of auction rate securities by underwriting the offerings and managing the auction process. The issuer of the securities also “pays an annualized fee to [the broker-dealers who] manage an auction (typically twenty-five basis points for the par value of the securities that it manages).” In order for the process to run efficiently, the broker-dealers specify a time by which investors must submit their bids to it. The broker-dealers then process and submit the orders to the

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56. Gitomer, supra note 12, at 363. “Between auctions, investors might . . . [have the opportunity] to buy or sell [the] auction rate securities in . . . [some type of] secondary market at prices greater than, equal to, or less than par.” Bear Stearns & Co., 88 SEC Docket at 260 n.3.
57. Gitomer, supra note 12, at 363. The fail rate “is the [m]aximum [a]uction [r]ate specified in the prospectus or debt instrument.” Id.
58. Id.
59. Warren & Grant, supra note 36, at 2.
60. Gitomer, supra note 12, at 363.
61. Id.
62. Outside of a very thin secondary market, an investor would most likely have to hold their securities until the sooner of “the next successful auction at which there are sufficient purchasers willing to buy all of the [auction rate securities] offered . . . or the maturity or earlier call of the [auction rate securities].” Id.
63. Id. While there is not a large secondary market for these auction rate securities, some “firms with electronic trading networks are now attempting to offer secondary markets for auction-rate securities that cannot be sold at auction.” Alan Rappeport, Buyers Be Where?, CFO.COM, Apr. 1, 2008, http://www.cfo.com/article.cfm/10950592?F-search.
64. Warren & Grant, supra note 36, at 2.
66. Id.
67. Id.
assigned auction agent before a certain deadline. As the auction rate securities market has progressed, the role of broker-dealers has become increasingly more involved with the facilitation of successful auctions.

Since its inception, the value of the auction rate securities market has blossomed, reaching over $200 billion in 2006, and over $330 billion in February 2008. Much of this success was due to the fact that the broker-dealers themselves are able to place bids in the auctions for these securities, along with the other investors whom the broker-dealers are helping to purchase or sell these securities. Broker-dealers submit their bids for several reasons, including “to avoid having a [f]ailed [a]uction or to avoid having an [a]uction clear at a [r]ate the [b]roker-[d]ealer in good faith believes is above its [e]stimated [m]arket [r]ate.” Broker-dealers, while not obligated to submit bids in a particular auction, may place bids that ultimately have an effect on the outcome of the auction “as long as it is an [e]stimated [m]arket [b]id.”

Since the market’s creation, broker-dealers have consistently submitted bids on their own behalf in auctions claiming that “their intervention is for the good of the market as a whole.” Due to “imbalances in bidding interest in a particular [a]uction,” the auction may be subject to failing or it may be “subject to clearing at a [r]ate that the [b]roker-[d]ealer in good faith believes is above an [e]stimated [m]arket [r]ate.” Therefore, broker-

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68. Id.
69. See generally Gitomer, supra note 12.
70. Martha Mahan Haines, Chief, Office of Mun. Secs., SEC, Comments to the Tenth Annual Conference of Women in Public Finance (Sept. 29, 2006).
73. Id. “Estimated Market Rate” is defined as

[a] Rate or range of Rates which, in the Broker-Dealer’s good faith judgment, reflects a fair and reasonable Rate, taking into consideration such circumstances as it believes are relevant, including prevailing market conditions with respect to such security at the time of the determination, general economic conditions and trends, current Rates for comparable securities, and the issuer’s financial condition and prospects. In determining the Estimated Market Rate, a Broker-Dealer should not take into consideration the interest of the issuer in paying a low Rate or the interest of investors in receiving a high Rate. In addition, in determining the Estimated Market Rate for purposes of submitting a Bid for its own account, the Broker-Dealer may also consider such factors as the expense involved, the size of the Broker-Dealer’s inventory position, its capital requirements and its risk management needs.

Id. § 3.
74. Id. § 4.3.2.
75. Mahan Haines, supra note 70.
76. SIFMA, supra note 72, § 4.3.2.
77. Id.
dealers have intervened to play a larger role in the market, providing increased liquidity to the auction rate securities market in order to prevent failed auctions.78

By injecting their own bids into the market to prevent failed auctions, the broker-dealers were market saviors; that is, “[i]f you had more sell orders than buy orders, they’d pick up the difference and you wouldn’t have a failed auction.”79 In short, the broker-dealers were acting as “buyers of . . . last resort.”80 According to some, the reason the broker-dealers consistently submitted bids in order to prevent auction failures was obvious since the “broker-dealers had every financial incentive to sell them to their customers.”81

II. THE COLLAPSE OF THE AUCTION RATE SECURITIES MARKET

For over two decades, the auction rate securities market seemed to work seamlessly, with the “market facilitat[ing] incredible amounts of volume” among investors.82 Until late 2007, “there were less than [fifty] failed auctions,”83 which resulted in confidence among investors and a high demand for the auction rate securities. However, under this shroud of success was a somewhat finicky market that did not always operate the way that its creators intended. In early February 2008, the auction rate securities market, touted as a safe, highly liquid, and short term investment option for investors, “vanished into thin air . . . [and] became illiquid.”84 “In the week of Feb[ruary] 11, 2008 alone, almost 1,000 [auction rate securities auctions] failed,” resulting in the loss of liquidity for thousands of investors who held a significant number of these securities.85 By tracing the history of the auction rate securities market, it is easy to see why the market ultimately collapsed in early 2008. As this note suggests, the main reason for the collapse was the role that broker-dealers and investment banks were playing in the market—acting as bidders of last resort.

As explained in Part I, broker-dealers and the investment banks that ran the auctions would submit bids on their own behalf in order to prevent an auction failure and to facilitate the exchange of these securities among investors. However, as the market became more vulnerable, the broker-dealers and investment banks pushed the market’s limits, and the market’s inherent weaknesses became apparent. The collapse of the auction rate securities market in early 2008 was a result of the interplay between market dynamics and the actions of broker-dealers and investment banks. The catastrophic failure of the market underscored the importance of understanding the role that broker-dealers and investment banks play in the auction rate securities market and the potential for a market failure in the future. 

78. Preston, supra note 15.
79. Id.
80. Carney, supra note 14.
83. Id.
84. Cherdack & Ball, supra note 81, at 337.
85. Warren & Grant, supra note 36, at 2.
investors.\textsuperscript{86} While this may have continued to keep the market afloat when there were not enough investors in a particular auction willing to purchase the securities, this practice was also the main cause of the demise of the market.\textsuperscript{87} Broker-dealers, by submitting their own bids, created a “managed bidding system” within the auctions.\textsuperscript{88} “Broker-dealers participated in the auctions by infusing their own capital in order to prevent them from failing” when there was not enough demand for a particular security.\textsuperscript{89} Because of the increased participation of the broker-dealers in the auctions, the auction rate securities market had an “illusory liquidity.”\textsuperscript{90}

As the size of the auction rate securities market boomed, and the small number of broker-dealers managing the auctions stayed relatively the same, “it became [more difficult] for [the broker-dealers] to arrange true auctions regularly.”\textsuperscript{91} Therefore, in order to keep the market running smoothly, the broker-dealers continually intervened by participating in the auctions at a greater rate than they had in the past, instead of “rustling up thousands of buyers to meet up with sellers every week or so.”\textsuperscript{92} For example, during the period between January 2006 to February 2008, it is reported that Swiss bank “UBS alone may have submitted bids in just under 70% of [the] auctions” that it managed.\textsuperscript{93} By intervening in the auctions to keep them afloat, “[t]he banks were the backstop,”\textsuperscript{94} by preventing failed auctions from occurring. The investment banks had a number of reasons to keep the market afloat, most notably because they received significant fees from the issuers of these securities for managing the auctions.\textsuperscript{95} However, as the United States’ economy began to struggle over the last two years, the broker-dealers became nervous about their involvement in the market.\textsuperscript{96}

\textsuperscript{86} See \textit{supra} Part I.C.

\textsuperscript{87} See Preston, \textit{supra} note 15.

\textsuperscript{88} Cherdack & Ball, \textit{supra} note 81, at 344. “Given the size of the [auction rate securities] market, and the fact that each security required a separate auction on the date that the interest rate was set to expire, conducting the weekly auctions became unwieldy.” \textit{Id.} at 343. Therefore, in order to further facilitate the market, the broker-dealers used their own funds to keep the securities moving between investors. \textit{Id.} at 343.

\textsuperscript{89} \textit{Id.} at 343 (“Having invested their own capital in the [auction rate securities] market in order to make a secondary market, broker-dealers had every financial incentive to sell them to their customers.”).

\textsuperscript{90} \textit{Id.}

\textsuperscript{91} Gretchen Morgenson, \textit{It’s a Long, Cold, Cashless Siege}, N.Y. \textit{T}IMES, Apr. 13, 2008, at BU.

\textsuperscript{92} \textit{Id.} Instead of finding a sufficient number of buyers to meet up with the number of sellers, the broker-dealers put up more and more of their own funds to purchase the securities from those who wanted to sell them. \textit{Id.} Finding a sufficient number of participants would “be an enormous undertaking for the handful of underwriters in the arena.” \textit{Id.}


\textsuperscript{94} Preston, \textit{supra} note 15.

\textsuperscript{95} See Cherdack & Ball, \textit{supra} note 81, at 343.

\textsuperscript{96} See Rockey, \textit{supra} note 53.
The collapse of the auction rate securities market “traces back to the surprise surge in mortgage defaults that started” in 2007. As the subprime mortgage crisis unfolded, the “$146 billion in credit losses and write-downs” that investment banks experienced began to negatively affect other securities markets as well. Due to these losses, the broker-dealers had a “shortage of cash available to commit to the auctions.” In short, the auction rate securities market became the odd man out because “given their exposure to other subprime-tainted securities related to the credit crunch, many banks could no longer afford to provide . . . support” to the auctions. Furthermore, the balance of ownership of auction rate securities seemed to shift from institutional investors, such as mutual funds and insurance companies, to individual investors, such as the Maher brothers and other wealthy investors. This led to a scenario in which many of the auction rate securities were held by less sophisticated investors unfamiliar with the true risks of the instruments.

All of these problems culminated in February 2008, with the auction rate securities market coming to a near standstill. Due to investors’ fears regarding the strength of the financial markets, the interest of institutional and individual investors in purchasing auction rate securities diminished greatly, resulting in a shortage of buyers, putting great pressure on the investment bank and broker-dealers to prop-up the markets. Finally, during the week of February 11, 2008, “the broker-dealers, en masse, ceased participating in the [auctions],” and no longer acted as “buyers of last resort.” The broker-dealers and investment banks essentially “remain[ed] on the sidelines,” neglecting to play the role of savior in the auction rate securities auctions as they had done in the past. On February 13, 2008, approximately “80% of [the] auctions failed,” and on February 13, 2008, approximately “80% of [the] auctions failed.”

98. Gitomer, supra note 12, at 364.
100. Johnston, supra note 13.
101. Warren & Grant, supra note 36, at 2. As of July 1, 2007, corporations held a large amount of the auction rate securities available, owning “$170 billion of these securities, or just over half of the total outstanding, according to Treasury Strategies.” Morgenson, supra note 91. However, institutional investors began to decrease their holdings through 2007, holding only $98 billion of the almost $330 billion auction rate securities available through the second half of 2007. Id.
102. Warren & Grant, supra note 36, at 2.
103. Frank, supra note 1.
104. Fazio et al., supra note 82, at 329.
105. Cherdack & Ball, supra note 81, at 343–44.
106. Fazio et al., supra note 82, at 329.
107. Id.
108. Mandaro, supra note 97. During the week of February 11, 2008, “[i]n all, more than $1 billion of auctions of New York City and New York state-backed debt failed [and] . . . [o]ut of thirteen auctions of state-backed debt totaling $867.2 million, only a single $104.5 million series issued by
“more than 70% of the publicly offered bond auctions failed.”

Three days in February alone marked the failure of more than 1,000 auctions. This is especially noteworthy, because “[p]rior to 2008, there were only [forty-four] recorded auction failures since the [auction rate securities] market’s inception in 1984.”

So what did this mean for all of the investors who actually held these securities up to early February of 2008? Essentially, they were stuck with the auction rate securities and had no way of selling them to others because there was no one else looking to buy. Investors were informed by their brokers “that they could not sell the securities at auction and [therefore] could not access their funds” due to the lack of liquidity in the market.

The brokers told their clients “that the best [they] could do for them was to offer margin loans to ease the liquidity crunch or attempt to unload the securities at a discount to par value in the secondary markets.”

The Maher brothers are a typical example of investors who fell prey to the auction rate securities meltdown—investors who placed their money in auction rate securities thinking the securities were safe, short-term, and highly liquid, yet ultimately could not sell these securities and lost almost any sense of liquidity their investments once possessed.

