CHALLENGES TO THE TAKEOVER EARLY WARNING SYSTEM IN THE EU: THE CASE OF GERMANY

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Summary: The paper shows the regulation of particular duties of investors and issuers in relation to direct or indirect holdings of publicly listed shares, building together an early warning system indicating an imminent change of control in companies.

The early warning system is based on several duties, including: (1) the duty to disclose changes in the shareholdings in public companies above and below certain thresholds; (2) the duty to submit a takeover bid after reaching a certain threshold (the so-called controlling stake) or to publish forthwith a decision to launch a voluntary bid; (3) the duty to disclose in a timely manner relevant price-sensitive information in order to prevent insider dealing, as well as not to distribute any misleading information that would manipulate the market. The system is underpinned by the concept of 'acting in concert' whereby these three duties can be triggered with respect to more investors acting as a group with a view to acquiring or divesting shares in a company in order to influence the management of the company who would otherwise, individually, remain below the relevant thresholds.

The purpose of the early warning system is to protect participants of the capital markets, minority shareholders and other stakeholders (management board members, creditors, employees, local communities, etc). The protection is achieved through increased transparency of the capital markets which enables the timely reaction of all interested parties: either by selling or buying the shares or by the activation of defence strategies before the actual change of control takes place.

The paper also comments on recent changes in EU and German securities legislation.

1. Introduction

On 15 July 2008, Schaeffler, a family-owned company from Herzogenaurach, Germany, a major manufacturer of rolling element bearings for automotive, aerospace and industrial uses, announced its intent to acquire a strategic holding of more than 30% in a much larger tyre

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and automobile parts producer, Continental AG. Most shocking for the market was Schaeffler's statement that together with direct ownership of 2.97% of Continental AG shares and physically settled swaps relating to 4.95% of Continental AG shares, it also held cash-settled total return equity swaps relating to approximately 28% of Continental AG shares, which could be offered to it upon their termination.[1]

The following questions instantly arose: did Schaeffler need to disclose its holdings of equity swaps relating to Continental shares? Was it obliged to file a mandatory bid as soon as it acquired the equity swaps, thereby crossing the relevant threshold for calculation of the controlling stake? Was Schaeffler acting in concert with the banks which offered those swaps so they also had to notify their shareholdings as members of a group formed with Schaeffler? Was there any violation of the market abuse rules in terms of keeping the price-sensitive information away from the relevant public? The German supervisory authority, BaFin,[2] found no violations of the German securities law[3] despite the opposing views of the Continental executive board[4] and legal authorities.[5] Basically, the answer to the above four questions depended largely on finding whether the holder of the shares had an actual obligation to deliver those shares to the holder of the equity swaps upon its request and whether the latter could direct the voting under those shares. It is, however, still not clear whether the legislation in force already provided an adequate legal basis to catch the cash-settled security-based instruments or whether it really needed an express mention of such instruments. If such instruments

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1 Schaffler Group, 'Schaeffler Gruppe strebt strategische Beteiligung an der Continental AG an' (Press Release) (15 July 2008) <http://www.pressebox.de/pressemitteilung/schaeffler-ag/Schaeffler-Gruppe-strebt-strategische-Beteiligung-an-der-Continental-AG-an/boxid/190982> accessed 27 June 2014. In order to build this big stake unnoticed, Schaeffler supposedly used nine banks as counterparties who bought the referenced shares in order to hedge their short positions in total return swaps. All banks, except one, held shares just under the 3% threshold in order to avoid disclosure under German securities law (see M Habersack, 'Beteiligungstransparenz adieu? – Lehren aus dem Fall Continental / Schaeffler' (2008) Die Aktiengesellschaft (AG) 817).

2 Bundesanstalt für Finanzdienstleistungsaufsicht (hereinafter: BaFin).

3 BaFin, 'No Breach of Reporting Requirements Identified in Continental AG Takeover Procedure' (Press Release) (21 August 2008) <http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2008/pm_080821_conti.html> accessed 27 June 2014. Following BaFin's decision, Habersack professed the end of the transparency of major holdings. See Habersack (n 1).

4 Continental AG, 'Continental Rejects Takeover Offer by the Schaeffler Group' (Press Release) (16 July 2008) <http://www.continental-corporation.com/www/portal_com_en/themes/hidden/press_services/press_releases/financial_information/pr_2008_07_16_schaeffler_en.html> accessed 27 June 2014.

5 Continental AG, 'Continental AG's Opinion Confirmed by Renowned Experts: Use of 'Schaeffler Swaps' Is Illegal' (Press Release) (23 July 2008) < http://www.continental-corporation.com/www/portal_com_en/themes/continental/archive/hidden/takeover_offer/pr_2008_07_30_steuer_en.html> accessed 27 June 2014.

had been covered by the legislation in force, the answer to those questions might have depended also on the regulator's limited fact-finding powers.[6] Due to a great deal of criticism, all this, together with similar cases,[7] led to an amendment of the German securities law in 2011.

This is only one of the cases that caught the attention of the public on the practice of secret stake building, ie acquiring shares in a publicly listed company via financial derivatives that do not give their holder any voting rights in the company, but entitle it, if necessary, to acquire those shares and the pertaining voting rights later on.[8] Moreover, these practices seem to continue around the world and require an adequate response from the competent authorities.[9]

[6] In the US, at least, the mandatory discovery procedure enables the parties, and ultimately the courts, to gather more evidence than the regulators in the EU. Discovery is a pre-trial stage where each party can seek evidence from the other party subject to sanctions by the court in the case of no cooperation. See US Federal Rules of Civil Procedure, Rule 26, 37. Since it is basically a civil procedure, the required standard of evidence is also lower than in criminal proceedings.

[7] A similar case was Porsche's offer for Volkswagen AG when in October 2008 Porsche announced it held 42.6% of VW ordinary shares together with 31.5% in cash-settled options relating to VW ordinary shares, causing the VW share price to soar to EUR 1,276 per share which, at the time (ie on 28 October 2008), was the most expensive share worldwide. RT Law 'The Derailment of Section 13(D) Liability After CSX v. Children's Investment Fund: An Argument for Maintaining the Beneficial Ownership Requirement for Section 13(D) Disclosure' [Fall 2009] 59 Cath UL Rev 259, 260.

[8] The same year, a similar case raged in the US financial markets. In *CSX Corporation v The Children's Investment Fund Management (UK) LLP et al*, No 08-Civ 2764 (LAK) (2008) (United States District Court for the Southern District of New York), the court ruled that total return equity swaps conferred beneficial ownership of referenced shares and that the hedge funds, thus, violated their duty to file a timely Schedule 13D under US securities law. BT Sullivan, 'Recent Development: CSX Corp. v. Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership' (2009) 87 NCL Rev 1300, 1013; JC Coffee, 'The Wreck of the CSX: Transparency and Derivatives' (17 July 2008) 240 NYLJ; S Beck, 'Blood on the Tracks: Hedge Fund Tactics and Traditional M&A Principles Collide in the Startling CSX Decision' (2008) 30(8) American Lawyer; EJ Johnsen, 'Southern District on Beneficial Ownership, Equity Swaps' (23 July 2008) 240(16) NYLJ. The ruling was remanded in July 2011 by the US Court of Appeals for the 2nd Circuit without a final solution which is yet to be determined upon the results of further findings in the new proceedings, unless the parties relinquish the case after waiting so long for the final decision. SM Davidoff, 'Anticlimax in Long-Running CSX Railroad Court Case' *The New York Times* (Dealbook blog, 19 July 2011) <http://dealbook.nytimes.com/2011/07/19/anticlimax-in-long-running-csx-court-case/?_php=true&_type=blogs&_r=0> accessed 17 June 2014.

[9] In July 2013, Moët Hennessy - Louis Vuitton (LVMH) was punished by the French Financial Markets Authority for secretly acquiring shares in Hermès by use of equity-linked swaps. N Vulser, 'L'Autorité des marchés financiers sanctionne LVMH pour son entrée masquée au capital d'Hermès' *Le Monde* (2 July 2013) <http://www.lemonde.fr/economie/article/2013/07/02/l-autorite-des-marches-financiers-sanctionne-lvmh-pour-son-entree-masquee-au-capital-d-hermes_3440294_3234.html> accessed 22 June 2014; N Vulser, 'Le plan très secret de LVMH pour entrer chez Hermès' *Le Monde* (18 May 2013) <http://www.lemonde.fr/economie/article/2013/05/18/comment-lvmh-a-planifie-son-entree-chez-hermes_3301911_3234.html> accessed 22 June 2014. For other examples, see PH Conac, 'Cash-Settled Derivatives as a Takeover Instrument and the Reform of the EU Transparency Directive' in HS Birkmose, M Neville and KE Sørensen (eds), *The European Financial Market in Transition* (European Company Law Series, vol 9, Kluwer 2012).

Change-of-control situations raise important issues for target companies, their directors, shareholders and other participants in the capital markets. In principle, the market for corporate control[10] is geared to maximising shareholder value and is supposed to prevent management entrenchment. On the other hand, the acquisition of a controlling stake in a company, eg by a competitor or by short-term profit-oriented hedge funds, can considerably change its course to the detriment of the long-term interests of the company, its shareholders and other corporate constituencies, such as employees, local communities and others.[11] Even the announcement of intent to acquire a controlling stake in a company can considerably influence the price of the target company's stock.

Without the appropriate regulation, minority shareholders and other investors would be deprived of the necessary information to make an informed decision whether to sell or to buy the stock on time; the directors would not be able to launch defence strategies, which would leave the company at the mercy of hostile bidders such as competitors or short-term, profit-oriented investors such as hedge funds.

To prevent such information asymmetries and market distortions, the modern capital markets regulation provides for an early warning system based on three duties, including: (i) the duty to disclose changes in the shareholdings in public companies above and below certain thresholds; (ii) the duty to submit a takeover bid after reaching a certain threshold (the so-called controlling stake) and to publish forthwith a decision to launch a voluntary bid; (iii) the duty to disclose in a timely manner the relevant price-sensitive information in order to prevent insider dealing, as well as not to distribute any misleading information that would manipulate the market. All this information helps the directors, shareholders, the regulator and other capital market participants to become aware of an ongoing stake-building activity that will probably in the end lead to a change of control in the company. In addition, the concept of 'acting in concert' enables the regulators to extend those duties to all investors who act as a group with respect to acquiring or divesting shares in the company with a view to interfering with the management of the company who would otherwise, individually, remain below the relevant thresholds.