The freeze-up in the auction rate securities market also caused a diminution in value of many individual investors’ portfolios, at least for accounting purposes. While these securities are still worth the same value that they were previously, their illiquidity has caused some brokers to write-down the value of some of their clients’ holdings. For example, “UBS AG announced that despite the soundness of the collateral backing the auction rate securities, the bank was moving to lower the value of the securities.”


112. Rockey, supra note 53, at 3.

113. Id.

114. See supra Introduction.

115. Rappeport, supra note 63.

116. See Rockey, supra note 53.
issues its customers held in their investment accounts to reflect the lack of liquidity in the instruments.”

The loss of liquidity has also harmed small business owners, causing some who had invested in auction rate securities to draw funds from other sources in order to operate their businesses or pay their taxes. Even though the collapse in the auction rate securities market is “not a credit problem, [but] a liquidity problem,” the fact that investors in these securities cannot access their funds has had an extremely detrimental impact on the financial stability of the investors. And while the focus has been on the detriment caused to the individual investors, many corporate holders of these securities have faced massive write-downs in the value of their auction rate holdings.

Not only did this collapse in the market have a significant impact on the investors who held these securities, it also greatly affected the issuers of these bonds. As explained earlier, when an auction fails, the issuer of the securities must pay a “fail rate” to the investors, which can be described as a punitive penalty rate specified in the bond documentation. Therefore, when there are not enough buyers for a particular auction, the company that issued the bonds must pay the investors still holding these securities a higher interest rate than they would had the auction been successful. For

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117. Id. “As a rough measure of the magnitude of the problem faced by investment banks whose customers were sold these securities, Morgan Stanley announced in its March 19 conference call with investors that the value of the auction-rate securities held by its customers alone was roughly $20 billion.” Id.

118. Rappeport, supra note 63. For example, Bill Freeman, an owner of a small copy-machine company in Irvine, California, had about $200,000 invested in auction rate securities in an account held by UBS. Id. Without the liquidity once provided to his funds, “[he] may have to draw operating capital from his 25-employee company, Century Business Services, just to pay his taxes this year.” Id. Furthermore, “Freeman also has another $550,000 locked up in auction-rate savings with Wells Fargo, which offered him an $80 credit on his checking account to switch his money from a savings account into securities that he was told would take a few days longer to liquidate.” Id.

119. Id.

120. See Rockey, supra note 53. For example,

[In its most recent 10K annual report filed with the SEC, airline JetBlue announced that as of December 31, 2007, 72 percent of its $834 million in cash and investment securities was held in auction-rate securities. Though it managed to trim its exposure to auction-rate securities to $330 million by February 11, JetBlue confirmed that $144 million of the securities was subject to failed auctions and that, because of current market conditions, auctions related to these securities will likely be unsuccessful in the near future.

Id. (footnote omitted). “Best Buy, the world’s largest consumer electronic retailer, owned $397 million in auction-rate securities as of April 25, 2008.” Mike Meyers & Chris Serres, Auction-Rate Securities Get No Bidders; The Exoteric Debt Vehicles Promised Low Short-Term Interest Rates on Long-Term Debt but Wound Up Costing Millions to Minnesota Companies, STAR TRIB., May 26, 2008, at 1D. However, the company had not marked down these investments as of May 2008, stating that they “believe that the credit quality of [their] auction-rate securities is high and that [they] will ultimately recover all the amounts invested in these securities.” Id.

121. See supra Part I.B.

122. See discussion supra Part I.B.
example, around the time of the freeze-up “[r]ates on $100 million of bonds sold by the Port Authority of New York and New Jersey . . . soared to 20 percent . . . from 4.3 percent a week earlier.” This jump in interest rates was also reflected in the fact that “the average rate for seven-day municipal auction [rate securities] rose to a record 6.59 percent on February 13, 2008, from 4.03 percent the previous week.” This deterioration of the auction rate market has also affected the plans of other companies and municipalities to raise capital for long-term projects, with most companies now relying on other debt markets to raise funds instead of using the once reliable auction rate securities market.

III. MARKET “STABILIZATION” VERSUS MARKET “MANIPULATION”

A. MARKET “STABILIZATION” AND ITS USES

“The Securities and Exchange Commission (SEC) stated in 1940 that ‘stabilization’ . . . may be ‘broadly defined’ as ‘. . . the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public.’” Since that time, the SEC has promulgated numerous rules and regulations regarding the practices of broker-dealers in the stabilization and manipulation of the prices of securities within the financial markets, setting forth what practices are and are not allowed to be used by participants in the exchange of securities. The most important regulation set forth by the

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125. See Meyers & Serres, supra note 120.
Securities Act of 1934\textsuperscript{128} regarding the practice of manipulation was § 10(b), which provided that

\begin{quote}
[j]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange—
\end{quote}

\begin{quote}
. . . .
. . . .
\end{quote}

\begin{quote}
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.\textsuperscript{129}
\end{quote}

Under the authority set forth in this statute, the SEC adopted Regulation M in December 1996.\textsuperscript{130} “Regulation M restricts offerings, activities, and persons where there is a readily identifiable incentive to manipulate the price of an offered security.”\textsuperscript{131} Regulation M is also meant to “govern[] the activities of underwriters, issuers, selling security holders, and others in connection with securities offerings.”\textsuperscript{132}

Today “stabilizing” is defined by the SEC as “the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining a price of a security.”\textsuperscript{133} Stabilization is permissible, but only in certain situations and when the regulations set forth by the SEC are specifically followed.\textsuperscript{134} Regulation M prohibits bids or purchases “except for the purpose of preventing a retard or decline in the market price of a security,” and forbids “stabilizing at a price that the person stabilizing knows or has reason to know is . . . the result of activity that is fraudulent, manipulative, or deceptive.”\textsuperscript{135} It is also interesting to note that this

\begin{thebibliography}{9}
\bibitem{131} PRIFTI, supra note 130.
\bibitem{132} Id.
\bibitem{133} 17 C.F.R. § 242.100(b) (2009).
\bibitem{134} \textit{See} Anti-Manipulation Rules, \textit{supra} note 127, at 535–37.
\bibitem{135} 17 C.F.R. § 242.104 (2009). Specifically, § 242.104 states:
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regulation does not allow for the placing of “more than one stabilizing bid in any one market at the same price at the same time.”136

The practice of price stabilization is a “price-influencing activity intended to induce others to purchase the offered security.”137 Therefore, “when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.”138 The SEC has set forth strict guidelines regarding the practice of price stabilization in order to “address[] the risk that stabilization will create a false or misleading appearance [of the security] with respect to the trading market for the offered security.”139 This practice of price stabilization is also meant to “occur[] most frequently during the period [when a new security enters the market, or] during the period of flotation of a new issue.”140

The practice of price stabilization stems from underwriters’ actions during the initial flotation of a security in the market.141 When a corporation seeks to raise capital by issuing shares of equity or debt, it will hire an investment bank to underwrite the securities being issued to the public and to help sell these securities to investors.142 However, when a security

(a) **Unlawful Activity.** It shall be unlawful for any person, directly or indirectly, to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid, in connection with an offering of any security, in contravention of the provisions of this section. No stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of this section, or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder.

(b) **Purpose.** Stabilizing is prohibited except for the purpose of preventing or retarding a decline in the market price of a security.

(c) **Priority.** To the extent permitted or required by the market where stabilizing occurs, any person stabilizing shall grant priority to any independent bid at the same price irrespective of the size of such independent bid at the time that it is entered.

(d) **Control of Stabilizing.** No sole distributor or syndicate or group stabilizing the price of a security or any member or members of such syndicate or group shall maintain more than one stabilizing bid in any one market at the same price at the same time.

Id. 136. Id.
137. Anti-Manipulation Rules, supra note 127, at 535.
140. Alexander Hamilton Frey, Federal Regulation of the Over-the-Counter Securities Market, 106 U. PA. L. REV. 1, 25 (1957). The practice of stabilization usually “consists of purchases of the security being distributed for the account of the underwriting syndicate in order to maintain the initial offering price or to prevent a decline.” Id.
141. Id.
142. Id. The corporation issuing the securities contract[s] for these services with an investment banker or underwriter. This contract contains the agreed terms of the issue as well as the approximate price to the issuer and
initially hits the market, “there may . . . be a time lag between the offering of an issue at a stated price and public awareness of its worth, during which period the market price may sag.” Therefore, instead of waiting for the public to realize the actual value of the security, the underwriter may “purchase blocks of the very issue they are trying to sell, in order to create artificially an appearance of real demand at the offering price, and thus to induce prompt public interest in purchasing the securities at that price.”

B. MARKET MANIPULATION IN THE AUCTION RATE SECURITIES MARKET

The main purpose of market stabilizing activities is to more efficiently facilitate the purchase and sale of a particular security when it is first offered to the public in order to prevent an extreme drop in the price of that security. This practice is a way for broker-dealers and investment bankers to legally manipulate the price of a security for the betterment of the market as a whole. The SEC, in the Securities Act of 1934 and Regulation M, has laid out specific situations in which market stabilizing practices are allowed and guidelines that broker-dealers should follow when taking part in these practices. While the practice of stabilization is legal and somewhat encouraged, this note argues that the practices used by the broker-dealers in the auction rate securities market went beyond the realm of stabilization, to a level of manipulation that contributed to the market’s breakdown.

By consistently injecting their own funds into the auctions in order to prevent failed auctions, the broker-dealers and financial institutions were acting as more than just “buyers of the last resort . . . [They were] consistently called upon to stabilize the [auction rate securities] market.” As one bond trader stated, “[t]he truth is there was no natural auction success rate. But for the banks acting as market-makers, these auctions would have failed from the get go.” Rather than injecting capital into a security offering for a short period of time to stabilize and prevent undue decline in the security’s price, the broker-dealers and financial institutions

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the ‘spread’ (i.e., the difference between the price realized by the issuer and the price charged to the public by the underwriter). The originating underwriter then forms an underwriting syndicate, the other members of which proportionately share the risk and the potential profit. The members of the underwriting group sell at least half of the issue to their customers, and the balance is sold for their account by a selling group which they form and with whom they split commissions on this latter amount of the total issue.

Id. at 25–26.
143. Id. at 26.
144. Id.
145. PRIFTI, supra note 130.
146. See supra Part III.A.
147. Carney, supra note 14.
148. Id. (internal quotation marks omitted).
manipulated the auction rate securities market for years. The broker-dealers caused the auction rate securities market to have an “illusory liquidity,” by consistently manipulating the auctions in order to prevent failures.149

Unlike the practice of market “stabilization,” in which a broker-dealer may attempt to keep the price of a security at a sufficient level for a short period of time after the security initially hits the market,150 the broker-dealers continued to inject their own capital into the auction rate securities market on a weekly basis.151 The purpose of stabilizing the price of a newly issued security is to show other market participants that the particular security is an attractive investment that is trading below its actual value.152 Further, “[m]any courts have held that stabilization is legal if its purpose is in fact to provide support against unusual market conditions in a sincere effort to protect the interests of shareholders and investors.”153 However, to create a “false impression as to the degree of real interest in a security is a form of deception,” and some forms of alleged stabilization may be used to disguise illicit manipulation. In the auction rate securities market, the alleged “stabilization” that took place was meant to further the interests of the broker-dealers and not the investors in those securities.154 By continuing to support these auctions that should have failed, the broker-dealers were able to continue to reap the large fees that they charged both to the issuers of the securities and to the purchasers of the investments.

IV. HOW GREED FOR MORE FEES FUELED THE COLLAPSE OF THE AUCTION RATE SECURITIES MARKET

For the past two decades, the auction rate securities market provided broker-dealers and investment banks with the opportunity to collect enormous fees from both the issuers of auction rate securities and the investors who placed their funds into these markets.155 The broker-dealers used what many would describe as deceptive practices in order to fool investors into believing that the market was as safe and as liquid as their savings account at their local bank. Most investors in auction rate securities now give the same explanation when asked why they invested so heavily in a market that was so dysfunctional on the inside; “‘they were told by their brokers [that] these [auction rate securities] were safe as cash . . . .’”156 What has resulted since the collapse of the market has become almost too

149. Cherdack & Ball, supra note 81, at 343.
150. See supra Part III.A.
151. See Cherdack & Ball, supra note 81, at 343.
152. See Frey, supra note 140, at 26.
153. Id. at 50.
154. Cherdack & Ball, supra note 81, at 343.
155. See id. at 343–44.
recognizable in the financial services industry—a slew of lawsuits by investors and a rash of investigatory probes by state and federal government agencies targeted against the broker-dealers who propped-up this faulty market.\footnote{See Efrati, \textit{supra} note 17.}

As the auction rate securities market meltdown slowly unfolded to the public eye, many began to question the interventionist practices that the broker-dealers employed in the market. For example, Martha Mahan Haines, Chief of the Office of Municipal Securities at the SEC, asked the following question: “Was it in the best interests of issuers and investors to be so heavily dependent on broker-dealer intervention to support the expansion of [the auction rate securities] market?”\footnote{Mahan Haines, \textit{supra} note 70.} Looking back on what took place in the auction rate securities world over the past several years, the answer is clearly “No.” While the broker-dealers who worked in the market may defend their practices as stabilizing activities that helped to bring liquidity to the market, these practices were the ultimate reason that the auction rate securities market came to a extraordinary crash in early 2008.

In the auction rate securities market, there were rules and guidelines put in place to deal with failed auctions for a reason: failed auctions were a natural part of the market. By allowing an auction to fail early in its life, signals are sent to investors regarding the credit-worthiness of a particular investment, as well as signals sent to issuers that they may want to restructure their debt so that they do not use auction rate securities to raise capital. While some intervention by broker-dealers is proper and useful when dealing with the stabilization of a newly issued security, the continuous manipulation of a security over a long period of time could only lead to disaster. The intervention by broker-dealers “supported the rapid growth of [the auction rate securities] market to over $200 billion.”\footnote{Id.} However, the only proper action that should have been taken by the broker-dealers was to allow the auction rate securities to continue along their true path, even if that meant allowing certain auctions to fail. That a particular offering of securities may prove to be unpopular to investors is a “risk inherent in the business of underwriting,”\footnote{Frey, \textit{supra} note 140, at 50.} the broker-dealers should not have taken steps “to avoid this risk by creating an unreal appearance of demand for the securit[ies] at the expense of unsuspecting investors thus induced to pay artificially inflated prices” on a weekly basis.\footnote{Id.}

While many people have asked “[h]ow long did [the broker-dealers] know the auctions were on life support,”\footnote{Carney, \textit{supra} note 14.} the real question that should
have been asked is why did the broker-dealers continually prop-up the market knowing that it was flawed from the beginning? The only answer to this question appears to be greed. While the financial services markets have benefited a great number of people with the creation of new products and investment vehicles, there always seems to be a group of people who are taken advantage of in order for a select few to gain exorbitant amounts of wealth. In the case of the auction rate securities market, not only were unsuspecting investors duped into believing they were investing in safe and liquid investments, but the companies and municipalities that issued these securities were also deceived into believing that the securities they were issuing would always allow them to borrow money at low interest rates. The actions of the broker-dealers in deceptively framing the auction rate securities market as safe and liquid adds to a long list of irrational behavior within the financial markets that has pervaded our newspapers and television sets over the last two years.

As one managing director at a financial advisory firm stated, “[auction rate] securities really worked very well for a relatively long period of time . . . . It’s possible that people were lulled into a sense of false security because if something works well for 20 years you might not be as attentive.” The “[s]upply [of auction rate securities] would have long since exceeded demand had [broker-dealers] not prevented failed auctions by buying [the securities] at auctions where there otherwise would not have been enough buyers to prevent auction failures.” Investors in these securities were “unaware of the extent to which dealers were propping up the [auction rate securities] auctions,” causing investors to believe that they could always easily liquidate their holdings regardless of the financial situation of the markets. By creating a market that was fueled by a thirst for more investment fees, the broker-dealers and investment banks essentially caused the mess that they are dealing with today.

When the auction rate securities market was first created, it was intended to be an investment vehicle for corporations and municipalities to raise capital using long-term debt with low, short-term interest rates. These securities were also seen as highly safe investments for investors who wanted to gain a slightly higher interest rate on their funds, while maintaining liquidity that one would normally associate with a bank

163. See discussion supra Part II.
164. See generally Meyers & Serres, supra note 120.
166. Morgenson, supra note 91.
168. Id.
169. Bisbey Colter, supra note 34.
account or a money-market fund. However, over time, this sense of liquidity eroded as fewer investors showed up for the auctions each week, and the demand for auction rate securities dwindled to extremely low levels. But instead of allowing the auctions to fail when this demand first decreased, the broker-dealers used their own capital to supplement the market and plunge the investors into a dangerous state of affairs that resulted in the complete collapse of liquidity in the market.

The problems that took place within the auction rate securities market are simply a furtherance of what we have witnessed in the securities markets for the past two decades: “The outrageous bonuses, the slender returns to shareholders, the never-ending scandals, the bursting of the internet bubble, [and] the crisis following the collapse of Long-Term Capital Management . . . .” The collapse of the auction rate securities market likewise signals how the financial services industry has operated in our country, and the great reluctance of those who run the industry to “not face up to how badly [they] have mismanaged [their] business.” The financial markets should function with a “survival of the fittest” mentality, with the strongest investment products and services rising to the top, while the inefficient and unproductive products and services are disposed of over time. As new and innovative investment tools and vehicles have been created, investors and issuers alike have realized more and more ways to not only raise capital, but also to subsequently distribute securities among those wishing to purchase them. Whenever a new type of security or instrument does not function properly, or if demand in that type of security greatly decreases, one would imagine that investment banks and broker-dealers would just replace that security with a newer, more advanced investment. However, in the case of auction rate securities, broker-dealers and investment bankers continued to support a faulty market, instead of allowing the market to follow along on its path to either ultimate failure or greater innovation. And why? Because, the broker-dealers still “receive[d] . . . auction fees even when the auctions fail[ed].”

170. Id.
171. See supra Part II.
172. See supra Part II.
173. Lewis, supra note 165.
174. Id.
175. See generally id. (describing, for example, how secured assets like mortgages were pooled and divided into collateralized debt obligations, which were further divided and spooled into increasingly complicated and overrated collateralized debt obligations).
176. Morgenson, supra note 91.
V. HOW TO HELP AUCTION RATE SECURITIES INVESTORS

A. CONTINUED SETTLEMENTS WITH INVESTORS AND REGULATORY AGENCIES

Since 2008, a number of financial institutions, including Citigroup, Wachovia, and UBS, have reached massive settlements with various regulatory institutions regarding their involvement in the auction rate securities market meltdown.177 These settlements were in response to state and federal investigations of the broker-dealers’ marketing and selling of auction rate securities, with many regulatory agencies alleging that the broker-dealers and investment banks falsely sold these products as highly liquid and cash-equivalent securities.178 In particular, these settlements, many of which were reached between the broker-dealers and groups such as the Financial Industry Regulatory Authority (FINRA) and the New York Attorney General’s Office, have resulted in the buyback of approximately $61 billion of auction rate securities from investors,179 as well as the payment of over $360 million in fines by the broker-dealers.180

Since these settlements began to unfold, broker-dealers and financial institutions have essentially performed a “mea culpa” of ultimate proportions, attempting to reimburse the damaged investors in auction rate securities with the hope of keeping them around for future business.181 This is significant due to the nature of the financial services market, where very rarely will a financial institution reach out to help a struggling investor. In


Merrill Lynch did not make adequate disclosures that the liquidity of these securities was based on Merrill Lynch supporting the auctions it managed when there was not enough demand . . . . Furthermore, Merrill Lynch continued to tout the purported liquidity of [auction rate securities] to customers despite its awareness of the escalating liquidity risks in the weeks and months preceding the collapse of the [auction rate securities] market.

Id.

181. See id.
today’s financial world, where the trust that existed between investors and broker-dealers has essentially vanished, it is pertinent that the financial institutions “make good” with their customers who were duped into purchasing auction rate securities.

As is expected in the financial markets, “we understand we assume risk when we purchase financial instruments, and don’t expect sellers to compensate us for market vagaries.” However, if the financial institutions and broker-dealers are going to regain the trust of the spurned investors to try to jumpstart our struggling economy, they must be held accountable for their products that they manipulated in order to gain exorbitant profits. The settlements that have taken place since 2008 are a welcome sign that the broker-dealers recognized their “breach of fair-business-conduct-rules,” an essential step in restoring confidence to an industry that has seemingly lost the respect of many American citizens.

B. END INVESTMENTS OF THIS NATURE

It is easy to see how the collapse of the auction rate securities market has affected the overall sentiment surrounding the financial markets; it has significantly added to the negativity that is so often associated with Wall Street. However, a broader picture that has been painted by this fiasco: the limits on how financial institutions and broker-dealers can make money. These limitations should be recognized and respected.

Auction rate securities were products created to fill a long term funding need for issuers while supplying investors with a short term borrowing opportunity. This long-term/short-term arrangement was created with the hopes of constantly creating massive fees for broker-dealers, while attempting to keep clients and investors blinded from the dangers that came along with these investment instruments. However, this breakdown in the market has shown us that “[s]uch an arrangement is impossible” because any type of arrangement that funds long term investments with short term liabilities is “inherently unstable.” Essentially, auction rate securities proved that it is unreasonable and irresponsible to match up sellers of oranges with buyers of apples, for the sole purpose of accumulating higher investment fees and profits for financial institutions.

Certain risks and limitations are inherent in the financial services market and they are essential restrictions against the creation of investment instruments such as auction rate securities. If confidence is going to be restored in the financial services industry, broker-dealers and investment institutions must understand that there are certain boundaries in which they

182. Id.
183. Id.
184. See D'Silva et al., supra note 178.
185. See id.
186. Id.
can operate. And while there are countless numbers of investment products which have been created that have benefited both issuers and investors, not every investment instrument will prove to be successful. Financial institutions must realize that not every financial product that is created is beneficial, and only the strongest and safest investment products should be marketed to their customers.

CONCLUSION

Since the breakdown of the auction rate securities market in early 2008, there has been a wave of litigation against the broker-dealers and investment banks that so recklessly helped to damage the financial circumstances of many. Furthermore, the SEC and several state Attorney Generals, including New York’s Andrew Cuomo, have conducted investigations of numerous broker-dealers that have resulted in the buyback of millions of dollars worth of auction rate securities from investors harmed by the breakdown in the market. However, there are still a large number of investors who have lost a great deal of wealth and liquidity from the destruction of the auction rate securities market, which could negatively affect their financial situation for years to come.

The fear of many is that those who were spurned by the investment banks and broker-dealers in the auction rate securities meltdown may have finally lost all trust in Wall Street and will refuse to come back for their services in the future. This refusal to return may be warranted, with the meltdown of the auction rate securities market causing individual investors to finally realize the “[m]e [f]irst” motto that has been embraced by Wall Street for such a long time.

While new and innovative investment vehicles are beneficial to the securities market, not all investment tools prove to be successful. The auction rate securities market was created for those needing capital to raise long-term debt with short-term interest rates, and for those needing safe

187. See Sabry et al., supra note 109. “The [auction rate securities] market problems have led to various lawsuits against broker-dealers such as Wachovia, Goldman Sachs, Wells Fargo, UBS, JP Morgan, Merrill Lynch, Morgan Stanley, TD Ameritrade, and others, all of which face allegations that they misrepresented the risk-level and liquidity of the [auction rate securities] they sold.” Id.

188. Efrati, supra note 17.


190. Robert Frank & Liz Rappaport, The Auction-Rate Monster in the Closet—Settlement Excludes 4Kids, Other Firms; Battle With Lehman, WALL ST. J., Aug. 29, 2008, at C1. There are hundreds of U.S. companies that have lost money in the auction rate securities crisis, including 4Kids, a children’s entertainment company. Id. “While some investors—individuals, charities, municipalities—are getting their money back as part of the $50 billion in settlements paid out by Wall Street . . . other companies are being left out.” Id.


192. Id.
investments to gain a reasonable interest rate using a highly liquid securities market. However, once the broker-dealers began to manipulate the market by refusing to allow auctions to follow their natural path, the safety and security of the market vanished. Innovation and productivity are essential for the proliferation of wealth in the ever-changing financial markets. Yet, with innovation and productivity also comes the risk of failure that not every investment tool is worthy of the support of investors and financial institutions. The auction rate securities market may have been wildly successful for a period of time, but it never should have been falsely sustained for so long by the broker-dealers who were the key players in its inception.

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193. *Supra Part II.