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[10] This term generally refers to changes of the management team of publicly listed companies due to changes in the structure of the equity ownership, ie their shareholders, which happen because certain investors consider that the management is not doing its job of increasing the share value properly. See JR Macey, 'Market for Corporate Control' (The Concise Encyclopedia of Economics 2008) <http://www.econlib.org/library/Enc/MarketforCorporateControl.html> accessed 27 June 2014.

[11] DJ Berger and KM Murray, 'Practitioners Note: As the Market Turns: Corporate Governance Litigation in an Age of Stockholder Activism' [Spring 2009] 5 NYU JLB 207; E Wymeersch, 'Shareholder After the Crisis' (December 2009) Universiteit Gent, Financial Law Institute, Working Paper Series 2009-12 <http://ssrn.com/abstract=1524249> accessed 23 June 2014.

Yet new forms of financial derivatives allow the market players to 'fly' under the regulatory radar by using various methods of decoupling the economic ownership of shares from the voting rights of those shares. In this context, the legal framework may need some refurbishment to cover those borderline cases.

In Europe, many of the legal issues regarding change of control situations have been harmonised at the European level, as part of common efforts in creating a single European capital market. The most important pieces of legislation at the EU level include the Transparency Directive,[12] the Takeover Directive,[13] the Market Abuse Directive,[14] and the Markets in Financial Instruments Directive.[15] The latest amendment to the Transparency Directive seems to have addressed the issue, and the EU Member States need to include these financial instruments in their transparency requirements by 26 November 2015.[16]

The aim of this paper is to present the relevant regulation and the challenges it faces, especially with respect to economic positions in stocks by means of cash-settled security-based derivatives, as well as to offer practical solutions in EU Member States where there is still no specific regulation of the issue.

2. Cash-Settled Security-Based Derivatives

Generally speaking, derivatives are a type of *financial instrument*[17] whose value is derived from and depends on the value of the *underlying*

[12] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38.

[13] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12.

[14] Directive 2003/6 of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [2003] OJ L96/16.

[15] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (hereinafter: MiFID).

[16] Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market; Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading; and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC [2013] OJ L294/13 art 4 (hereinafter: the 2013 amendment to the Transparency Directive).

[17] As defined by MiFID, Annex I, Section C. See Transparency Directive, art 13(1b), as added by the 2013 amendment, and WpHG, s 2(2b).

asset.[18] Basically, it is an agreement between two parties which is to be performed in the future with respect to a certain underlying asset and under terms set in advance. The party *selling* or *writing* the derivative is called a *short party*, usually a bank, and its client is called a *long party*.

Derivatives include options, forwards, futures, swaps and their combinations.[19] They can be used for a number of purposes, all of which can be grouped into (a) hedging of risk, and (b) speculation purposes. Depending on the place they are entered into and/or traded, one can distinguish exchange-traded derivatives[20] from bilateral derivatives or derivatives traded over the counter (OTC).[21]

The underlying asset (or simply an *underlying*) can include all kinds of assets, usually shares and other securities (bonds, etc), commodities and currencies, but also various economic variables such as interest rates or yields, financial indices or financial measures, freight rates, inflation rates or other official economic statistics and even climatic variables[22] or emission allowances under the Kyoto Protocol,[23] in fact almost anything one could think of.[24] The underlying variable determines the internal logic and the cash-flow structure of the derivative at hand, as will be shown below.

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[18] JC Hull, *Options, Futures and Other Derivatives* (7th edn, Pearson Prentice Hall 2009) 1.

[19] Cf art 13(1b) of the Transparency Directive, as added by the 2013 amendment, and WpHG s 2(2b).

[20] The best known derivatives exchanges include Eurex <http://www.eurexchange.com/exchange-en/>, and NYSE Liffe <http://globalderivatives.nyx.com/>.

[21] Most derivatives are traded off exchange as bilateral contracts with banks. At the end of 2013, notional amounts of outstanding OTC derivatives totalled $710 trillion. According to the Bank for International Settlements '[a]ctivity in equity-linked contracts declined precipitously in 2008–09 but has since fluctuated around levels similar to the notional amount reported at end-December 2013, $6.6 trillion', BIS, 'OTC derivatives statistics at end-December 2013' (Report) (May 2014) 6 <http://www.bis.org/publ/otc_hy1405.pdf> accessed 18 June 2014. This is most probably the result of the regulatory action following the reported instances of their use in hostile takeovers and the resulting uncertainty as to the legality of previously used tactics.

[22] Especially in the field of energy power, utility companies often use these derivatives to hedge their risk with respect to wind farms or hydro power plants whose production volumes depend on wind power and precipitation levels, respectively. In Europe, this type of derivative is traded on specialised energy exchanges such as the European Energy Exchange in Leipzig <www.eex.com>.

[23] Kyoto Protocol (adopted on 11 December 1997, entered into force on 16 February 2005) to the United Nations Framework Convention on Climate Change (adopted on 9 May 1992, entered into force on 21 March 1994) <http://unfccc.int/kyoto_protocol/items/2830.php> accessed 27 June 2014. The Protocol entered into force on 16 February 2005, following the ratification by at least 55 countries, including countries listed in Annex I which accounted in total for at least 55% of the total carbon dioxide emissions for 1990.

[24] The list is non-exhaustive and covers variables mentioned in Section C of Annex I to the MiFID. See A König, 'Finanztermingeschäfte und Derivate' in CT Ebenroth and others (eds), *Handelsgesetzbuch,* (2nd edn, Verlag CH Beck/Verlag Franz Vahlen 2009) vol II, 2153; T Holzborn and A Israel, 'Die Neustrukturierung des Finanzmarktrechts durch das Finanzmarkt-richtlinienumsetzungsgesetz (FRUG)' (2008) 12 Neue Juristische Wochenschrift 791.

On maturity, derivatives can be settled either (a) physically or in kind, by delivery of the underlying asset, transfer of shares, etc, or (b) in cash.[25] If a derivative is settled in cash, any difference in the value between the agreed price of the underlying (so-called *strike price* or *exercise price*) and the market value of the underlying asset on the day of the derivative's maturity or termination is paid in cash.

To give an example, let us say that an investor enters into an agreement giving it the right to buy a certain number of shares of a certain company in a year's time. It pays right away a *premium*[26] representing the value of the option embedded in the agreement, depending on a number of factors, such as the value of the underlying asset and its volatility. Should the price of the shares in a year's time be higher than the agreed price (in other words, should the option be *in the money*[27]), the investor will exercise the option and buy the shares from its short party at the strike price. If it is not interested in holding the shares, it will enter into an agreement providing for settlement in cash. Should the option be in the money, the short party will pay to the long party the difference between the market price and the strike price in cash. This way, the investor does not need to obtain the financing for the share purchase in order to further sell the shares at the current market price and earn the difference between the market and the strike price. In this respect, the cash-settled derivatives function more like a bet on the rising or falling share prices.

Options are derivatives entitling the long party to either (a) buy (as in example with a call option above), or (b) sell the underlying asset (in the case of put options) in the future. There is no obligation on the part of the long party, which is also the main difference between options, on the one hand, and forward or futures contracts, on the other hand.[28]

If the payment of the premium is disregarded, one could argue that options basically entail a single cash-flow, ie the flow of money from the short party to the long party, either (a) in exchange for the underlying asset (in the case of settlement in kind) or (b) representing the excess over or below the strike price (in the case of settlement in cash). In the case

[25] In the case of an abstract underlying 'asset', such as financial indices, economic statistics and climatic variables, the derivatives can only be settled in cash.

[26] This is a key difference with respect to forwards and futures that require payment only at the maturity date.

[27] There are two other theoretical possibilities when an option is not exercised: (i) either the market price of the underlying is below the strike price ('the option is out of money') and (ii) the market price is equal to the strike price ('the option is at the money'). Hull (n 18) 179ff; R Brealy, SC Myers and F Allen, *Corporate Finance* (9th edn, McGraw-Hill International Edition 2008) 565, 566, 589.

[28] The latter call for irrevocable delivery of the underlying asset under the price set by the parties in advance. See Brealy, Myers, Allen (n 27) 729 ff.

of swaps, the parties exchange two independent cash-flows, thereby assuming the risk of the other party's cash-flow.

The most common swaps include interest rate swaps[29] and currency swaps, but the market has also developed more complex and more abstract forms of swaps.[30] One of the more complex forms is the total return swap, which will be explained in more detail, as it has been used in takeover strategies as a tool for secret stake-building, along with cash-settled call options.

A *total return swap* (TRS) is an agreement whereby parties to the agreement exchange the total return on any notional portfolio of assets (ie a specified number of reference bonds, stocks, etc) in consideration for interest[31] on a notional principal ('virtual bond'[32]).[33] Basically, the long party assumes the total economic exposure to the referenced assets as if it were owner of the referenced assets.

The total return swap is a type of *credit derivative*,[34] which under MiFID corresponds to a separate category of *contracts for differences* (CfDs), a term mainly used in the UK.[35]

A *total return equity swap* is an agreement to exchange: (1) the total return on a notional amount of specified shares, including any dividends and, upon termination of the swap, any share price increase (capital gains) above the agreed reference share price,[36] and (2) the interest on the notional principal and, upon termination of the swap, any share price decrease (loss in value) below the agreed reference share price.[37] Similar

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[29] Parties typically exchange floating to fixed interest rates and vice versa.

[30] For more detailed information on swaps, see Hull (n 18) chs 7 and 32.

[31] Defined as reference interest rate (such as EURIBOR, LIBOR, etc) plus a spread.

[32] The notional principal represents the amount agreed between the parties, which is not paid out to the long party, but only serves as a reference amount for the calculation of interest owed to the short party. This is why it can be called a 'virtual bond'. D Zetzsche, 'Continental AG vs. Schaeffler, Hidden Ownership and European Law – Matter of Law, or Enforcement?' (2009) 10 European Business Organization Law Review 9 <http://ssrn.com/abstract=1170987> accessed 22 June 2014.

[33] Hull (n 18) 527; Brealy, Myers and Allen (n 27) 741; T Siebens and M Gambol, 'Who's Hiding Behind the Hedges? Developments in the USA and UK May Limit Use of Total Return Swaps to Conceal Equity Stakes in Public Companies' (2009) 4(2) Capital Markets Law Journal 173.

[34] Credit derivatives are financial instruments used for hedging the credit risk, either credit default risk or credit spread risk. See Hull (n 18) ch 23. The MiFID calls them derivative instruments for the transfer of credit risk. MiFID, Annex I, Section C, Point 8.