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ROAD CLOSED:
THE INEQUITABLE TREATMENT OF
PRE-CLOSING PRODUCTS LIABILITY
CLAIMANTS UNDER THE AUTO INDUSTRY
BAILOUT

O thou wicked servant, I forgave thee all that debt, because thou
desiredst me:

[S]houdest not thou also have had compassion on thy fellow servant,
even as I had pity on thee?1

INTRODUCTION

Throughout 2008, the American automobile manufacturing industry
faced a steady decline in market share and revenue due to increasing foreign
competition and decreasing demand resulting from spiking oil prices.2
Pension obligations and other legacy costs, coupled with poor
decision-making and financial planning on the part of management, only
exacerbated the problem, and by the end of 2008 domestic sales fell to their
lowest ebb in over 25 years.3 On December 19, 2008, Secretary Henry
Paulson of the United States Department of the Treasury (Treasury
Department) announced the Treasury Department’s and President George
W. Bush’s intention to prevent imminent and potentially disastrous
bankruptcies in this industry by providing billions of dollars in loans to
General Motors Corporation and its related companies (GM) and Chrysler
L.L.C. and its related companies (Chrysler) under the Troubled Asset Relief
Program (TARP).4 The rationale for the bailout was manifold5 but is,

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2. See Alex Ortolani, GM, Chrysler May Lead Sales Slide to Cap 16-Year Low, BLOOMBERG,
3. See CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP
FUNDS IN SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 1 (2009),
1964.pdf.
4. Press Release, U.S. Dep’t of the Treasury, Secretary Paulson Statement on Stabilizing the
[hereinafter Press Release, Secretary Paulson]; Troubled Asset Relief Program (TARP), 12
that U.S. automakers’ failure would result in the unemployment of an unacceptably large number
of Americans employed directly by the automakers). The resultant failure of businesses that rely
directly (such as suppliers and dealerships) and indirectly (such as local businesses in factory
towns) on the industry would magnify those losses exponentially, resulting in essentially
incalculable costs to the American taxpayer. Id.
perhaps, best summarized by the term “too big to fail.”6 Through the end of 2008 and the first half of 2009, President Barack Obama’s Administration and the Treasury Department, under the new leadership of Timothy Geithner, continued the government’s commitment to GM7 and Chrysler8 by making them a series of loans, guarantees, and equity investments before, during, and after each filed for Chapter 11.9 The government’s purpose was to ensure the automakers’ orderly restructuring10 in anticipation of bankruptcy.11

While the paths taken by GM and Chrysler differed, most of the salient components were essentially the same: (1) each relied on massive federal financial assistance12 to stave off what would have been a disastrous liquidation;13 (2) each received this assistance before, during, and after

7. See ProPublica, Eye on the Bailout: General Motors, http://bailout.propublica.org/entities/233-general-motors [hereinafter ProPublica–General Motors] (last visited Feb. 11, 2010) (detailing the government’s commitment to GM totaling $50,744,684,329 and breaking down as follows: $884 million debt obligation (Dec. 29, 2008); $13.4 billion debt obligation (Dec. 31, 2008); $2 billion debt obligation (Apr. 22, 2009); $4 billion debt obligation (May 20, 2009); $360.6 million debt obligation guaranteeing GM’s warranty commitments for its cars during the bankruptcy period under the Warranty Commitment Assistance Program (May 27, 2009); $23 billion debt obligation, equity interest (June 3, 2009); and $7.1 billion debt obligation (July 10, 2009)).
8. See ProPublica, Eye on the Bailout: Chrysler, http://bailout.propublica.org/entities/93-chrysler [hereinafter ProPublica–Chrysler] (last visited Feb. 11, 2010) (detailing the government’s commitment to Chrysler totaling $12,812,130,642 and breaking down as follows: Pre-filing: $4 billion debt obligation (Jan. 2, 2009) and $280.1 million debt obligation guaranteeing Chrysler’s warranty commitments for its cars during the bankruptcy period under the Warranty Commitment Program (Apr. 29, 2009); During Bankruptcy: $1.9 billion debt obligation (May 1, 2009); Post-Closing: $6.6 billion debt obligation (May 27, 2009)).
12. See ProPublica–General Motors, supra note 7; ProPublica–Chrysler, supra note 8.
13. See In re General Motors, 407 B.R. at 480–81. The realizable value, net of costs, of the liquidation of GM’s assets was approximately $6 to $10 billion. Id. Total secured debt was
restructuring;14 (3) each participated in the Obama Administration’s warranty commitment plan designed to promote consumer confidence in the distressed manufacturers by ensuring the coverage of warranties for cars purchased during the restructuring period;15 (4) each restructured under the shield of § 363 of the Bankruptcy Code (the Code),16 explicitly, or in the case of GM, functionally,17 insulating the emerging companies from certain products liability claims;18 and (5) each voluntarily assumed products liabilities arising from automobiles purchased before bankruptcy involved in accidents occurring post-closing,19 although this last concession was only made after intense pressure was applied by Washington.20

Section 363(f) of the Code enables a trustee or debtor in possession21 to sell assets outside the ordinary course of business “free and clear” of interests in those assets.22 Stripping the debtor’s property of these

approximately $50 billion and general unsecured liabilities were estimated at nearly $117 billion, without even accounting for several classes of potential claims. *Id.* See also Ramifications of Auto Industry Bankruptcies (Part III): Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary, 111th Cong. 17 (2009) (joint prepared statement of Louann Van Der Wiele, Vice President and Associate General Counsel, Chrysler Group, L.L.C. and Kevyn D. Orr, Partner, Jones Day) (stating that no class of Chrysler creditors other than first-lien creditors would receive any value upon liquidation).


17. *See* Interview with J. Kent Emison, *infra* note 133. The GM plan does provide for unsecured creditors, of which pre-closing products liability claimants are a subclass. *Id.* However, given the many products liability claimants’ contingent status, the vast difference between the total debt due to unsecured creditors and what is provided for in the plan, and that this amount is to be divided among all unsecured creditors pro rata, the provision is unlikely to account for much, if any, relief for their substantial injuries. *Id.*


20. *See*, e.g., Spector, *supra* note 19. This pressure was, in turn, generated through powerful lobbying efforts on the part of plaintiffs’ advocates; but it was the government’s influence, powerful due to the massive assistance the companies received in the bailout, which proved crucial to obtaining their acquiescence. *Id.*; *see also* Tomoeh Murakami Tse & Kendra Marr, *GM to Allow Some Product Liability Claims*, WASH. POST, June 29, 2009, at A11, available at [http://www.washingtonpost.com/wp-dyn/content/article/2009/06/28/AR2009062802466.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/06/28/AR2009062802466.html).

21. *See* 11 U.S.C. § 1107(a) (2006) (“Subject to . . . limitations . . . a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter.”).

22. 11 U.S.C. § 363(f) (2006) (“The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate . . . ” subject to certain restrictions.).
encumbrances encourages buyers to pay a premium price well above what the assets would receive in liquidation in a way that, in theory, produces a more efficient result than a standard Chapter 11 reorganization plan. However, commentators have argued that § 363(f) was intended to perform this function within the context of a fully negotiated plan and that allowing debtors to use it in preplan sales is an unacceptable end-run around reorganization, freeing purchasers from liabilities which might otherwise attach to assets using the standard mechanism. Courts, however, have not sided with the critics, and the “free and clear” provision has firmly ensconced § 363 as the most attractive mechanism for the sale of liability-burdened businesses. It is the standard operating procedure of such sales that injury claims rest against the debtor-seller. The injury claims at issue in this note may be separated into a tripartite framework of injuries arising from products purchased before the debtor filed for bankruptcy: those that were involved in accidents that occurred (1) prepetition; (2) during pendency; and (3) post-closing (so-called “future claims”).

It is this note’s position that the federal government, in providing bankruptcy-anticipatory bailout monies to these companies under TARP, made a perverse—yet correctable—policy choice to preserve its own investment in the automobile industry by choosing to promote consumer confidence in the automakers while neglecting to protect accident victims whose interests in recovery would be severely curtailed by the provisions of § 363. It exerted pressure on the companies to assume future claim liability for accidents arising from cars purchased prepetition, but without insisting

23. Jason Brege, Note, An Efficiency Model of Section 363(b) Sales, 92 VA. L. REV. 1639, 1655–73 (2006) (arguing that optimizing efficiency in § 363 sales can be a function of locating the appropriate level of judicial oversight in such sales).

24. George W. Kuney, Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process, 76 AM. BANKR. L.J. 235, 236 (2002) (showing that courts have, for the most part, interpreted “interests” in this provision to include “claims,” and more specifically, unsecured claims like products liability claims, which are normally disposed of through the normal course and application of a Chapter 11 reorganization plan, but which may sometimes attach to the assets themselves and thus fall upon the purchaser through the application of successor liability principles).

25. See id. at 236. Despite Professor Kuney’s textual critique,

[b]ankruptcy courts . . . have chosen not to follow the plain meaning of § 363(f), but instead to interpret that subsection’s words “any interest” to mean “any claim or interest” so as to give the debtor or trustee the same power to sell prior to plan confirmation as that under a confirmed plan, and to strip off liens, claims and other interests in the process.

Id. (citations omitted).

26. Id. at 267 (“[T]he dominant interpretation is that § 363(f) can be used to sell property free and clear of claims that could otherwise be assertable against the buyer of the assets under the common law doctrine of successor liability.”).

27. “Injury claims,” as a subset of “claims,” are herein defined as claims which derive from product liability principles or from a breach of the implied warranty of merchantability.

28. See Kuney, supra note 24, at 267.
on the provision of similar protection to prepetition and pendency claimants. The federal government’s choices—massive public investment, resort to the liability shield of § 363, and selective mitigation of its effects for only certain classes of similarly situated claimants—have thus produced an arbitrary and unacceptable result that will allow some claimants, but not others, to recover based entirely on when their injuries occurred.

Part I of this note will discuss the § 363 process, focusing particularly on the policy reasons for the “free and clear” provision and some of the counterarguments. Part II will describe the GM and Chrysler bankruptcies themselves: the background leading to their potential insolvency, and the federal government’s measures under both the Presidential Task Force on the Auto Industry (Task Force) and the bailout designed to stave off their liquidation. Part III will outline the current legal status of the four primary companies emerging from the § 363 sales (Old GM, New GM, Old Chrysler, and New Chrysler) with respect to the disposition of assets and the assignment of products liabilities for prepetition claims, claims during pendency, and future claims. Part IV will discuss the policy considerations informing the federal government’s decision to intervene in the automobile industry crisis, how those decisions militate toward a vision of the automakers’ restructuring as primarily policy-based, and why, given that vision and the automakers’ voluntary assumption of future claims liability, the extinguishment or practical inconsequence of prepetition and pendency products liability claims is unacceptable. Finally, Part V will present and discuss options open to GM, Chrysler, and the policy-makers in the Obama Administration and the Treasury Department that may produce a more equitable result.

I. OVERVIEW OF § 363 SALES

Central to both GM’s and Chrysler’s plans for reorganization was the asset sale process afforded to debtors under § 363 of the Code. Contextualizing the operation of § 363 within Chapter 11 requires a brief discussion of the reorganization process itself.

A. CHAPTER 11 REORGANIZATION: PRESERVING GOING CONCERN VALUE

Historically, a primary function of Chapter 11 reorganization has been to free a distressed, but valuable, business from liabilities attached to its assets so as to preserve it as a going concern. The concept of “going
concern value” derived from eighteenth century railroad receiverships as
the model for modern bankruptcy. That model developed because the
assets of insolvent railroad companies (e.g., miles of track, railroad cars,
etc.) were close to valueless without the superstructure of a functioning
railway system. Given that a core concern of bankruptcy is the retention
of the maximum value of the debtor’s assets, that goal in the railroad context
meant establishing the concept of going concern value. One commentator
has distilled a simple (if somewhat reductive) rule: When the value of a
firm’s assets exceeds the value those assets would garner in liquidation, the
goals of the Code are best served by the firm’s continuing operation.

B. CHAPTER 11: THE REORGANIZATION PLAN

Chapter 11 traditionally accomplishes the goal of preserving and
maximizing value through the mechanism of the reorganization plan, an
involved process that often, in the case of large companies, requires several
years to complete. During this process, the Code provides a variety of
mechanisms for the disposal of debtors’ and creditors’ various interests.
The debtor is aided by such devices as the power to reject executory
contracts, the automatic stay of actions against her, and the right to
propose the plan of reorganization. Creditors are afforded, among other
things, the right to commence an involuntarily Chapter 11 proceeding
against the debtor, the right to participate in and consent to the
reorganization plan, due process rights, and the protection that their best
interests be served by the reorganization plan. The primary object of this

154 (2004); see also Douglas G. Baird, Bankruptcy’s Uncontested Axioms, 108 Y ALE L.J. 573, 580 (1998) (discussing the conflict between two axiomatic approaches, traditionalist and proceduralist, to bankruptcy policy in the context of Chapter 11, but averring that any approach must accept that “Chapter 11 of the Bankruptcy Code helps ensure that firms in distress survive”).
31. See Miller & Waisman, supra note 30, at 160–66.
32. See id. at 164.
33. See id. at 165.
34. Omer Tene, Revisiting the Creditor’s Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 BANKR. DEV. J. 287, 292 (2003). Tene explains that “[i]f . . . the firm [will] be viable despite its financial distress, the firm is reorganized and it continues to operate as a going-concern.” Id. The article further states: “[W]e subscribe to the view that bankruptcy law . . . must seek to maximize the going-concern value of the assets of the debtor . . . .” Id. at 294 (citations omitted).
36. See, e.g., Brege, supra note 23, at 1637, 1639; Kuney, supra note 24, at 236–37.
37. Miller & Waisman, supra note 30, at 177.
39. Id. § 362.
40. Id. § 1121.
41. Id. § 303.
42. Id. § 1126.
43. Id. § 102.
44. See Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.), 843 F.2d 636, 649 (2d Cir. 1988) (interpreting 11 U.S.C. § 1129(a)(7) to provide that a plan passes that section’s “best
process is to balance all parties’ interests with the larger policies that undergird bankruptcy law: the preservation of value and the prevention of inefficient economic dislocation. These policies provide a sort of overriding philosophical template through which the corporate reorganization is to be administered. Ideally, the plan should operate to reorganize the company efficiently, and to maximize the overall value of the estate’s assets.

C. SECTION 363: ASSET SALES DESIGNED TO MAXIMIZE VALUE

Pre-confirmation § 363 asset sales in Chapter 11 theoretically operate as a streamlining method for preserving the maximum value of the assets of a deeply distressed corporation. As the primary goal of Chapter 11 is to retain maximum value for assets, often those assets are worth more before a lengthy plan of reorganization is consummated. This is especially true for large companies. Often, a large business in Chapter 11 is bleeding money at a substantial rate for many of the same reasons for which it filed for bankruptcy protection, such as paralyzing pension obligations and other agency costs, but which are not necessarily related to the value of its assets. For large, financially distressed businesses like GM and Chrysler, this bleeding may be caused by enormous contract, salary, and pension obligations, coupled with shrinking market share and depleted creditworthiness that can make such obligations even harder to satisfy.

Section 363, therefore, was intended to operate within Chapter 11 to provide the trustee with the power to sell assets outside the normal course of business when they are “of a perishable nature or liable to deteriorate in value.” As most businesses in Chapter 11 qualify as “distressed” in one

interest test” if creditors are no worse off than they would have been in a liquidation under Chapter 7; David Gray Carlson, Indemnity, Liability, Insolvency, 25 CARDOZO L. REV. 1951, 1959 (2004) (explaining 11 U.S.C. § 1129(a)(7)(A) provides that “when a plan is actually confirmed, it must give every creditor at least what she would have received in [C]hapter 7”).

45. See Miller & Waisman, supra note 30, at 176–77.
46. Brege, supra note 23, at 1640.
47. Bonner Mall P’ship v. U.S. Bancorp Mortgage Co. (In re Bonner Mall P’ship), 2 F.3d 899, 916 (9th Cir. 1993) (“[S]uccessful debtor reorganization and maximization of the value of the estate are the primary purposes [of Chapter 11].”) (citations omitted).
48. See Brege, supra note 23, at 1648 (explaining that “section [363(b)] applies to Chapters 7, 11, 12 and 13 of the Code”).
50. See, e.g., In re Chrysler L.L.C., 405 B.R. 84, 95 (Bankr. S.D.N.Y. 2009), aff’d, 576 F.3d 108 (2d Cir. 2009), vacated as moot sub nom. Ind. State Police Pension Trust v. Chrysler L.L.C., 130 S.Ct. 1015 (2009) (explaining that the most important factor in determining when the resort to § 363 is the product of sound business judgment is “whether the asset is increasing or decreasing in value”) (citation omitted).
51. See Brege, supra note 23, at 1653–58.
52. See CONG. OVERSIGHT PANEL, supra note 3, at 1, 5.
way or another, § 363 asset sales have largely replaced the more costly and
time-consuming process of confirming standard Chapter 11 reorganization
plans. While commentators and jurists debate the correct interpretation of
“interests” under the “free and clear” provision of § 363(f), the popularity
of these asset sales has stemmed primarily from the enormous insulation
from liability that the subsection affords and the generally broad
interpretation given to it by the courts. That debate has sought to reconcile
the provisions of § 363(b) and (f), governing the trustee’s power to
counsel sales of substantially all the assets of the estate outside the ordinary
course of business, with the provisions of correlative sections of the Code
governing the use of such sales within the more deliberative context of a
reorganization plan.

1. The Minority Position: A Conservative Reading of § 363

Early in the jurisprudential history of the Bankruptcy Reform Act of
1978, courts were loath to extend the protection of § 363’s liability shield
in sales of substantially all the assets of the debtor’s estate, except in the

54. See Kuney, supra note 24, at 236.
55. 11 U.S.C. § 363(f) (2006) (“The trustee may sell property under subsection (b) or (c) of
this section free and clear of any interest in such property of an entity other than the estate . . . .”); see also In re General Motors Corp., 407 B.R. 463, 500–05 (Bankr. S.D.N.Y. 2009) (explaining
that the debate has focused primarily on whether “interests” within this section implicates
“claims” and specifically those claims which may otherwise attach to a purchaser in a
reorganization plan under successor liability principles).
There may be strong textual and doctrinal reasons for a narrow definition of “interests”
under § 363(f). See Kuney, supra note 24; Steinberg, supra note 49; see also Christopher M.E.
Painter, Note, Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worse of
Times, 36 STAN. L. REV. 1045, 1080–83 (1984) (arguing that the situation of tort creditors as a
subclass of unsecured creditors leads to economically inefficient results and that giving such
claimants a superpriority may better serve the goals of efficiency and fairness). These arguments
have not, for the most part, carried the day. See In re Trans World Airlines, Inc., 322 F.3d. 283,
288–90 (3d Cir. 2003); George W. Kuney, Hijacking Chapter 11, 21 EMORY BANKR. DEV. J. 19,
56. See Bryant P. Lee, Note, Chapter 18? Imagining Future Uses of 11 U.S.C. § 363 to
Accomplish Chapter 7 Liquidation Goals in Chapter 11 Reorganizations, 2009 COLUM. BUS. L.
REV. 520, 530–31 (2009) (“These objections have begun to approach irrelevancy . . . . [T]he
volume of this type of disposition of reorganization proceedings has been increasing exponentially
in recent years . . . .”).
57. 11 U.S.C. § 363(b)(1) (2006) (providing for the power of the trustee to conduct an asset
sale outside “the ordinary course of business”).
58. Id. §§ 1123, 1141.
59. See generally Kuney, supra note 24 (outlining the arguments for and against the use of
asset sales outside the context of the reorganization plan and arguing that a limited use of § 363 is
more in line with the overall goals of the Code).
61. See In re White Motor Credit Corp., 14 B.R. 584, 589–90 (Bankr. N.D. Ohio 1981); see
also Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways), 700 F.2d 935,
943 (5th Cir. 1983).
case of an “imminent loss of all assets.” That position was softened considerably by the influential decision of the Second Circuit in *In re Lionel Corp.*, which eschewed a bright-line rule for the use of § 363, giving deference to debtors’ decisions by adopting a “business judgment” standard that leaves the propriety of such a sale to a case-by-case judicial determination. For the most part, courts have interpreted this business judgment rule liberally, allowing asset sales to proceed on assertions and some evidence of savings in time and money, administrative costs and the preservation of value. Critics, however, suggest that while the court in *Lionel* loosened the judicial requirements for § 363’s use, it did so by articulating a limiting standard and cautioning against its unfettered use.

The primary textual critique against the use of § 363 centers on the provisions of Chapter 11 itself. Because the Code allows assets to be rendered “free and clear of claims and interests through a process of plan confirmation, consummation and post-confirmation vesting,” and because the “free and clear” provision in § 363 explicitly insulates only “interest[s] in such property,” a strict textual interpretation seems to militate for the more limited vision of § 363.

However, courts have generally rejected this textual critique, favoring instead a broad reading of § 363. Commentators have therefore resorted to more doctrinal critiques of large-scale pre-confirmation asset sales to support their opposition to the use of § 363. Their main criticism has been that § 363 circumvents a reorganization plan process that is designed to manage the interests of all concerned parties and that allows the debtor to

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62. *In re White Motor Corp.*, 14 B.R. at 590.

63. *Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1069 (2d Cir. 1983) (noting that the language of § 363 in the Bankruptcy Reform Act of 1978 differed from its statutory antecedents and did not explicitly require a showing of emergency or cause for the bankruptcy judge to wield his or her discretionary power in authorizing sales under the section).

64. See Brege, *supra* note 23, at 1653–54; see also Kuney, *supra* note 24, at 242–43 n.30 (discussing the evolution of the soft reading of the *Lionel* standard, citing *In re Delaware & Hudson Railway Co.*, 124 B.R. 169 (Bankr. D.Del. 1991), for one court’s liberal approach in suggesting that avoiding the delays attendant to a bankruptcy proceeding itself could constitute a sufficient business justification for resort to a § 363 asset sale).

65. See, e.g., Lee, *supra* note 56, at 528 (noting that while *Lionel* did, in fact, set forth a limiting standard, that standard was flexible and weak, and bankruptcy courts have, for the most part, required little business justification under it). See also DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 249 (4th ed. 2006) (suggesting that *Lionel* has generally been used as a permissive rather than a restrictive standard by the courts).


68. See Kuney, *supra* note 24, at 238–44.

69. See id. at 236.

dispose of assets while ignoring the interests of large classes of creditors. Thus, the debtor is improperly afforded the benefit of Chapter 7’s efficient liquidation within the context of Chapter 11 in a way that unfairly favors secured creditors, and potentially insulates the debtor from the requirements of disclosure, creditor approval, and good faith. The result has been, in the words of one critic, the “shift[ing of] Chapter 11 from a process originally focused on the confirmation of a plan of reorganization into one making the bankruptcy courts the forum of choice for the sales of businesses, troubled or not.” Despite these condemnations, however, the trend has been toward a broad judicial interpretation of § 363 and a resultant proliferation of its use in the last two decades.

2. The Majority Position: A Broad Reading of § 363

In In re General Motors Corp., Justice Gerber articulated the primary counterattack to the critics’ textual argument. While some provisions of § 1123 mandate how a sale under a reorganization plan must proceed, § 363 operates within § 1123(b)(4) as a discretionary power. The idea is that only when the debtor in possession undertakes to sell assets within the context of the reorganization plan must she follow through with the strict requirements laid out in Chapter 11 in order to properly strip those assets of the claims and interests attached to them. However, the argument goes, Chapter 11 should not be read, and has not been read by substantial authority, to trump the debtor’s resort to § 363 to effectuate a sale. Furthermore, the Lionel court observed that § 363 provides no textual impediment to the bankruptcy judge’s discretionary power to authorize such sales.

Commentators in support of pre-confirmation asset sales also argue that § 363 provides for increased efficiency in the achievement of Chapter 11’s goals, namely the extraction of maximum value for corporate assets and the avoidance of the high transactional costs associated with its comprehensive reorganization and confirmation requirements. The present net value of assets is maximized by freeing them from successor liability and other

71. See Brege, supra note 23, at 1643 (discussing the “cynical” perspective of § 363’s critics).
72. See Lee, supra note 56, at 524 (cataloging some arguments against the use of § 363).
73. See Rose, supra note 70, at 257–58.
74. Kuney, supra note 24, at 235.
75. See id. at 235–36.
78. In re General Motors, 407 B.R. at 486.
79. Id. at 486–93.
80. Id.
82. See, e.g., Brege, supra note 23, at 1655–73.
unsecured claims. This is especially true for corporations with such enormous potential liability for those claims, that without insulating the assets, no buyer could be found for them. Furthermore, the potential transaction costs of a lengthy plan confirmation process can deplete the market value of the assets in a way that may leave creditors worse off than they would be under a more streamlined process. Finally, contrary to critics who see § 363 as transforming bankruptcy into an auction forum used to improperly insulate potential purchasers from claims attaching to a debtor’s assets, proponents argue that it achieves the Chapter 11 goal of allocating maximum return to creditors with greater economic efficiency. In this light, § 363 simply compliments Chapter 11, which also, subject to more strict requirements, seeks to sell valuable assets “free and clear” of claims in a way that raises purchase prices and ensures greater returns to creditors. Most courts have embraced these arguments, and asset sales under § 363 have become common practice, subject to only the most liberal requirements of business judgment: effective notice to interested parties, fair price, and good faith on the part of the purchaser. Such justifications will serve to insulate the sale from accusations that it improperly “amount[s] to a sub rosa plan of reorganization.”