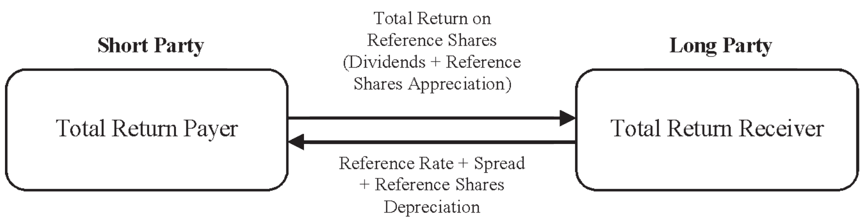
[35] Siebens and Gambol (n 33); JM Lamontagne-Defriez, 'The Use of Derivative Contracts (in Particular Contracts for Differences) as Impacted by Changes to the Takeover Code and the Code of Market Conduct' (2006) 21(1) Journal of International Banking Law and Regulation 24; A Kimball-Stanley, 'A Tale of Two Cities: Regulating Equity Derivatives in New York and London' (Spring 2009) 32 Boston College International and Comparative Law Review 455.

[36] In analogy to the strike price in the case of options.

[37] Hull (n 18) 172.

to options, total return equity swaps can be settled either in kind or in cash, depending on whether the long party has the right to seek delivery of shares upon the swap's maturity or its earlier termination.

Figure 1 – Total return equity swap[38]



In practice, the short party (usually an investment bank as a professional swap counterparty) buys the referenced shares to hedge its position from the risk of share appreciation.[39]

As long as there is no appreciation of the share beyond the strike price, the short position is neutral (zero). However, if the share price goes up, the long party needs to pay the short party the amount of appreciation. If the short party buys the corresponding number of referenced shares, it effectively hedges against the risk of appreciation (the so-called *natural hedge*) – the short party can sell the shares on the market and pay the amount of appreciation to the long party or it can offer the shares to the long party. Instead of buying the referenced shares, hedging strategies can also include further derivative instruments, such as physically settled call options and others.[40]

The fact that most counterparties hedge their short position by buying the referenced stock is also the main reason for a hot debate over the use of total return equity swaps in hostile takeovers. Since cash-settled total return equity swaps have not been subject to disclosure, it is argued that bidders use these instruments (together with other cash-settled financial instruments, such as call options) in order to secretly build up significant equity stakes in their targets, without informing the target and other market participants. Although cash-settled financial instruments, in principle, do not grant their holder the right to directly acquire

[38] The figure was made according to examples given in Siebens and Gambol (n 33) 173 and Hull (n 18) 527.

[39] Zetzsche (n 32) 9.

[40] T Baums, M Sauter, 'Anschleichen an Übernahmeziele mittels Cash-Settled Equity Derivaten – ein Regelungsvorschlag' (February 2009) Institute for Law and Finance Working Paper Series no 97, 6, 8 <http://www.ilf-frankfurt.de/uploads/media/ILF_WP_097.pdf> accessed 27 June 2014.

the referenced shares, or to instruct the voting of shares bought by the short party as a hedge, the fact is that upon termination most counterparties do sell the hedge shares to their long parties.[41]

3. Effects on the market for corporate control and the corporate governance

The market for corporate control and shareholder votes are considered to be effective tools of corporate governance that prevents management entrenchment and the pursuit of goals other than the goal of shareholder wealth maximisation. However, with the numerous possibilities that derivatives offer today with respect to creating different products for hedging or speculation purposes, this is sometimes far from being true. Some shareholders (typically hedge funds) usually seek only short-term gains, which can go against the long-term interests of the company, its shareholders and other corporate constituencies, such as employees, local communities and others.[42] Professors Henry TC Hu and Bernard Black describe the practices used by these activist shareholders as the *decoupling of economic ownership of shares* (ie economic returns associated with shares) *from the voting rights of those shares* (new 'vote buying'), which can take the forms of either 'empty voting' or 'hidden (morphable) ownership'.[43]

Empty voting refers to a situation where an investor holds more voting rights than shares, eg by way of a share loan. On the other side, hidden ownership refers to undisclosed economic ownership, such as in the case of cash-settled derivatives referencing shares of a company. If hidden ownership is combined with probable informal voting power, this is referred to as hidden morphable ownership.[44]

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[41] Zetzsche (n 32) 11-12; D Bertaccini, 'To Disclose or Not to Disclose? CSX Corp., Total Return Swaps, and Their Implications for Schedule 13D Filing Purposes' [September 2009] 31 Cardozo Law Review 267, 279.

[42] DJ Berger and KM Murray (n 11); E Wymeersch (n 11).

[43] HTC Hu and B Black, 'The New Vote Buying: Empty Voting And Hidden (Morphable) Ownership' (2006) 79 Southern California Law Review 811-908; HTC Hu and B Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 University of Pennsylvania Law Review 625, 661-81; HTC Hu and B Black, 'Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms' (2006) 61 Business Lawyer 1011; W Savitt, 'The Dilemma of Empty Voting – When Votes are Cast by Investors with No Stake in a Corporation, Rationale for Vote is Imperilled' (17 November 2008) 31(12) National Law Journal; A Brav, RD Mathews, 'Empty Voting and the Efficiency of Corporate Governance' (3 February 2010) AFA 2009 San Francisco Meetings Paper <http://www.ssrn.com/abstract=1108632> accessed 22 June 2014; E De Nardis, M Tonello, 'Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests' (July 2010) Conference Board Director Notes No DN-009 <http://www.ssrn.com/abstract=1648526> accessed 22 June 2014.

[44] 'Morphable ownership' would also mean here economic ownership that can easily be converted into actual ownership and actual voting rights, which can usually happen, eg

Economic ownership can be acquired either directly by holding shares, or indirectly by holding other financial instruments or contractual rights.[45] The final result or 'net economic ownership' can be either positive[46] – the same direction as the return on shares, zero–neutral, or negative[47]– the opposite direction from the return on shares. This can go farther, and even positive net economic ownership can result in negative 'overall economic interest' in the concerned company if it is combined with an investment in the shares of another competing company whose value relates in the opposite direction to the first company.[48] Obviously, someone holding voting rights with a negative overall economic interest will not vote in the best interests of the host company and other shareholders, yet other market participants are not aware of this, unless the law requires disclosure. In countries that have adopted the record date system for entitlement to attend and vote at the general meetings of listed companies rather than real-time verification of records, these practices have even more effect on corporate governance.[49]

This, combined with the information asymmetry, clearly shows that traditional corporate governance rules require re-thinking, together with better disclosure rules that would capture the indirect economic ownership and empty voting practices that often run against the long-term interest of the host company.[50]

4. Disclosure of Major Shareholdings

4.1 European Union

The transparency and disclosure requirements in relation to information on issuers admitted to trading in the EU are regulated and

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upon termination of a total return equity swap or of a cash-settled call option, bearing in mind the fact that most short parties hedge their positions in referenced shares.

45 Hu and Black, 'Empty Voting and Hidden (Morphable) Ownership' (n 43) 1022. These other assets are called 'coupled assets'.

46 Eg in the case of a combination of share ownership and equity derivatives or a share loan (record-date capture). ibid 1023-24.

47 Eg in the case of a combination of share ownership and a short equity swap or record-date capture via stock borrowing in combination with a short-sale.

48 This is what Hu and Black refer to as a 'related non-host asset'. Hu and Black, 'Empty Voting and Hidden (Morphable) Ownership' (n 43) 1022.

49 N De Luca, 'On Record Date, Empty Voting, and Hidden Ownership: Some Remarks on EU Directive 2007/36/CE from a European Perspective' (2010) Rivista di diritto societario, RDS, 2010/2, 311-339 <http://www.ssrn.com/abstract=1633749> accessed 22 June 2014.

50 Cf Hu and Black, 'Empty Voting and Hidden (Morphable) Ownership (n 43) 1048; also D Zetzsche, 'Against Mandatory Disclosure of Economic-only Positions referenced to Shares of European Issuers: Twenty Arguments against the CESR Proposal' (2011) 11(2) European Business Organization Law Review <http://www.ssrn.com/abstract=1559787> accessed 22 June 2014, although with certain caveats; MC Schouten, 'The Case for Mandatory Ownership Disclosure' (2010) 15 Stanford Journal of Law, Business, and Finance, 127-182 <http://www.ssrn.com/abstract=1327114> accessed 22 June 2014.

harmonised at the European level by the Transparency Directive.[51] The Transparency Directive provides for the obligation to disclose both periodic and ongoing information with respect to the issuer and its shares.

The obligation to disclose *periodic information* includes, amongst other things, the obligation to draft and issue (a) annual financial reports and (b) half-yearly financial reports.[52]

The obligation to disclose *ongoing information* refers to: (a) information on major shareholdings (ie the acquisition or disposal of major holdings and/or major proportions of voting rights), and (b) information requirements for issuers whose shares and/or debt securities are admitted to trading on a regulated market.[53], [54] For the purpose of this paper, the focus will be on notification duties with respect to major shareholdings, as these duties directly relate to possible change-of-control situations.

The Transparency Directive requires all EU Member States to adapt their laws so as to ensure that a shareholder, who acquires or disposes of shares of an issuer whose shares are admitted to trading on a regulated market and to which voting rights are attached, notifies the issuer of *the proportion of voting rights* of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of 5%, 10%, 15%, 20%, 25%, 30% (alternatively, one-third), 50% and 75% (alternatively, two-thirds).[55] The notification to the issuer has to be effected promptly, but in any case not later than four trading days and the issuer has to publish such notification within another three trading days.[56]

Voting rights are calculated on the basis of all the shares to which voting rights are attached even if the exercise of the voting rights is sus-

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[51] A directive in the legal system of the EU, contrary to a regulation, does not in principle have direct effect, but it requires implementation measures on the part of EU Member States. See art 288 of the Treaty on the Functioning of the EU (TFEU) (*ex* art 249 EC). Following the expiry of the time-limit for implementation (eg in the case of the Transparency Directive, this was 20 January 2007 (see art 31 thereof)), directives can have direct effect if certain criteria defined by the case law of the ECJ are satisfied. See P Craig and G de Búrca, *EU Law: Texts, Cases and Materials* (4th edn, OUP 2008) 279ff.

[52] Arts 4-8 Transparency Directive.

[53] A regulated market, as defined by the MiFID, refers to a prime or general standard or main market of stock exchanges ('a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments') while alternative markets, open markets or over-the-counter markets are referred to as multilateral trading facilities ('a multilateral system operated by an investment firm, ie a brokerage company, or a market operator, which brings together multiple third-party buying and selling interests in financial instruments"). Art 4(1)(14), 4(1)(15) MiFID.

[54] Arts 9-16 Transparency Directive.

[55] Art 9(1), 9(3) Transparency Directive.