83. Id. at 1644.
85. See Brege, supra note 23, at 1644.
87. See Miller & Waisman, supra note 30, at 194 (arguing that Professors Baird and Rasmussen, by focusing selectively on the procedural aspects of § 363 as supplanting Chapter 11, neglect to recognize that § 363 may function within Chapter 11 and help to achieve its goals more efficiently).
88. Id.
90. In re General Motors Corp., 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009); see also In re Braniff Airways, 700 F.2d 935, 940 (5th Cir. 1983) (“The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with the sale of assets.”). While the language in Braniff seems to strongly implicate § 363, Judge Jacobs noted in Chrysler that the Braniff court meant only sales that were specifically designed to “evade or subvert” were impermissible when the terms of the sale specify ex ante the terms of a subsequent plan. In re Chrysler L.L.C., 576 F.3d 108, 117–18, 117 n.9 (2d Cir. 2009), vacated as moot sub nom. Ind. State Police Pension Trust v. Chrysler L.L.C., 130 S.Ct. 1015 (2009). In essence, the court in Chrysler (as well as Judge Gerber, who followed the same reasoning in General Motors) limited the reach of the sub rosa exception to the very narrow set of facts of Braniff. Id.; In re General Motors 407 B.R. at 496–98. Accordingly, the sub rosa exception is satisfied by the prongs of the “good business reason” test the bankruptcy court uses to judge the sale as a whole. See Motorola, Inc. v. Official Comm. Of Unsecured Creditors & JPMorgan Chase Bank, N.A. (In re Iridium), 478 F.3d 452, 466–67 n.21 (2d Cir. 2007).
II. THE GM AND CHRYSLER BANKRUPTCIES

A. THE ROAD TO INSOLVENCY

Perhaps no industry in the United States has been hit as hard by the economic downturn as the automobile manufacturing sector. By late Summer 2008, the Wall Street Journal was already reporting that “the U.S. auto industry has slipped into its worst crisis in decades” and that “[a]nalysts have warned [that] GM, Ford, and Chrysler are all in danger of running short of cash.”91 Debate has since raged as to the core causes of the industry’s woes. Environmentalists and critics of U.S. energy policy have insisted that the rising price of oil in the mid-to-latter part of the decade, as well as the U.S. automakers’ apparent refusal to embrace fuel efficiency, led to the industry’s decline and injured the economy as a whole.92 Some have blamed the intransigence of labor unions and the breadth of obligations to current and former employees as severely disadvantaging domestic automakers in an era of free trade and comparative advantage.93 Others have pointed to gross mismanagement in the upper echelons of power at both companies.94 All of this took place amid an overall economic downturn that saw a sharp decline in demand.95

Of course, there can be no one root cause for a precipitous decline that saw an over 40% drop in sales in 2008 for both Chrysler and GM,96 that saw GM’s market share drop from 45% in 1980 to a projected 19.5% in

94. Steven Rattner, The Auto Bailout: How We Did It, FORTUNE, Nov. 9, 2009, at 55. Steven Rattner, head of President Obama’s Task Force, emphasized the more arrogant and defiant aspects of the automakers’ corporate cultures as indicative of a stasis in their organizational management systems that infected every aspect of their businesses, but was particularly harmful to their finance operations. Id.
95. See CONG. OVERSIGHT PANEL, supra note 3, at 5.
96. See Ortolani, supra note 2.
and that saw, in 2008, the “Big Three”—GM, Chrysler, and Ford Motor Company—account for less than 50% of the total domestic market for the first time since foreign manufacturers began competing with them in earnest in the early 1990s. Each of these industry problems are worthy of some blame.

B. THE FEDERAL GOVERNMENT’S RESPONSE

In response to the crisis facing the automobile manufacturing industry, Treasury Secretary Paulson announced the government’s intention to bail out the industry with some of the money set aside by Congress to stabilize the imploding financial sector. Continuing this commitment, President Obama, in the early days of his administration, established the Task Force. Based in part on the Task Force’s findings, the administration developed comprehensive plans for the government-assisted rescue and reorganization of GM and Chrysler.

While the putative goal of the bailout was to guide the automakers toward long-term financial viability, there was ample evidence that such a mission was possibly quixotic. Indeed, President Obama’s Task Force was deeply torn on the wisdom of saving Chrysler, especially considering the government’s enormous investment in GM, a Chrysler competitor. However, GM and Chrysler were companies seen as “too big to fail,” in that their insolvency created a potentially disastrous ripple effect in the economy, “impos[ing] great harm on vendors and other interrelated businesses . . . causing cascading business failures and layoffs.” The potential job losses, cited by the court in GM, numbered in the hundreds of thousands. In addition to unemployment and interrelated business failures, the possibility of the government having to take over the companies’ pension and healthcare obligations was extremely daunting. Based on these startling projections, it appears the decision to bail out GM

98. See Ortolani, supra note 2.
100. See Rattner, supra note 94.
101. See id. (claiming that the findings of the Task Force did not necessarily support a conclusion that the automakers’ viability merited what would be a huge government investment in their respective futures, but that other policy considerations militated for the bailout).
103. Rattner, supra note 94.
104. Kuney & St. James, supra note 6, at 73 (arguing that Chapter 11 reorganization is ill-suited to the particular problems inhering in too-big-to-fail bankruptcies and that Chapter 10 can and should be amended to solve them).
106. Id. at 483.
and Chrysler was one couched in politics and macroeconomics rather than being based on the real lasting economic viability of either company.\footnote{107}

GM and Chrysler’s paths during the bailout differed in certain salient respects. Due to its smaller size, Chrysler was able to locate, at least in part, a private purchaser in Fiat, S.p.A. (Fiat, operating in conjunction with other purchasers as New CarCo Acquisition LLC, or New Chrysler\footnote{108}).\footnote{109} However, GM’s sale, which was between two and three times larger than Chrysler’s, could only be accomplished through the creation of a Treasury Department-sponsored purchaser, Vehicle Acquisition Holdings LLC (New GM),\footnote{110} using TARP funds as an equity investment in New GM rather than encumbering it with a massive debt repayment obligation post sale.\footnote{111}

Between December 28, 2008 and July 10, 2009 the federal government loaned or invested nearly $51 billion in GM.\footnote{112} Between January 2, 2009 and May 27, 2009, the federal government loaned or invested nearly $13 billion in Chrysler.\footnote{113} While some payments were made prior to the companies’ bankruptcy filings, they were predicated on the submission of restructuring reports from both automakers that contemplated resorting to § 363 asset sales from the start.\footnote{114}

### III. THE GM AND CHRYSLER BANKRUPTCIES

Sales of substantial portions of company assets—those conducted preplan under § 363(b) as well as those authorized as part of § 1141(c) reorganization plans—generally result in the emergence of two separate

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107. The appropriateness of the government’s decision to rescue GM and Chrysler is beyond the scope of this Note; however, Part IV will argue that certain consequences and equitable considerations should properly flow from the manner in which these policy choices were effectuated.

108. New CarCo, or New Chrysler, is a limited liability Delaware corporation formed to accomplish the goals of the Fiat Alliance—a term-sheet alliance that initially arranged for certain considerations, such as a distribution network, to flow from Fiat to Chrysler in exchange for a 35% equity stake in Chrysler, but that matured into the purchaser entity for the accomplishment of the § 363 sale. In re Chrysler L.L.C., 405 B.R. 84, 91–92 (Bankr. S.D.N.Y. 2009), aff’d, 576 F.3d 108 (2d Cir. 2009), vacated as moot, sub nom. Ind. State Police Pension Trust v. Chrysler L.L.C., 130 S.Ct. 1015 (2009).

109. Id.


111. See Rattner, supra note 94.

112. See ProPublica–General Motors, supra note 7.

113. See ProPublica–Chrysler, supra note 8.

corporate entities with their own distinct asset and liability profiles.\textsuperscript{115} The four companies that emerged from the GM and Chrysler bankruptcy proceedings were Old GM, New GM,\textsuperscript{116} Old Chrysler, and New Chrysler.\textsuperscript{117} Since the two deals differed in their details, a brief outline of the ownership of each, with particular attention paid to their legal obligations regarding products liabilities, is called for. It will be beneficial to first discuss GM’s bankruptcy and then use it as departure point for comparison with Chrysler’s.

\textbf{A. OLD GM / NEW GM}

As the purchaser, New GM emerged from the § 363 sale and subsequent litigation with substantially all the assets of Old GM,\textsuperscript{118} but shielded from all liabilities not expressly assumed in its Master Sale and Purchase Agreement (MPA).\textsuperscript{119} New GM assumed liabilities for both companies’ recall and warranty commitments, certain employment-related obligations arising from the assumed benefit plans covered under the United Auto Workers (UAW) collective bargaining agreement (CBA), and products liability claims for injuries that occurred after the sale’s closing arising from automobiles purchased pre-closing.\textsuperscript{120} These last two categories of liabilities—those related to employee benefits under the CBA and the expansion of products liability for future claims arising from cars purchased not only from New GM, but also Old GM—were assumed at the insistence of both the Treasury Department\textsuperscript{121} and the Obama Administration.\textsuperscript{122} The implication, particularly with regard to the

\textsuperscript{115} This statement is subject to limitations that are beyond the scope of this Note. For further discussions on issues such as successor liability, the propriety of cleaving assets from corporate liabilities, and other concerns, see William T. Bodoh & Michelle M. Morgan, \textit{Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimants}, 4 Am. Bankr. Inst. L. Rev. 325 (1996); George W. Kuney, \textit{Bankruptcy and Recovery of Tort Damages}, 71 Tenn. L. Rev. 81 (2003); George W. Kuney, supra note 24; J. Maxwell Tucker, \textit{The Clash of Successor Liability Principles, Reorganization Law, and the Just Demand that Relief Be Afforded Unknown and Unknowable Claimants}, 12 Bankr. Dev. J. 1, 8–9 (1995). See also Lawrence P. Schnapf, \textit{CERCLA and the Substantial Continuity Test: A Unifying Proposal for Imposing CERCLA Liability Asset on Purchasers}, 4 Envtl. Law. 435, 493 n.401 (1998) (discussing how the economic benefits of selling assets free and clear of liabilities may implicitly serve the goals of the Code).

\textsuperscript{116} \textit{In re General Motors Corp.}, 407 B.R. 463, 477 n.6 (Bankr. S.D.N.Y. 2009).


\textsuperscript{118} \textit{In re General Motors}, 407 B.R. 473, 480–81.

\textsuperscript{119} Id. at 481–82.

\textsuperscript{120} Id.

\textsuperscript{121} Id. at 478 (discussing some of the Treasury Department’s prerequisites for GM, such as committing to the provision of funds to support UAW beneficiaries, as well as other commitments to bring its employment-related obligations more in line with industry standards).

\textsuperscript{122} See Spector, supra note 19 (noting GM’s willing assumption of future claims products liabilities was not exactly “willing,” as it was a result of pressure from the Obama Administration
assumption of products liabilities, is that without this voluntary commitment, these claims would have been reserved to Old GM as standard operating procedure under the “free and clear” provision of § 363(f). Indeed, the claims retained by Old GM include, among others, products liability claims (“to the extent they weren’t assumed by reason of the change in the MPA”) and warranty-of-merchantability-derived liabilities for all cars purchased pre-closing arising from accidents occurring prepetition and during pendency.

Under the MPA, New GM’s common stock would be divided among various parties, with the bulk of ownership reserved to the Treasury Department. This structure has two unusual aspects. First, the vast majority of ownership in New GM is reserved to an arm of the Federal Government (with a lesser stake in ownership reserved for an arm of the Canadian Government), historically an uncommon purchaser in § 363 sales and, arguably, one not envisioned by the Code. Second, an ownership stake was provided to the debtor, Old GM, for the benefit of its general unsecured creditors. Although a significant amount of money was

and other interested parties despite GM’s continued insistence that it was not legally required to do so under the rules governing these kinds of asset sales).

123. See discussion supra Part I.C.2 (discussing the inclusion of “claims” with the definition of “interests” under jurisprudential interpretations of § 363(f)).

124. In re General Motors, 407 B.R. 463, 482 (Bankr. S.D.N.Y. 2009) (noting that GM amended its MPA after filing to include claims arising from accidents before closing). The implication is that without New GM assuming these liabilities, they would be part of the broader category of “excluded liabilities” to be retained by Old GM. Id.

125. Id.

126. Id. at 482–83. Atop the hierarchy would sit the Treasury Department, owning nearly 61% of New GM’s common stock, undiluted, as well as just over $2 billion in Class A Preferred Stock. Id. at 482. Of the undiluted common stock, 17.5% would be owned by a New Employees’ Beneficiary Trust, which would also take possession of $6.5 billion in Class A Preferred Stock, as well as a six-year warrant to purchase an additional 2.5% of the common stock. Id. A Canadian Governmental instrument, Export Development Canada, provided additional bailout financing to GM, contributing $3 billion and committing to an additional $6 billion in exchange for nearly 12% equity in the form of New GM undiluted common stock and $400 million in Class A Preferred Stock. Id. Finally, Old GM was given, in consideration of the § 363 asset sale to New GM, 10% ownership of New GM undiluted common stock as well as a commitment by New GM for an additional 2% if Old GM’s unsecured claims, of which products liability claims are a subcategory, were to exceed $35 billion. Id. at 483.