[56] Art 12(2), 12(6) Transparency Directive.

pended (eg in the case of own or treasury shares).[57] The Transparency Directive further requires that the issuer discloses to the public the total number of voting rights and capital at the end of each calendar month during which an increase or decrease of such a total number has occurred, for the purpose of calculating the thresholds above.[58]

Shareholders also have to notify the issuer of the proportion of voting rights, where that proportion reaches, exceeds or falls below the thresholds above, as a result of events changing the breakdown of voting rights (eg in the case of cancellation of own or treasury shares).[59]

The Transparency Directive adopted a more realistic approach in requiring disclosure of the aggregated number of voting rights held by both shareholders and holders of voting rights in situations where the economic ownership of shares is decoupled from the voting rights. Thus, a natural person or legal entity is subject to the notification requirements above, along with the shareholder, provided and to the extent the natural person or legal entity is entitled *to acquire, to dispose of or to exercise* the voting rights.[60] This way, in theory, even situations involving the use of cash-settled security-based instruments could be caught by the notification duties, provided that their holder is entitled to acquire, to dispose of or to exercise the voting rights.

Before the 2013 amendment to the Transparency Directive, the examples of decoupling in the Transparency Directive included situations where (a) voting rights are held by a third party – either a shareholder or another party holding voting rights – with whom the shareholder has concluded an agreement, which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question (*acting in concert*);[61] (b) voting rights are held by a third party under an agreement for the temporary transfer for the consideration of voting rights in question (ie a *share loan* used for the practice of short-selling); (c) voting rights are attached to shares which are lodged as collateral with that person or entity, provided that the person or entity controls the voting rights and declares the intention of exercising them (*share pledge*); (d) voting rights are attached to shares in which that person or entity has a life interest (*life interest* or *usufruct*); (e) voting rights are held, or may be exercised, by an undertaking controlled by that person or entity (*controlled undertakings*); (f) voting

[57] Art 9(1) Transparency Directive.
[58] Art 15 Transparency Directive.
[59] Art 9(2) Transparency Directive.
[60] Arts 10, 13, Transparency Directive, prior to the 2013 amendment.
[61] See section 6 of this paper (acting in concert).

rights are attached to shares deposited with that person or entity which the person or entity (eg financial institution) can exercise at its discretion in the absence of specific instructions from the shareholders (*share deposit*); (g) voting rights are held by a third party in its own name, but on behalf of that person or entity (*holding on behalf*); (h) voting rights can be exercised by that person or entity as a proxy, provided that it can exercise the voting rights at its discretion in the absence of specific instructions from the shareholders (*proxy*); and (i) a natural person or legal entity holds, directly or indirectly, financial instruments that result in an entitlement to acquire, on such a holder's own initiative alone, under a formal agreement, already issued[62] listed[63] shares to which voting rights are attached[64] (*physically settled equity-based instruments*).[65]

The 2013 amendment to the Transparency Directive goes even further by providing that the notification requirements apply both to physically settled and cash-settled equity-based instruments. The disclosure duty now covers: (a) financial instruments that, on maturity, give their holder, under a formal agreement, either the unconditional right to acquire or the discretion as to its right to acquire already issued listed shares to which voting rights are attached (basically, physically settled equity-based derivatives); and (b) all other financial instruments which are referenced to already issued listed shares and with economic effect similar to that of the financial instruments, whether or not they confer a right to a physical settlement (basically, all other cash-settled instruments).[66]

The result of this extended rule is, basically, the aggregation of all voting rights decoupled from the economic ownership of shares with the voting rights attached to shares owned outright. If the voting rights thus aggregated exceed or fall below the thresholds specified above, they must be disclosed.[67] The number of voting rights is calculated by reference to the full notional amount of shares underlying the financial instrument, except where the financial instrument provides exclusively for a cash settlement, in which case the number of voting rights shall be calculated on a 'delta-adjusted' basis, by multiplying the notional amount of underlying

[62] This requirement excludes financial instruments relating to new issues of shares, such as convertible bonds or similar instruments.

[63] Shares that are admitted to trading on a regulated market.

[64] This requirement limits the notification duty only to financial instruments relating to ordinary shares and excludes preference shares.

[65] Art 10 (with respect to items (a) to (h) above) and art 13 (with respect to item (i) above) Transparency Directive prior to the 2013 amendment.

[66] Art 13(1a) Transparency Directive, as added by the 2013 amendment.

[67] Art 13a Transparency Directive, as added by the 2013 amendment.

shares by the so-called delta[68] of the instrument.[69] For this purpose, the holder needs to aggregate and notify all financial instruments relating to the same underlying issuer, while only long positions are taken into account for the calculation of voting rights and they are not to be netted with short positions relating to the same underlying issuer.[70] In the Schaeffler example, this means it would need to disclose its holdings if its overall position of direct ownership of 2.97% of Continental AG shares, physically settled swaps relating to 4.95%, and cash-settled total return equity swaps relating to approximately 28% of Continental AG shares crossed one of the relevant thresholds mentioned above. Due to the application of the delta adjustment to cash-settled financial instruments, one would need to add the number of voting rights attached to the directly held shares and the full notional amount of shares underlying the physically settled swaps (ie 2.97% + 4.95% = 7.92%) plus the reduced delta amount of shares underlying the cash-settled TRSs (if the delta was 0.6, then the number of votes attached to the shares underlying the cash-settled TRSs would be 16.8%, totalling 24.72% of voting rights in Continental AG).

The duty to notify does not apply to shares acquired for the sole purpose of clearing and settling within the usual short settlement cycle,[71] or to custodians holding shares in their custodian capacity provided such custodians can only exercise the voting rights attached to such shares under instructions given in writing or by electronic means.[72]

The same is true for the acquisition or disposal of a major shareholding reaching or crossing the 5% threshold by a *market maker*,[73] provided

[68] Delta (Δ), as one of the so-called 'Greek letters' in finance, is an important parameter in the pricing and hedging of options. 'The delta of a stock option is the ratio of the change in the price of the stock option to the change in the price of the underlying stock'. Hull (n 18) 247. If the delta of a call option is 0.6, it means that when the underlying share price changes, the option price changes by roughly 60% of that amount (ibid 349ff). The delta of a call option is positive and the delta of a put option is negative. It is not fixed, but it changes over time (ibid 247, 248). 'As an in-the-money call option nears expiration, it will approach a delta of 1.00, and as an in-the-money put option nears expiration, it will approach a delta of -1.00'. Investopedia <http://www.investopedia.com/terms/d/delta.asp> accessed 27 June 2014. The latter is true because, on maturity, the short party needs to perform its obligation, ie to deliver the referenced shares, in the case of a call option, or to buy off the referenced shares, in the case of a put option, so the value of the option is equal to the referenced share itself (ibid 4ff).

[69] Art 13(1a) Transparency Directive, as added by the 2013 amendment.

[70] ibid.

[71] The maximum length of the usual short settlement cycle, under art 5 of the Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (the so-called Level 2 Transparency Directive) [2007] OJ L69/27, is three trading days.

[72] Art 9(4) Transparency Directive.

[73] Under art 4(1)(8) MiFID, a market maker means a person who holds himself out on the

that (a) the market maker is authorised by its home Member State under MiFID and (b) it neither intervenes in the management of the issuer concerned nor exerts any influence on the issuer to buy such shares or back the share price.[74]

Member States can apply the same treatment to voting rights held in the *trading book*[75] of a credit institution or investment firm, provided that (a) the voting rights held in the trading book do not exceed 5%, and (b) the voting rights attached to shares held in the trading book are not exercised or otherwise used to intervene in the management of the issuer.[76]

The notification requirements also do not apply to shares provided to or by the members of the European System of Central Banks[77] in carrying out their functions as monetary authorities, provided that the voting rights attaching to such shares are not exercised.[78]

The 2013 amendment to the Transparency Directive also added an exemption with respect to shares acquired as part of buy-back programmes and stabilisation measures, subject to the requirement that the voting rights attached to those shares are not exercised or otherwise used to intervene in the management of the issuer, similarly to the market maker and trading book exemptions above.[79]

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financial markets on a continuous basis as being willing to deal on his own account by buying and selling financial instruments against his proprietary capital at prices defined by him.

74 Art 9(5) Transparency Directive.

75 As defined by Directive 2006/49EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions [2006] OJ L177/201, art 11.

76 Art 9(6) Transparency Directive. The 2013 amendment to the Transparency Directive (n 16) made this obligation more explicit. The previous provision only stated that the credit institution or investment firm had to *ensure* that the voting rights attaching to shares held in the trading book are not exercised or otherwise used to intervene in the management of the issuer.

77 ESCB comprises the European Central Bank and the national central banks of all EU Member States. Art 282ff TFEU.

78 Art 11 Transparency Directive.

79 Art 9(6a) Transparency Directive, as added by the 2013 amendment. This is in line with Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council (Market Abuse Directive) as regards exemptions for buy-back programmes and stabilisation of financial instruments [2003] OJ L336/33. Buy-back programmes refer to issuers trading in their own shares in order to (i) reduce their capital; (ii) meet obligations arising from debt financial instruments exchangeable into equity instruments (such as convertible bonds); (iii) meet obligations arising from allocations of shares to employees. Regulation No 2273/2003, Recital 5. Stabilisation measures refer to transactions having the effect of providing support for the price of an offering of relevant securities during a limited period (eg initial public offering of shares) if they come under selling pressure. They typically include over-allotment facilities and 'greenshoe options'. Regulation No 2273/2003, Recitals 11, 19.

4.2 Germany

In Germany, the disclosure requirements of the Transparency Directive were implemented by the Transparency Directive Implementation Act (TUG),[80] but the core provisions on transparency of shareholdings are found in the Securities Trading Act (WpHG).[81]

In accordance with Section 21(1) WpHG, any person who reaches, exceeds or falls below a threshold of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75%[82] of the voting rights[83] in a German issuer must notify the issuer, and at the same time the supervisory authority – BaFin.[84] The notification must be effected within four trading days as of the moment the acquirer became aware of the fact it reached, exceeded or fell below the thresholds specified above. The change in the thresholds and the subsequent notification duty can result from acquisition or disposal of voting rights or *in any other particular way*.[85] The notifying party is in any case deemed to be aware of the said fact on the third trading day after reaching, exceeding or falling below the thresholds above.[86]

In the case of an initial public offering and listing of shares, any person who acquires at least 3% of voting rights in a German issuer[87] must make a corresponding notification to the issuer and BaFin, as provided by Section 21(1) WpHG above.[88]

Section 22(1) WpHG provides for aggregation or imputation of voting rights (*Zurechnung von Stimmrechten*) (a) held by a subsidiary (*Tochter-*

[80] *Transparenzrichtlinie-Umsetzungsgesetz*, published on 5 January 2007, BGBl vol I, 10.

[81] *Wertpapierhandelsgesetz*, published on 9 September 1998, BGBl vol I, 2708, as last amended by art 6 of the Law of 28 August 2013, BGBl vol I, 3395; UH Schneider and T Brouwer, 'Kapitalmarktrechtliche Meldepflichten bei Finanzinstrumenten' (2008) Die Aktiengesellschaft (AG) 557.

[82] The thresholds of 3%, 15%, 20% and 30% were added in 2007 by the Transparency Directive Implementation Act (TUG).

[83] The issuer has to publish the information on the total number of voting rights at the end of each month if there was a change in the total number of voting rights (ie in the case of a share capital increase). WpHG s 26a. This number is then used as the denominator in calculating the corresponding proportions of voting rights held by different holders of voting rights.

[84] Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*). In the case of depositary receipts (*Zertifikate*), the duty to notify applies to the holder of the receipts. WpHG s 21/1.

[85] Cf art 9(2) Transparency Directive above – events changing the breakdown of voting rights.

[86] WpHG s 21(1) states: 'two trading days after reaching, exceeding or falling below the thresholds above'.

[87] For the purpose of the disclosure requirement, the issuer refers only to publicly listed companies. See WpHG s 21/2.

[88] WpHG s 21(1a).

unternehmen) of the notifying party;[89] (b) held by a third party on behalf of the notifying party or its subsidiary; (c) attached to shares which are lodged by the notifying party or its subsidiary as collateral with a third party;[90] (d) attached to shares in which the notifying party or its subsidiary has life interest (*Nießbrauch*); (e) that can be acquired by a simple declaration of the notifying party or its subsidiary;[91] (f) attached to shares deposited with the notifying party or its subsidiary or that can be exercised by the notifying party or its subsidiary as a proxy,[92] which the notifying party or its subsidiary can exercise at its discretion in the absence of specific instructions from the shareholder.

Section 22(2)[93] also provides for aggregation of voting rights in the case of acting in concert, ie in the case of voting rights held by a third party with whom the notifying party or its subsidiary coordinates its conduct in respect of the issuer, based on an agreement *or in any other particular way*, with the exception of isolated agreements (*Vereinbarungen in Einzelfällen*). Coordinated conduct exists in the case of understanding between the third party and the notifying party or its subsidiary with the aim of permanent and substantial change in the issuer's strategic direction.[94]

Section 25 WpHG provides that any person, who directly or indirectly holds financial instruments[95] giving *right* to their holder, by virtue of a legally binding agreement, *to unilaterally acquire already issued shares*[96]

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[89] In the sense of accounting rules on the consolidation from Section 290 of the Commercial Code (HGB) (*Handelsgesetzbuch*, as last amended by art 1 of the Law of 4 October 2013, BGBl vol I, 3746); WpHG s 22/3a provides that investment services undertakings are not to be considered as subsidiaries if they can vote independently of the notifying party.

[90] Unless the third party controls the voting rights and declares its intention of exercising them.

[91] This provision includes physically settled call options and other derivatives authorising their holder to acquire shares by a simple declaration. However, according to the majority of German scholars, for the purpose of aggregation of voting rights under WpHG s 22, the financial instrument must be designed in a way that the long party's declaration has *in rem* effect on the transfer of shares, and not just the effect of creating an obligation on the part of the short party to deliver the shares. Therefore, for WpHG s 22 to apply, the short party has to give a legally binding and irrevocable transfer statement (*dingliche Übertragungserklärung*). See C Cascante and C Topf , '"Auf leisen Sohlen"? – Stakebuilding bei der börsennotierten AG' (2009) Die Aktiengesellschaft (AG) 63 and the authors cited there.

[92] If a power of attorney is issued for the purpose of exercising voting rights at a single general meeting, WpHG s 22(4) requires a single notification at the moment of issuing the power of attorney, ie no subsequent notification is needed.

[93] The German law was here probably inspired by the definition provided in the Takeover Directive, where persons act in concert if they cooperate with the offeror or the offeree company on the basis of an agreement, either express or tacit, either oral or written. See section 6 of this paper (acting in concert).

[94] ibid.

[95] Annex I, Section C MiFID.

[96] The notification duty, therefore, does not apply to financial instruments, such as convertible bonds or bonds with warrants for new shares, authorising their holder to acquire new shares in the course of a share capital increase.

to which voting rights of a German issuer are attached, has to notify the issuer and BaFin if the person has reached, exceeded or fallen below the thresholds from Section 21(1) WpHG above, with the exception of the 3% threshold (ie at least 5%). Unlike Section 22(1)(5) WpHG, Section 25 WpHG covers all call options and other financial instruments authorising their holder to acquire shares and not just those with an irrevocable transfer statement issued by the short party. However, Section 25 WpHG does not cover cash-settled financial instruments, as they do not grant any right to acquire the referenced shares.

Following the notification, the issuer has to make a public announcement of the change within a further three trading days, both in the case of acquisition or disposal of shares and/or security-based financial instruments.[97]

Section 23 WpHG provides for the following exemptions from the notification duty for: (1) investment services undertakings that hold shares in their trading book (*Handelsbestand*) representing not more than 5% of the voting rights, provided they ensure that the voting rights attached to the shares held in the trading book are not exercised or otherwise used to intervene in the management of the issuer; (2) shares acquired for the sole purpose of clearing and settling within three trading days, even where shares are traded over the counter; (3) custodians holding shares in their custodian capacity provided they can only exercise the voting rights attached to such shares under instructions given in writing or by electronic means; (4) the voting rights attached to shares provided to or by the members of the ESCB in carrying out their duties as monetary authorities; (5) the acquisition or disposal of a major shareholding reaching or crossing the 3% and 5% thresholds by a market maker, provided that (a) it trades in its capacity as market maker, (b) it holds a licence in accordance with the German banking law, (c) it neither intervenes in the management of the issuer concerned nor exerts any influence on the issuer to buy such shares or back the share price, and (d) it notifies BaFin within four trading days that it traded in its capacity as market maker with respect to the concerned shares. As a general requirement to qualify for the exemptions above, the voting rights must not be exercised, except in the case of custodians who can vote only in accordance with the instructions received from their client.

The Risk Limitation Act (*Riskobegrenzungsgesetz*) introduced an additional disclosure obligation for investors who reach a significant holding (*wesentliche Beteiligung*) of 10% or more of the voting rights.[98] Thus,

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[97] WpHG s 26.

[98] WpHG s 27a. See S Hutter, K Kaulamo and MO Plepelits, 'Die Verwendung von Total Return Equity Swaps bei feindlichen Übernahmen, eine Analyse nach deutschem und

an investor who reaches or exceeds 10% of the voting rights has to disclose the motive behind the acquisition and the origin of the funds used for the purchase of the voting rights within 20 trading days.[99]

In order to achieve better transparency of the capital market and the market for corporate control, in response to the outcome of the *Schaeffler* and similar cases, the German legislator added in 2011 the new Section 25a WpHG[100] under which any person, who directly or indirectly holds financial instruments or *other instruments*,[101] not covered by Section 25 WpHG, *enabling* their holder or a third party to acquire already issued shares to which voting rights of a German issuer are attached, has to notify the issuer and BaFin within four trading days if the person has reached, exceeded or fallen below the thresholds from Section 21(1) WpHG above, with the exception of a 3% threshold (ie at least 5%).

The new provision includes (a) cash-settled instruments (such as cash-settled call options and total return equity swaps), provided that the counterparty is in a position to exclude or reduce the risk of its position through the holding of referenced shares, or (b) the financial instruments or other instruments granting their holder a right to acquire the referenced shares (however, not unconditionally and unilaterally, as in the case of financial instruments under Section 25 WpHG) or creating an obligation on the part of their issuer to acquire the referenced shares.[102] The latter include physically settled call options providing for a condition

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US-amerikanischem Wertpapier- und Übernahmerecht' in T Baums and S Hutter (eds), *Gedächtnisschrift für Michael Gruson* (De Gruyter Recht, 2009) 231; S Pluskat, 'Investorenmitteilung nach § 27a WpHG – wie viel Beteiligungstransparenz geht noch?' (2009) 6 Neue Zeitschrift für Gesellschaftsrecht (NZG) 206ff.

[99] This requirement can be waived by the company's articles of association, WpHG s 27a(3).

[100] Art 1 of the Law on the Strengthening of Investor Protection and Improved Functioning of the Capital Markets (*Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarkts – Anlegerschutz- und Funktionsverbesserungsgesetz*), published on 5 April 2011, BGBl vol I, 538. In accordance with art 9(3) of the Law, the new disclosure rules of ss 25 and 25a WpHG entered into force on 1 February 2012.

[101] Other instruments include re-transfer claims under security loans and repurchase claims under repo transactions. Allen & Overy, 'German Parliament Resolves Extended Disclosure of Equity Derivatives Relating to Listed Companies' (eBulletin, February 2011) < http://www.allenovery.com/publications/en-gb/Pages/German-Parliament-resolves-extended-disclosure-of-equity-derivatives-relating-to-listed-companies.aspx > accessed 27 June 2014, in contrast to 2009 BaFin Issuer Guideline (*Emittentenleitfaden)* <http://www.bafin.de/SharedDocs/Downloads/EN/Leitfaden/dl_Emittentenleitfaden_2009_en.pdf?__blob=publicationFile > accessed 27 June 2014. The provision of WpHG s 25 is also amended in order to include other instruments alongside the financial instruments granting their holder the right to acquire shares.

[102] See Allen & Overy (n 101); Freshfields Bruckhaus Deringer, 'Extended Notification Requirements Increase Transparency in Shareholdings' (March 2011) <http://m.freshfields.com/uploadedFiles/SiteWide/Knowledge/Extended%20requirements_30012.pdf> accessed 27 June 2014; A Merkner and M Sustmann, 'Vorbei mit dem unbemerkten Anschleichen an börsennotierte Unternehmen?' (2010) 18 Neue Zeitschrift für Gesellschaftsrecht (NZG).

which is beyond the control of the holder of the instrument, or the writer (short party) positions in physically settled put options.[103]

With respect to the overall voting power, the new Section 25a(2) WpHG provides that the voting rights arising from the potentially obtainable shares are to be aggregated with any other holdings described under Sections 21, 22 and 25 WpHG.[104] Therefore, from 1 February 2012 any combination of positions in shares and instruments under Section 25 and 25a WpHG needs to remain below 5% in order not to trigger the disclosure duties.