127. Id. at 482. (stating that the Treasury Department “will own 60.8% of New GM’s common stock on an undiluted basis”).

128. Id. (Export Development Canada, a company created by the governments of Canada and Ontario “will own 11.7% of New GM’s common stock on an undiluted basis.”).

129. See Ramifications of Auto Industry Bankruptcies (Part I), Hearing Before the H. Comm. on the Judiciary, 111th Cong. 75–81 (2009) (testimony and prepared statement of David A. Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School) (arguing that the intrusion of the Federal Government into these bankruptcies combined with the use of § 363 amounted to “sham” sales common in the early days of railroad receiverships, but curtailed by the New Deal reforms).

130. In re General Motors, 407 B.R. at 483 (“Old GM will own 10% of New GM’s common stock on an undiluted basis.”).
reserved for this fund in numeric terms, the proceeds from this stake will be divided among all of Old GM’s unsecured creditors on a pro rata basis.\footnote{131} Given GM’s "assumed $116.5 billion in general unsecured claims,"\footnote{132} the real recovery afforded to excluded products liability claimants under this scheme will, in practice, amount to pennies on the dollar.\footnote{133} For a seriously injured victim such recovery is functionally meaningless, and a secondary market for these claims has already sprung up with plaintiffs being offered no more than 15–20% of the value of their claims.\footnote{134}

**B. OLD CHRYSLER / NEW CHRYSLER**

New Chrysler’s consideration, provided to Old Chrysler in exchange for substantially all of the latter’s assets, consisted of $2 billion in cash and New Chrysler’s assumption of “certain liabilities.”\footnote{135} An employee-benefit entity created by the UAW union (VEBA) would emerge with roughly 68% of New Chrysler’s stock and a membership interest of 55%.\footnote{136} While an additional $10.96 billion in financing for the deal was provided by the Treasury Department and Export Development Canada\footnote{137} in return for an equity stake in New Chrysler,\footnote{138} such governmental ownership was not envisioned by this agreement to have, as in the case of New GM, lasting effect.\footnote{139} Indeed, the two asset sales differ primarily because a viable purchaser for Old Chrysler’s assets emerged from the private sector\footnote{140} while GM’s liabilities were so great that governmental ownership control was the...
only alternative to liquidation. To that end, the Chrysler agreement sets out procedures by which Fiat could turn its 20% equity stake in New Chrysler into a 51% holding. This maturation is predicated on New Chrysler repaying, in full, debts it owed to the governmental entities whose ownership stakes would be the first to flow to Fiat, with the remainder deriving from a purchase of shares from VEBA. This structure is, by design, intended to accomplish the eventual transfer of a controlling ownership share to Fiat through the temporary use of governmental loans providing sustained viability through the transitional period.

The prime classes of liabilities assumed by New Chrysler as part of the agreement were warranty, return, and rebate obligations for all Chrysler automobiles purchased prior to the closing. All products liability claims were, under the “free and clear” terms of § 363(f), to be reserved to Old Chrysler. These included all past, pending, and future products liability claims arising from cars purchased before the sale was accomplished. Unlike New GM, which assumed the future claims liability in its asset sale proper, New Chrysler voluntarily assumed such liability well after its asset sale was consummated. While New Chrysler pointed to its unanticipated new viability as the central reason for its assumption of future claims liability, it had previously fought against it.

142. In re Chrysler, 405 B.R. at 92. Fiat’s ownership would mature to 35% “[a]ppon the reaching of certain milestones” and to 51% based on a right to purchase the requisite additional 16%. Id. at 192 n.11; see also Hearing Part II, supra note 11, at 19 (explaining that the administration’s willingness to provide financial assistance to these companies was predicated on them restructuring in such a way as to “not require ongoing government assistance”).
143. In re Chrysler, 405 B.R. at 92 n.11.
144. See id. (highlighting provisions for the accrual of majority of ownership by Fiat).
146. See id. (“New Chrysler initially disclaimed any liability for product liability claims involving vehicles manufactured and sold by Old Chrysler prior to [the closing date].”)
147. See id.
150. Id. (“Today, Chrysler Group has a much better appreciation of the viability of our business than it did on June 10. As a result . . . the company will accept product liability claims on vehicles manufactured by [Old Chrysler] before June 10 that are involved in accidents on or after that date.”)
of liability under its MPA was public record and New Chrysler was surely aware of it. Furthermore, it is curious that Chrysler’s determination of its present viability resulted in the assumption of liability for an unknowable class of claims, while preserving its protection from prepetition and pendency claims that are more readily identifiable and thus more susceptible to a viability assessment. These factors suggest that Chrysler’s decision was more likely a response to political pressure and the prospect of fighting these claims in multifarious state court actions. Despite the corporate largesse, however, prepetition and pendency claims remain the sole responsibility of Old Chrysler, an entity which, unlike Old GM, has no ownership stake in the new company and thus has even fewer assets to cover such claims.

C. THE AFFECTED CLASSES LEFT WITH INSIGNIFICANT RECOVERY

The class of prepetition and pendency products liability claimants left with no meaningful recovery against Old Chrysler is roughly two-fifths the size of Old GM’s correlative class. Using estimates derived primarily from historical averages, GM’s class consists of roughly 2000 people, 500-600 of whom are likely to have serious claims, with a potential total liability to GM of between $1 billion and $2 billion. This puts Chrysler’s affected claimant class at roughly 800 people, with 200 to 250 being serious claims, resulting in $400 million to $800 million in potential liability. Using the most liberal estimates, the total liability for both companies could fall between $3 billion and $4 billion with the class of claimants being between 2800 and 3000 people. While not inconsiderable, these figures represent a fraction of the total government auto bailout. The use of § 363 is an unacceptable result given this discrepancy, particularly in light of the

153. See discussion infra Part IV.B (discussing how future claims liability for auto manufacturers with a long history may be more susceptible to actuarial estimation than would be true for companies with a less extensive products liability track record).
155. Interview with J. Kent Emison, supra note 133.
157. Id.
159. See Interview with Larry Coben, supra note 156 and accompanying text.
160. Id.
161. See ProPublica–General Motors, supra note 7; ProPublica–Chrysler, supra note 8.
new companies’ assumption of future claims liability for accidents arising from what are, essentially, the same automobiles as those excluded—those purchased prior to closing.

IV. PUBLIC POLICY: CONSIDERATIONS AND CONSEQUENCES

Historically, federal bailouts of private firms have been largely ad hoc government reactions to threats of failure of important private enterprises. Given that a public bailout results from a balance of public and private considerations, the relative weight accorded those interests should be subject to reasoned scrutiny and analysis. In order to address these policy considerations in context, it would be helpful to first analyze the federal government’s approach to the automobile industry bailout of 2008 and 2009.

A. THE GOVERNMENT GETS INVOLVED

In late 2008, it had become clear that the American automobile manufacturing industry was facing imminent insolvency and collapse. By December of that year, the Bush Administration and the Treasury Department announced their intention to provide government financial and oversight assistance to stabilize and ensure the long-term viability of the industry. Congress had ceded broad authority to the Treasury Department in administering TARP under the Emergency Economic Stabilization Act of 2008 (EESA) “to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States.” While acknowledging that TARP was originally intended to authorize the Treasury Department to “stabilize our financial sector,” Secretary Paulson suggested that the Bush Administration’s position was that the auto industry’s insolvency

162. Cheryl D. Block, Overt and Covert Bailouts: Developing a Public Bailout Policy, 67 IND. L.J. 951, 1036 (1992) (arguing that a coherent legislative approach to bailout policy should be developed with a more considered approach to economic and non-economic factors, changes to bankruptcy laws and bankruptcy perceptions, the development of strict guidelines for the granting of bailouts, and a stronger regulatory regime to oversee their application).

163. Id. at 1037.


165. See Press Release, Secretary Paulson, supra note 4.


168. Id. § 5201(1).
contemplated a “significant [enough] disruption to our economy,” to be within TARP’s mandate. The Treasury Department, under President Obama, reiterated that the provision of government assistance was predicated on the automaker’s willingness “to fundamentally restructure, address prior bad business decisions, and chart a path toward a sustainable future.”

One commentator has suggested that as a precondition for the provision of bailout monies, companies should be required to explore bankruptcy options. Indeed, the mission of the Task Force was primarily to explore and influence ways to ensure that the automobile companies could restructure efficiently and in a way that optimized the likelihood of long-term financial viability independent of ongoing federal assistance or participation. For example, after determining that the viability plan proposed by Chrysler was inadequate, the Task Force worked with Chrysler to ameliorate the plan’s shortcomings and to ensure the participation of Fiat. This resulted in a plan in which the Task Force and President Obama determined Chrysler could achieve viability. In short, the government’s requirement that the companies provide plans for long-term viability and its acceptance of those plans were in clear contemplation of the use of bankruptcy, and specifically § 363, to achieve the bailout’s goals.

Behind the decision to bailout the automobile manufacturing industry, however, was a consideration of interests outside and beyond the straightforward goal of making GM and Chrysler work better. Two examples are particularly telling with respect to the interests of tort claimants: the Warranty Commitment Program and the “voluntary” assumption of future claims liability by GM within the context of its MPA and by Chrysler well after the conclusion of its sale.

The Warranty Commitment Program was initiated by the Task Force and the Treasury Department in an effort “to give confidence to GM’s and Chrysler’s customers . . . regarding the outlook for the companies.” The program created an account with enough funds to cover 125% of all expected warranty obligations, with the automakers providing 15% in cash

170. See Hearing Part II, supra note 11, at 19.
171. Block, supra note 162, at 1010–11 (referring to generic Chapter 11 as a “private bailout” of sorts and one that should be explored before a publicly financed option is considered).
172. See Hearing Part II, supra note 11, at 19 (“Our role was to act as a potential investor of taxpayer resources, and not become involved in specific business decisions.”).
173. Id. at 19.
174. See Rattner, supra note 94. This was, however, not without controversy. The Task Force was essentially even-split on Chrysler’s true long-term potential for financial and commercial viability. See id.
175. See Fact Sheet, Chrysler, supra note 114; Fact Sheet, GM, supra note 114.
and the government providing 110% in loans. Furthermore, the only warranties guaranteed were those attached to automobiles purchased during the restructuring period. If the “disaster” of liquidation, in bankruptcy terms, is generally thought of as the potential for the less than optimal distribution of value, the fact that warranty commitments for automobiles purchased during pendency would normally, in the context of a § 363 sale, attach only to the debtor demonstrates the Treasury Department’s commitment to circumventing bankruptcy policy when public policy favors a different outcome. Here, that policy was the boosting of consumer confidence in the restructuring companies.

As discussed in Part III, both GM and Chrysler voluntarily assumed future claims liabilities despite their freedom from such encumbrances under § 363(f) of the Code. This was due, in large part, to the application of political pressure by the Obama Administration. Given the Treasury Department’s trumpeting of § 363 as the primary vehicle for the automakers to “clear away the remaining impediments to its successful re-launch,” its subsequent application of political pressure to accept some liabilities strongly suggests a grounding in policy considerations. However, the fruits of such considerations should not be meted out arbitrarily.