The provisions of the new Section 25a WpHG catch all economic positions in shares regardless of whether there is any influence on the control of the voting rights attaching to the referenced shares. The only possible way out would be to expressly provide in a written agreement that the counterparty is prohibited from acquiring shares or physically settled derivatives relating to those shares for hedging purpose. However, it is unlikely that banks as professional counterparties would take on the risks of unhedged positions. This approach was criticised even before the enactment, as going further than necessary to achieve transparency and market efficiency.[105]

According to some authors, even prior to this amendment one could have included security-based financial instruments by using the 'holding on behalf' clause of Article 10(g) of the Transparency Directive in conjunction with Section 22(1)(2) WpHG if certain additional conditions had been satisfied:[106] (1) first of all, the short party must hold shares in the target (ie the shares it bought as a hedge); (2) the economic risk of the underlying shares is transferred to the long party; and (3) the long party is able to influence how voting rights are exercised. If one can influence how voting rights attaching to shares held by another are exercised, it seems reasonable to request notification, as this person serves only as a 'straw man'.[107]

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103 ibid.

104 If the number of votes cannot be determined from the number of shares to which the instrument relates, the number of votes is then determined from the amount of shares the counterparty should acquire to fully hedge its position. The calculation is based on the delta value of the derivative position, with a value of delta equal to 1 (Δ=1), in accordance with the Solvency Regulation (*Solvabilitätsverordnung*). See the new WpHG s 25a(2). A similar solution has been accepted in Art 13(1a) Transparency Directive, as added by the 2013 amendment. In the case of options or comparable transactions, it is to be assumed that they have been exercised. See new WpHG s 25a(1). The 2013 amendment to the Transparency Directive does not provide for such a presumption.

105 In Zetzsche (n 32) 36-37 and Zetzsche (n 50) 3, Dirk Zetzsche gives 20 arguments against the mandatory disclosure of mere economic positions referenced to shares and advocates disclosure of economic positions only where the long party can exercise at least factual influence on voting rights.

106 Zetzsche (n 32) 20ff and the German and Portuguese authors cited there.

107 ibid.

However, other legal authorities claim that the holding on behalf clause cannot be applied to cash-settled security-based financial instruments in the context of German law.[108] According to his view, typical examples of holding shares on behalf of another under German law include a trust (*Treuhand*) or indirect representation/agency (*mittelbare Stellvertretung*).[109] First of all, the short party to a cash-settled security-based financial instrument keeps some economic risk of the underlying share, namely the risk of share appreciation, which is then payable to the long party upon the unwinding of the financial instrument.[110] The fact that the short party hedges against the risk of appreciation does not change anything itself. One could speak of the total transfer of economic risk only if (1) the short party has an option to perform by delivery of shares in lieu of its payment obligation (*an Zahlungs statt*), or (2) the long party has to sell shares in a commercially reasonable way and its right to receive payment from the short party is limited to the amount of proceeds received from the sale of shares.[111] Furthermore, the long party would need to have the right to acquire the shares (*Erwerbsanspruch*) or the right to surrender (*Herausgabeanspruch*).[112] On the other hand, the long party to a total return equity swap has no legal right to shares held by the short party as its hedge, nor can it request their delivery or surrender. Although practice shows that most of the counterparties do offer to their clients the shares they acquire as a hedge, it is always possible for them to offer the shares to another, eg to a 'white knight' in the case of a hostile takeover.[113] With respect to voting power, it is true that the law does not require a formal right to instruct how votes are cast, but factual influence is enough.[114] However, if the counterparty is a bank, which is mostly the case, it has to ensure that the voting rights are not exercised or otherwise used to intervene in the management of the issuer in order to avoid the disclosure of holdings kept in its trading book (Section 23(1) WpHG).[115]

Despite this view, one must not forget that hostile bidders and secret stake-builders, as in the example of the Schaeffler Group, typically use several banks or even a group of banks to distribute their holdings, and thus evade disclosure. The trading book exemption applies to holdings of up to 5%, but hostile bidders can always use more banks as their counterparties to keep their holdings undercover. This is why one should still leave the possibility of applying the holding on behalf clause to cash-

[108] Baums and Sauter (n 40) 11-15.
[109] ibid 11.
[110] ibid 13.
[111] ibid.
[112] ibid.
[113] ibid.
[114] ibid 15.
[115] ibid.

settled security-based swaps in certain exceptional cases, as advocated by Dirk Zetzsche, particularly if the applicable law does not expressly include economic positions in shares with respect to disclosure duties.[116] Only such a fact-specific provision would require broader investigative powers on the part of the regulators.

This was, after all, the opinion of BaFin in the *Schaeffler* case, although in that case it lacked firm evidence to show the existence of further agreement under which its counterparty (Merrill Lynch) or third parties had held Continental shares on behalf of Schaeffler.[117]

5. Mandatory bid and calculation of fair price

The mandatory bid is a peculiarity of EU law. In Germany, the mandatory bid was not introduced until 2001 when the Securities Acquisition and Takeovers Act (WpÜG)[118] was enacted following the first successful hostile takeover of Mannesmann AG by Vodafone.[119] At the European level, the mandatory bid was extended to all EU Member States by the adoption of the Takeover Directive in 2004 providing for implementation in the laws of all EU Member States by 20 May 2006.

5.1 European Union

Under the Takeover Directive, where a natural or legal person, as a result of its own acquisition or the acquisition by persons acting in concert with it, holds securities of a publicly listed company carrying voting rights in the company which, added to any existing holdings of those securities, directly or indirectly, give it a *specified percentage of voting rights giving it control of the company*,[120] Member States have to ensure

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[116] D Zetzsche, 'Challenging Wolf Packs: Thoughts on Efficient Enforcement of Shareholder Transparency Rules' (2009) Heinrich-Heine-University Düsseldorf, Germany, Faculty of Law, Centre for Business and Corporate Law Research Paper Series (CBC-RPS) No 0044/09 <http://www.ssrn.com/abstract=1428899> accessed 22 June 2014; also Zetzsche (n 32) 27-28, 35.

[117] The same was true for the application of WpHG s 22(1)(5) (acquisition of shares by a simple declaration) and 22/2 WpHG (acting in concert). See BaFin (n 3).

[118] *Wertpapiererwerbs- und Übernahmegesetz,* published on 20 December 2001, BGBl vol I, 3822, as last amended by Art 4(53) of the Law of 7 August 2013, BGBl vol I, 3154. It first entered into force on 1 January 2002 and was significantly amended by Art 3 of the Law of 30 July 2009, also known as the Risk Limitation Act (*Risikobegrenzungsgesetz*).

[119] M Höpner and G Jackson, 'An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance' (September 2001) Max Planck Institut für Gesellschaftsforschung, Discussion Paper 01/4 <http://ssrn.com/abstract=285232> accessed 27 June 2014. The first country to introduce a mandatory bid was the UK where it was introduced back in 1968 when the Panel on Takeovers and Mergers was set up.

[120] The controlling stake is determined by each Member State for companies that have their registered office on the territory of the respective Member State (art 5(3) Takeover Directive). What is to be considered as the controlling stake depends on the estimated average

that such a person is required to make a bid to all holders of those securities at the earliest opportunity and at an equitable price,[121] as a means of protecting the minority shareholders of that company.[122] Where control is acquired following a voluntary bid to all holders of securities for all their holdings, the acquirer does not need to submit a new mandatory bid.[123]

A decision to make a voluntary bid has to be made public without delay and the supervisory authority has to be informed of the bid.[124] The offeror has to draw up, communicate to the supervisory authority and make public in good time an offer document containing the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid.[125]

5.2 Germany

In Germany, any person who directly or indirectly acquires at least 30% of the voting rights in the target company has to make a mandatory offer (*Pflichtangebot*) and the acquirer also must make public the exact amount of voting rights acquired within seven days as of acquiring control.[126] Within an additional four weeks, the acquirer needs to submit an

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attendance rate at general meetings in a given country, as well as the average distribution of shareholdings (eg in the USA the shareholdings are much more dispersed on average than in Europe). The amount of voting rights triggering the obligation to publish a mandatory bid under German law is set at 30% (WpÜG s 29).

[121] The highest price paid for the same securities by the offeror, or by persons acting in concert with it, over a period of not less than six months and not more than 12 before the bid. If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with it purchases securities at a price higher than the offer price, the latter price is to be applied (art 5(4) Takeover Directive). The Takeover Directive also provides for certain price adjustments. In Germany, the equitable price must in any case be at least equal to the weighted average price for the last three months prior to making public the bid (Takeover Bid Regulation, *WpÜG-Angebotsverordnung*, published on 27 December 2001, BGBl vol I, 4263, as last amended by art 17 of the Law of 6 December 2011, BGBl vol I, 2481 s 5-6 in conjunction with WpÜG s 31).

[122] Art 5(1) Takeover Directive.

[123] Art 5(2) Takeover Directive; WpÜG s 35(3). Certain practices of secret-stake building, such as *creeping-in* or *low-balling*, which are not the topic of this paper, use this clause to circumvent the mandatory bid. Low-balling is a strategy that involves three stages: (1) in the first stage the offeror acquires shares just below the controlling stake; (2) the offeror then extends a voluntary bid for an unattractive price (just above the statutory minimum price); and (3) after acquiring control of the company, the offeror can freely continue to build up its stake on the market without having to make a mandatory bid. T Baums, 'Low-balling, Creeping-in und deutsches Übernahmerecht' (November 2010) Johann-Wolfgang-Goethe-Universität Frankfurt, Institute for Law and Finance, Working Paper Series No 122 <http://www.ilf-frankfurt.de/uploads/media/ILF_WP_122.pdf> accessed 27 June 2014. This is something that was probably also pursued by Schaeffler, but in the end it was not that successful.

[124] Art 6(1) Takeover Directive.

[125] Art 6(2) Takeover Directive; WpÜG s 35(2) in conjunction with s 14(2).

[126] WpÜG s 35(1) in conjunction with s 29.

offer document (*Angebotsunterlage*) to BaFin and make it public following approval by BaFin.[127]

For the purpose of calculating the control threshold, only *physically held shares*[128] are taken into account, together with holdings aggregated or imputed pursuant to Section 30 WpÜG.[129]

Thus, the voting rights the offeror already holds are aggregated with the voting rights attached to the following categories of shares of the target company: (a) shares held by the offeror's subsidiary; (b) shares held by a third party on behalf of the offeror or its subsidiary; (c) shares which are lodged to a third party as a security, unless the third party is authorised to exercise the voting rights attached to the shares and it declares the intention to exercise the voting rights independently of any instructions of the offeror or its subsidiary; (d) shares in which the offeror or its subsidiary has a life interest; (e) shares that can be acquired by a simple declaration of the offeror or its subsidiary;[130] and (f) shares that are deposited with the offeror or its subsidiary or shares for which the offeror or its subsidiary can exercise the voting rights attached to them as a proxy, so long as the offeror or its subsidiary can exercise the voting rights from these shares at its discretion in the absence of specific instructions from the shareholders.[131] The aggregation of voting rights applies also to instances of acting in concert,[132] which is discussed in detail in the next section.

The 2011 amendment to the WpÜG did not extend the aggregation provisions to financial instruments and other instruments under Sections 25 and 25a WpHG, considered for the purposes of disclosure under the Securities Trading Act. The amendment did include these instruments, though, in the so-called 'water-level'[133] reports duty explained below.

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[127] WpÜG s 35(2) in conjunction with s 14(1) and 14(2).

[128] The acquisition of financial instruments and other instruments under WpHG s 25 and 25a does not trigger the duty to make a mandatory offer, nor are these instruments taken into consideration when calculating the equitable price under WpÜG s 31.

[129] Although the Takeover Directive does not contain provisions on the aggregation/imputation of voting rights, Germany extended the application of the rule on the aggregation of voting rights from art 10 of the Transparency Directive to public takeovers. This is in line with art 3(2) of the Takeover Directive under which EU Member States need to harmonise their laws in a way to guarantee only the minimum provided by the Takeover Directive. They can always go beyond the requirements of the Takeover Directive and lay down additional conditions and provisions that are more stringent than those of the Takeover Directive. The opposite case is with the Transparency Directive which, in the context of ongoing reporting duties, generally prohibits Member States from making more stringent rules while providing specific exceptions (art 3(1a) Transparency Directive, as added by the 2013 amendment).

[130] As in the case of WpHG s 22(1)(5), only physically settled derivatives with an irrevocable and unconditional transfer statement of the short party are taken into account.

[131] WpÜG s 30(1).

[132] WpÜG s 31(2).

[133] A takeover is compared here to a flood where, instead of measuring the water level, the

During the entire offer period and after its expiry, the offeror has a duty to make so-called water-level reports (*Wasserstandsmeldungen*).[134] The offeror has to make public and at the same time notify BaFin of (a) the total number of voting rights it holds, (b) the persons acting in concert with it and their subsidiaries, as well as (c) all voting rights imputed to them in accordance with Section 30 WpÜG, including (d) the level of acceptance of the bid. During the offer period (which is at least four weeks, in accordance with Section 16(1) WpÜG), the offeror has to report the total number of voting rights on a weekly basis and on a daily basis in the last week of the offer. After the expiry of the offer period, the offeror has to make public the final number of voting rights without delay. From 1 February 2012, the water-level reports need to include instruments under Sections 25 and 25a WpHG.[135]

In the case of a voluntary bid, the offeror needs to publish its decision to make the bid without delay and submit its offer document within four weeks of the announcement.[136] German law is quite strict on the matter, as it requires publication of the offeror's decision, basically its board of directors, even prior to any approval by the general meeting that may be necessary under the offeror's constitutional documents.[137] Most legal authorities agree that the duty arises only after the offeror's management (board of directors) makes a final decision, and cannot be assumed from the offeror's stake-building activities.[138]

This solution is convenient for investors, since otherwise they would be obliged to make a bid as soon as a takeover intent could be established from their investments.[139] Although it may seem that this leaves room for further secret takeover strategies, they should be avoided by strict en-

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offeror needs to notify any change in its holdings of shares and financial instruments referencing the target shares in order to prevent acquisitions of shares in parallel to the takeover bid.

[134] WpÜG s 23; see Baums and Sauter (n 40) 31ff.

[135] Art 2 of the Law on the Strengthening of Investor Protection and Improved Functioning of the Capital Markets. In this case, a separate notification under the Securities Trading Act is not required, thanks to an exception provided in the new WpHG s 25a(1). According to Baums, this duty already applied to physically settled derivatives by virtue of WpHG WpÜG s 23(1) in connection with WpÜG s 31(6), although the Takeover Bid Regulation s 2(5) did not include them expressly (Baums and Sauter (n 40) 32). Physically settled derivatives with an irrevocable and unconditional transfer statement (*dingliche Übertragungserklärung*) of the short party are covered by s WpÜG 30(1)(5).

[136] WpÜG s 10(1), 14(1).

[137] ibid.

[138] Baums and Sauter (n 40) 18-19; cf Cascante and Topf (n 91) 55ff, who speak of a multi-stage decision-making process (*mehrstufige Entscheidungsprozesse*); similarly in Hutter and others (n 98) 228-229.

[139] According to BaFin's practice, an announcement of intent to make a takeover bid is the point of no return for the prospective offeror (Cascante and Topf (n 91) 56 and the authors cited there).

forcement of disclosure duties, whether under express provisions, such as Section 25a WpHG, or under the 'holding on behalf' clauses of Article 10(g) of the Transparency Directive in conjunction with Section 22(1)(2) WpHG.

6. Acting in concert

Acting in concert is an important notion that applies both to disclosure requirements and for calculation of the stake triggering the obligation to make a mandatory bid, and thus has far-reaching consequences for shareholders of publicly listed companies. It goes without saying that persons acting in concert can also all be considered as 'insiders' if they dispose of price-sensitive information with regard to a listed company. This is also true for the use of financial instruments and other instruments in hostile takeovers, where there is risk of establishing that the holder of instruments and its counterparties are acting in concert. However, as shown above in Section 5.2, the latter risk exists in Germany only with respect to violations of the disclosure rules and not in relation to the risk of triggering the mandatory bid.

6.1 European Union

Acting in concert is defined at the level of the EU both by the Takeover Directive[140] and the Transparency Directive,[141] each with different purposes.[142] Under the Takeover Directive, persons act in concert if they cooperate with the offeror or the offeree company on the basis of an agreement, either express or tacit, either oral or written, aimed either at (a) acquiring control of the offeree company, or (b) frustrating the successful outcome of a bid.[143] The Transparency Directive defines acting in concert,[144] for the purpose of aggregating the voting rights, as an agreement,[145] which obliges the notifying party and the third party to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question.

[140] Art 2(1)(d), 2(2) Takeover Directive.

[141] Art 10(a) Transparency Directive.

[142] This is not to be confused with the notion of 'concerted practices, in the competition law (TFEU 101).

[143] Pursuant to art 12 Takeover Directive, Member States may reserve the right not to require companies to apply the provisions relating to frustrating action. In that case, companies can still opt in and apply the said provisions by providing this in their articles of association. The opt-out can also be done by way of reciprocity, ie by providing that companies can disapply the provisions relating to frustrating action if they become the subject of an offer launched by a company which does not apply the same provisions.

[144] Although not expressly naming it as acting in concert.

[145] The Transparency Directive does not provide a broad definition of the *agreement*, as found in the Takeover Directive.

The definition of persons acting in concert also includes *persons controlled by another person* or *controlled undertakings*[146] within the meaning of the Transparency Directive that refer to any undertaking (a) in which a natural person or legal entity has a majority of the voting rights; (b) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time a shareholder in, or member of, the undertaking in question; (c) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders' or members' voting rights, respectively, pursuant to an agreement entered into with other shareholders or members of the undertaking in question; or (d) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.[147] Unfortunately, there is still no case law of the Court of the EU that would expressly address a situation of acting in concert.[148]

6.2 Germany

Under German takeover law, persons are acting in concert (*gemeinsam handelnde Personen*)[149] if they coordinate their conduct with respect to (a) acquisition of the target company's securities, or (b) exercise of their voting rights attached to the shares of the target company, based on an agreement or in any other particular way. On the part of the target company, persons are acting in concert if they coordinate their actions with the purpose of frustrating[150] a voluntary or mandatory bid, based on an agreement or in any other particular way. Subsidiaries (*Tochterunternehmen*) are in any case deemed to be acting in concert with their parent undertaking (*Mutterunternehmen*).[151]

For disclosure purposes, acting in concert is described, although not expressly named as such, in the aggregation provision of Section 22(2)

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[146] The Takeover Directive referred initially to a definition of controlled undertakings in Art 87 of the Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities [2001] OJ L184/1. This definition can be found now in art 2(1)(f) Transparency Directive that repealed certain parts of Directive 2001/34/EC, including its art 87.

[147] The last point (d) represents a new criterion that was not part of the definition under Directive 2001/34/EC.

[148] The only decision where the Court of the EU touched on an acting-in-concert situation in a takeover context is in its dictum in the decision in Case C-101/08 *Audiolux SA and Others v GBL and Others and Bertelsmann AG and Others* [2009] ECR I-9823.

[149] ss 2/5 WpÜG.

[150] This applies, however, only if the target company has not opted out from the application of WpÜG s 33 pursuant to WpÜG s 33c.

[151] WpÜG refers here also to HGB s 290.

WpHG while the Securities Acquisition and Takeover Act[152] adopted an identical provision in addition to Section 2(5) WpÜG.

The voting rights of a third party with whom the offeror (the notifying party in the case of WpHG) or its subsidiary coordinate their conduct with respect to the target company, based on an agreement or in any other particular way, are aggregated with the voting rights of the offeror (the notifying party). In the case of a pool of shares, the voting rights of pool members are mutually imputed to all members who are then subject to the disclosure duty.[153]

Coordinated conduct (*ein abgestimmtes Verhalten*) presupposes (a) an understanding between the offeror (the notifying party) or its subsidiary and the third party to act in a coordinated way with respect to the exercise of their voting rights, or (b) a common strategy between the offeror (the notifying party) or its subsidiary and the third party manifested in a particular way (*in sonstiger Weise*)[154] aiming at a permanent and substantial change of the target company's strategic direction. *Ad hoc* and isolated agreements (*Vereinbarungen in Einzelfällen*) are exempted. These are basically all one-time deals between a third party and the offeror or its subsidiary not resulting in a permanent and substantial change in the company's strategic direction.

Significant changes were introduced in 2009 by the Risk Limitation Act, which extended the legal definition of acting in concert. However, after this extension, it is not clear where the scope of the provision ends. This creates significant legal uncertainty for investors in German publicly listed companies. According to some authors, the extended provision of Section 30(2) WpÜG, although in line with the Takeover Directive, could violate free movement of capital, as guaranteed by Article 63 TFEU (*ex* Article 56 EC).[155]

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[152] WpÜG s 30(2).

[153] 2009 BaFin Issuer Guideline No VIII.2.5.8ff. This is true even for pool members having a very small number of voting rights in the pool, contrary to the majority opinion of German scholars (cf A Merkner and M Sustmann, 'Die Neuauflage des Emittentenleitfadens der BaFin – Rechtssicherheit bei der Abgabe von Stimmrechtsmitteilungen' (2009) Neue Zeitschrift für Gesellschaftsrecht (NZG) 818).