177. See Warranty Commitment Program, supra note 15.
178. Id.
179. See Brege, supra note 23, at 1639; Tene, supra note 34, at 295.
181. See Warranty Commitment Program, supra note 15.
183. See Fact Sheet, Chrysler, supra note 114; Fact Sheet, GM, supra note 114.
184. Under Chevron, courts review the decisions of administrative agencies in their interpretation of Congressional statutes by looking first at whether the nexus between statutory language and congressional intent is ambiguous. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984). If the expressed intent is ambiguous enough to leave room for agency interpretation, such interpretation is to be subject a reasonableness standard, which is designed to cede great deference to administrative agency decisions. See Gary Lawson, Outcome, Procedure and Process: Agency Duties of Explanation for Legal Conclusions, 48 Rutgers L. Rev. 313, 317–18 (1996). While the primary issue here—the application of political pressure for GM and Chrysler to assume liability for future claims but not prepetition or pendency claims—was not, strictly speaking, a Treasury Department “decision,” it may been seen as administrative policy-making. It is at least arguable that the Treasury Department’s authority to stabilize financial markets under EESA, 12 U.S.C.A §§ 5211–5261 (2008), did not impart authority to the agency to ameliorate the disposition of certain (future) tort claims to the exclusion of others in the context of an automaker’s bailout. Even so, the Treasury Department’s actions would likely survive judicial scrutiny since, as Judge Jacobs pointed out in Chrysler, Congress ceded broad discretion to the Treasury under the EESA and TARP legislation, provided for a high level of legislative oversight, and thus contemplated a very low level of judicial review. In re Chrysler L.L.C., 576 F.3d 108, 121–23 (2d Cir. 2009), vacated as moot, sub nom. Ind. State Police
B. SIMILARLY SITUATED, BUT OUT IN THE COLD

The government’s actions and decisions throughout the automotive industry bailout consistently led to disparate treatment of similarly situated owners. Under the Warranty Commitment Program, a purchaser of a GM or Chrysler automobile during the period of restructuring enjoyed a guarantee that the warranties protecting her car would be honored completely and in full.185 However, if the same purchaser were severely injured in the accident giving rise to the redemption of that warranty, she received no guarantee of her personal recovery, which, as an injury claim during pendency, would remain with the debtor—a functionally insolvent entity.186 Simply put, the Treasury Department was insuring the cars but not the people who would be injured by them.187 This is a perverse result, particularly given the Treasury Department’s explicit policy rationale for establishing the program was to promote consumer confidence in purchasing these automobiles.188 Committing over $640 million to insure the automobiles contemplates a significant likelihood that a number of them would be involved in accidents. It is absurd to imagine that no one would be injured in these vehicles, and capitalizing on the public’s failure to recognize this difference is ethically questionable.

Furthermore, the government’s application of pressure upon GM189 and Chrysler190 to assume future claims liabilities for injuries arising from automobiles purchased prepetition and during pendency produces a similarly arbitrary result. For example, someone suffering an injury arising from a manufacturing defect in an Old GM or Old Chrysler automobile can expect a meaningful recovery if their accident occurred after the sale’s closing date. However, someone else injured by the same automobile purchased at the same time and arising from the same defect may not expect recovery if their injury occurred prior to the sale’s closing. These people, differentiated only by when their accidents happened, are, through the application and then setting aside of bankruptcy rules, being subjected to radically disparate treatment, with future claimants being afforded full...
potential recovery and prepetition and pendency claimants afforded little to no recovery.\textsuperscript{191}

This unacceptable result is enhanced by the fact that while future claimants represent a contingent and nebulous class,\textsuperscript{192} prepetition and pendency claimants are a closed set.\textsuperscript{193} Prepetition and pendency claims are limited to accidents that have already occurred but have not yet been compensated, while future claims arise from accidents for all Old GM and Old Chrysler vehicles still on the road.\textsuperscript{194} Therefore, future claims encompass a potentially larger group with a greater encumbrance upon the purchasers’ assets than do prepetition and pendency claims. Perhaps the potential volume of such claims explains why the movement to pressure GM and Chrysler to accept future claims liability gained such traction and eventually succeeded. However, leaving prepetition and pendency claimants with either no recovery or meaningless recovery, given the extent of their injuries and the inadequacy of the money set aside for them, while allowing full recovery for future claimants, seems inherently capricious.\textsuperscript{195}

Admittedly, there are other distinctions to be drawn. For instance, the resale market is strongly implicated by the disposition of future claims but not by prepetition and pendency ones. If the status of future claims is uncertain, the value of used GM and Chrysler vehicles is diminished, thus impairing the new companies’ ancillary parts and repair concerns. It may also be argued that the government’s policy choices in the warranty and

\textsuperscript{191} See Interview with J. Kent Emison, \textit{supra} note 133. There are no limitations to either New GM’s or New Chrysler’s assumption of future claims liability while prepetition and pendency claims are left with either functionally meaningless recovery in the case of GM, or no recovery in the case of Chrysler. \textit{Id.}

\textsuperscript{192} See Tung, \textit{supra} note 152, at 438–40.

\textsuperscript{193} See Interview with J. Kent Emison, \textit{supra} note 133. Prepetition and pendency claimants (defined as those who purchased their automobiles before closing and were involved in accidents before closing) had until November 30, 2009 to assert their claims. \textit{Id.} The reason GM claimants would want to file such a claim is for the possibility that they may recover as members of the subclass of unsecured claimants entitled to a pro rata share of the consideration set aside for Old GM in the MPA. \textit{Id.} As discussed previously, however, recovery under this plan amounts to pennies on the dollar. \textit{Id.} This means that claimants in this position are under a great temptation to settle their claims or sell them in the unsecured claims market. \textit{Id.} In either of these scenarios, their expectation of recovery is minimal and often meaningless in relation to their injuries. \textit{Id.}

\textsuperscript{194} \textit{Id.}

\textsuperscript{195} See Thomas A. Smith, \textit{A Capital Markets Approach to Mass Tort Bankruptcy}, 104 YALE L.J. 367, 382 (1994). “[F]or mass tort bankruptcies that involve serious injuries to at least some claimants, fairness requires equal treatment of claimants regardless of the timing of their claims. This result, I believe, is consistent with the moral intuitions of most people who have reflected on these issues.” \textit{Id.} Professor Smith, in making these comments, was dealing with future tort claimants in the context of confirmation of a bankruptcy plan. \textit{See id.} Given their nebulous status compared to present claimants, future tort claimants are at a comparative disadvantage in the negotiation process and thus more risk averse and likely to accept less recovery in contemplating plan confirmation. \textit{Id.} While the result in the automakers’ situation may be inverted (with future claimants representing a potentially larger subclass), the thrust of Professor Smith’s argument remains: disparate treatment of future and present tort claimants in the context of bankruptcy is offensive to traditional notions of equity and fairness. \textit{Id.}
products liability arenas were grounded in purely financial considerations. In both situations the promotion of consumer confidence was a central concern. While these distinctions are warranted, the division between future claims and prepetition and pendency claims remains an arbitrary bifurcation of the class. Financial and commercial viability also informed the government’s decision to effectuate GM and Chrysler’s restructurings through the mechanism of § 363 asset sales so as to insulate the purchasers from cumbersome liabilities. If maximizing the fiscal value of the assets to the purchaser is a core function of § 363, that function is undermined—not enhanced—by some of the government’s actions. As noted above, the volume of liability for future claims may plausibly outweigh those for prepetition and pendency ones, suggesting that other considerations were also at play. If policy concerns weighed heavily on the government’s choices, then issues of fairness and equitable treatment are proper lenses through which to scrutinize those choices.

V. WHERE DO WE GO FROM HERE?

The special treatment of pendency warranty claimants under the Warranty Commitment Program demonstrates the federal government’s willingness to apply public policy to circumvent the generic application of a § 363 asset sale within Chapter 11. The considerations that led to this and other policy choices in the bailout may have been valid subjects of policy, but to allow GM and Chrysler to continue to use § 363 to shield themselves from liability for people situated so closely to those for whom exceptions have been made renders that policy’s application arbitrary and unfair. Given the dangerousness of the precedent set by the government, several solutions should be considered to ameliorate these inequities.

Using liberal estimates, GM and Chrysler’s prepetition and pendency products liability claimants represent a total potential class of 2000 people with potential recovery of up to $4 billion. While not an inconsiderable sum, this number is dwarfed by what the government has committed to ensuring these companies’ long-term viability. Because the Treasury Department insisted that New GM assume future claims liability within

196. See Warranty Commitment Program, supra note 15.
197. See Tung, supra note 152, at 482–83 (“Equal treatment of creditors similarly situated is a central bankruptcy policy.”). Professor Tung acknowledges that equal treatment across entire classes of creditors has been “described as a ‘weak’ bankruptcy norm,” but goes on to argue that fairness requires similar treatment of similarly situated subclasses, such as “current and future tort claimants.” Id. at 482–83 n.184.
199. See Tung, supra note 152, at 482.
200. See discussion supra Part IV.B.
201. See discussion, supra Part III.C.
202. See ProPublica–General Motors, supra note 7; ProPublica–Chrysler, supra note 8.
bankruptcy, and applied pressure to New Chrysler to assume it after its restructuring had been consummated, it is not unreasonable for the Treasury Department to make a similar demand for the sake of severely injured prepetition and pendency claimants for whom there exists no recovery under the current scheme.

This total-recovery solution, however, is not the only possibility. Despite Chrysler’s insistence that its financial outlook has improved greatly, the long-term viability of neither Chrysler nor GM is assured. Furthermore, since concerns about the resale market and about the difficulty in assuming all pre-closing products liability claims provide at least a plausible rationale for the bisection of the class of claimants, certain mitigations on recovery for prepetition and pendency claims may be justified. Given the fragility of the economy and the disastrous effects a failure of the automakers would wreak, more moderate options are available that could both provide significant recovery to victims and prove less of a burden on manufacturers. First, tort law provides precedent for the limitation of recovery to compensatory damages. Second, in exchange for the assumption of prepetition and pendency claim liabilities, manufacturers and claimants could insist on a substantial reduction of attorney’s fees, limiting the total amount by which recovery is offset. Third, an interest-bearing investment account, subject to some of the limitations listed above, could be established, funded by the automakers and through Treasury Department loans to provide for products liability claimants. Given tort

Like any patient that undergoes major surgery, a successful recovery is far from assured. For Chrysler, the biggest challenges are its need to regenerate its product line and manage a significantly leveraged balance sheet. In the case of GM, the overarching question is whether, without an infusion of new blood, its management team can implement the massive cultural change that is essential.

Id. See discussion supra Part IV.B.


209. Id. § 2678. The Federal Tort Claims Act places several limitations by percentage on the fees a plaintiff’s attorney may collect in tort actions against the government. Id. It is conceivable that similar limitations could be justified to provide recovery to claimants for whom no meaningful recovery presently exists.

210. The Warranty Commitment Program provides an excellent precedent for how such an account would function. See Warranty Commitment Program, supra note 15. GM and Chrysler have both already repaid the Treasury Department’s commitment under that program, totaling roughly $640 million. ProPublica–General Motors, supra note 7; ProPublica–Chrysler, supra note 8. While the amount necessary to cover recovery for prepetition and pendency claimants stands to be significantly higher, this total may be mitigated by some of the limitations set out above and by
claimants’ arguably unfair priority in bankruptcy,\textsuperscript{212} this fund should be shared only by them and not divided pro rata among all unsecured creditors. If the Treasury Department can justify providing “financial stabilization” TARP monies to cover GM and Chrysler warranties, temporarily funding a recovery trust for prepetition and pendency products liability claimants is surely within their purview.

CONCLUSION

This note has attempted to establish several key facts. First, without significant financial assistance from the Treasury Department, GM and Chrysler would likely have fallen into complete insolvency resulting in liquidation bankruptcies with catastrophic results.\textsuperscript{213} Second, that assistance primarily took the form of a distribution of bailout funds in debt and short and long-term equity totaling over $63 billion.\textsuperscript{214} Third, the government explicitly endorsed the use of asset sales under § 363 so that the companies could emerge from bankruptcy free and clear of burdensome liabilities.\textsuperscript{215} Fourth, despite this endorsement, the government, through the Warranty Commitment Program and the application of political pressure, ensured that the emergent purchaser-companies would be responsible for certain liabilities that would not have otherwise attached through such asset sales.\textsuperscript{216}

Had the GM and Chrysler restructurings occurred through the normal course of Chapter 7 or 11, or even through the expedited process afforded through a generic § 363 asset sale, all products liability claims arising from automobiles purchased pre-closing would have been either explicitly or effectively rendered moot. Others have argued that this result is unacceptable and that the Code should either be interpreted differently or amended.\textsuperscript{217} Those debates will continue to rage.

However, when the Treasury Department is used as an instrument for the effectuation of public policy, such power must not be wielded capriciously. Principles of fairness and equity should factor into any such decision, particularly when the interests of people with serious injuries are implicated. Because recovery has been provided to some claimants and not

allowing GM and Chrysler more time to repay loans under this program. See discussion supra Part III.C.

\textsuperscript{212} See Painter, supra note 55, at 1046–47.

\textsuperscript{213} In re General Motors Corp., 407 B.R. at 476–77 (noting that the government’s fear that the automakers’ failure would likely engender widespread job loss, ancillary business failures, and create a disastrous systemic ripple effect on the U.S. economy was well founded).

\textsuperscript{214} See ProPublica–General Motors, supra note 7; ProPublica–Chrysler, supra note 8.

\textsuperscript{215} See Fact Sheet, Chrysler, supra note 114; Fact Sheet, GM, supra note 114.

\textsuperscript{216} In re General Motors, 407 B.R. at 481–82.

\textsuperscript{217} See generally Baird & Rasmussen, supra note 86; Kuney, supra note 24; Kuney & St. James, supra note 6.
to others based on a somewhat arbitrary distinction between accidents that occurred pre- and post-closing, the government must ameliorate the injustice and insist upon a more equitable approach. Either all who merit it should recover or none should.

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