[154] WpÜG s 30(2). This part was included in the original draft in order not to have the definition too broad (see M Schockenhoff and E Wagner, 'Zum Begriff des "acting in concert"' (2008) Neue Zeitschrift für Gesellschaftsrecht (NZG) 364.

[155] R Schmidtbleicher, 'Das "neue" acting in concert – ein Fall für den EuGH?' (2008) Die Aktiengesellschaft (AG) 73.

7. Insider dealing and market manipulation

A decision to take over control in a company has a considerable effect on the price of its shares. This is why a decision to take over control in a company needs to be made public without delay,[156] although a mere decision to acquire or dispose of financial instruments *per se* does not constitute insider dealing.[157]

7.1 European Union

The legal framework regarding insider dealing and market manipulation has been harmonised at the EU level by the Market Abuse Directive. The purpose of provisions regulating insider dealing and market manipulation is to keep an integrated and efficient financial market and to enhance investor confidence.[158]

Inside information can be any price-sensitive information of a precise nature which has not been made public, relating directly or indirectly to one or more issuers of financial instruments or to one or more financial instruments.[159] This means information a reasonable investor would be likely to use as part of the basis of his investment decisions.[160]

On the other hand, market manipulation relates to the distribution of any misleading information and other defrauding activities distorting the price of financial instruments in order to deceive other investors and make profits or avoid losses.[161]

The Market Abuse Directive outlaws the use of insider information by acquiring or disposing of financial instruments. The prohibition applies to any person that possesses that information (a) by virtue of its membership of the administrative, management or supervisory bodies of the issuer; (b) by virtue of its holding in the capital of the issuer; (c) by virtue of its having access to the information through the exercise of its employment, profession or duties; or (d) by virtue of its criminal activities.[162] This definition

[156] Art 6(1) Takeover Directive; WpÜG s 10, even prior to a corresponding general meeting's decision.

[157] Recital 30 of the Preamble to the Market Abuse Directive.

[158] Cf recitals 2 and 12 of the Preamble to the Market Abuse Directive.

[159] Price-sensitive information means any information which could have a significant effect on the evolution and forming of the prices of those financial instruments or on the price of related derivative financial instruments. Recital 16 of the Preamble to the Market Abuse Directive; art 1(1) Market Abuse Directive.

[160] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation [2003] OJ L339/70, art 1(2).

[161] For a complete definition, see art 1(2) Market Abuse Directive.

[162] Art 2(1) Market Abuse Directive.

is interpreted objectively with presumed intent on the part of the person that uses this information if other constituent elements of insider dealing, described in the provision of Article 2(1) of the Market Abuse Directive, are present.[163]

The prohibition does not apply to transactions conducted in the discharge of an obligation that has become due to acquire or dispose of financial instruments where that obligation results from an agreement concluded before the person concerned possessed the inside information.[164]

Member States of the EU must prohibit any person from (a) disclosing inside information to any other person, unless such disclosure is made in the normal course of the exercise of its employment, profession or duties,[165] and (b) recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[166]

On the other hand, Member States should also ensure that issuers of financial instruments inform the public as soon as possible of inside information which directly concerns them.[167] The disclosure can be delayed in order not to prejudice their legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information.[168] In this case, Member States can require that the issuer informs the supervisory authority of the decision to delay the public disclosure of inside information.[169]

7.2 Germany

In Germany, insider dealing (*Insidergeschäft*)[170] and market manipulation (*Marktmanipulation*)[171] are regulated by the Securities Trad-

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[163] Case C-45/08 *Spector Photo Group NV and Chris Van Raemdonck v CBFA* [2009] ECR I-12073.

[164] Art 2/3 Market Abuse Directive. This provision could serve as a conduit for the use of cash-settled derivatives in stake-building, but only prior to making the decision to take over control of the concerned company based on a clearly defined plan in advance. This plan should be documented in detail to the extent possible and there should not be any deviation from the plan in its implementation (Cascante and Topf (n 91) 56).

[165] In its decision of 22 November 2005, the ECJ ruled that this exception presupposes a close link between the disclosure and the exercise of employment, profession or duties and that the disclosure is strictly necessary for the exercise of that employment, profession or duties. Case C-384/02 *Criminal proceedings against Knud Grøngaard and Allan Bang* [2005] ECR I-9939.

[166] Art 3 Market Abuse Directive.

[167] Art 6(1) Market Abuse Directive.

[168] Art 6(2) Market Abuse Directive.

[169] ibid.

[170] WpHG s 12-16b.

[171] WpHG s 20a.

ing Act (WpHG), which includes all the relevant provisions, as required by the Market Abuse Directive. The financial instruments to which the insider dealing regulation applies (*Insiderpapiere* – insider securities) are defined as financial instruments admitted to trade on regulated markets or over-the-counter markets (*Freiverkehr*)[172] in the EU or the EEA,[173] or derivatives relating to those financial instruments, such as cash-settled options, total return equity swaps and other instruments under Sections 25 and 25a WpHG.

Insider information is defined as information of a precise nature on circumstances[174] not publicly available concerning one or more issuers of insider securities or the insider securities themselves, which, if published, could considerably influence the price of the insider securities. The price sensitivity of the given information is determined from the perspective of a reasonable investor who would take the information into account when deciding on investment.[175]

It is prohibited (a) to use insider information for the acquisition or disposal of insider securities, either for one's own account or on behalf of another person, (b) to illegally communicate insider information or to make it otherwise available to another person, and (c) to recommend or to induce another person to acquire or to dispose of insider securities, on the basis of inside information.[176] Prosecution is allowed both for intentional (*vorsätzlich*) and negligent (*leichtfertig*) acts.[177]

As mentioned in the introduction, the implementation of a decision to acquire shares is not an instance of insider dealing *per se*.[178] The same is true for access to inside information and its use in the context of a public takeover bid,[179] but this is no surprise if one takes into account the level of regulation takeover bids are subject to. Nevertheless, even in these cases other accompanying circumstances can lead to violations of Section 14 WpHG.

In the case of a takeover bid, it is not uncommon for the prospective offeror to contact the target's management and to try to perform due diligence. If, following the due diligence or a communication of inside

[172] Multilateral trading facilities (MTF) in the sense of art 4(1)(15) MiFID.

[173] The European Economic Area (EEA) includes all EU Member States and all EFTA (European Free Trade Association) Member States: Norway, Iceland and Liechtenstein, except Switzerland.

[174] The term 'circumstances' includes future events where sufficient probability exists that they will actually occur.

[175] WpHG s 13(1).

[176] WpHG s 14(1). Under WpHG s 14(2), buy-back programmes and stabilisation measures are exempted from the prohibition.

[177] WpHG s 38.

[178] Recital 30 of the Preamble to the Market Abuse Directive.

[179] Recital 29 of the Preamble to the Market Abuse Directive.

information by the target itself, the prospective offeror deviates from its initial plan of investment and engages in the acquisition of securities or security-based financial instruments, this could represent a violation of Section 14 WpHG.[180] This is why it is recommendable to draft a detailed plan of investment before performing the due diligence or obtaining inside information from the target company, and to comply with it.[181] If a bid is not intended to acquire control of the target, it does not enjoy the preferential treatment of takeover bids.

In the case of acquiring shares on an exchange, the insider-dealing regulation together with other disclosure requirements tries to avoid information asymmetry that can exist between minority shareholders and an investor who has performed due diligence. This asymmetry usually does not exist between the investor and larger shareholders selling their stakes off exchange.[182]

Stake-building beyond reporting thresholds and in violation of the disclosure rules can represent a case of insider dealing. This is true especially if this information could have a considerable effect on the share price.[183]

If an investor decides to include third parties in its plan of investment, this could violate Section 14(1)(2) WpHG, unless it was an authorised communication of the inside information, such as in the normal course of the exercise of its employment, profession or duties. Should the third party unilaterally decide to acquire shares after obtaining information of a prospective investor's intent, this represents, in principle, a case of insider dealing.[184]

If the counterparty, in the case of cash-settled financial instruments, offers physical settlement, this is subject to limitations of insider dealing.[185] Nevertheless, if the investor did not possess any inside information at the time of acquiring the derivative and if it requests physical settlement at the moment that was agreed in advance, it is not insider dealing, although it could violate the transparency rules, as explained above.[186] A cash-settled derivative that is not exercised is not considered insider dealing, as decisions not to acquire or to dispose of one's shares do not fall within the ambit of the rules on insider dealing.[187]

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[180] Cascante and Topf (n 91) 57ff.
[181] ibid.
[182] ibid.
[183] ibid 58.
[184] ibid 59.
[185] ibid 62ff.
[186] ibid.
[187] ibid.

8. Conclusion

The early warning system described in this paper serves the purpose of protecting investors and other participants of the capital markets, but, also indirectly, the issuer's management boards, employees, local communities and other stakeholders.

The system is based on three duties, including: (i) the duty to disclose changes in the shareholdings in public companies above and below certain thresholds; (ii) the duty to submit a takeover bid after reaching a certain threshold (the so-called controlling stake); and (iii) the duty to disclose in a timely manner the relevant price-sensitive information in order to prevent insider dealing and/or not to distribute any misleading information in order to prevent market manipulation. The system is underpinned by the concept of 'acting in concert' whereby these three duties can be triggered with respect to more investors acting as a group with a view to acquiring or divesting shares in a company in order to influence the management of the company who would otherwise, individually, remain below the relevant thresholds.

Following the financial crisis and the opacity of the capital markets caused by the use of derivatives and other financial instruments just before the crisis, a general trend in many countries has been to extend the range of the regulatory radar by imposing disclosure duties on purely economic positions in the shares of publicly listed issuers. This was done in Germany in 2011 by the enactment of the Law on the Strengthening of Investor Protection and Improved Functioning of the Capital Markets, although the relevant provisions entered into force only later, on 1 February 2012. At the EU level, this was done at the end of 2013 by an amendment to the Transparency Directive which is to be transposed into the national legal systems of all Member States by 26 November 2015.

It remains to be seen whether such extended disclosure duties will help to achieve more transparency. The inclusion of purely economic positions in shares not entitling their holders to acquire or direct the voting rights from the shares will definitely create a flood of information, but also probably 'noise' in the system resulting from misinterpretation of various economic positions not designed to change control in the issuer. Future amendments should rather consider extending the national regulators' investigative powers, similar to the discovery procedure applied by the federal courts in the USA when enforcing the US securities law, which would enable the regulators to identify situations where banks and their clients informally communicate with respect to planned takeover strategies. Otherwise, the transparency of capital markets will still be at risk.