CLIFFORD
CHANCE

Newsletter
April 2011

Restricting stealth takeover strategies – The German Investor Protection Improvement Act

Contents

The German Investor Protection and Capital Markets Improvement Act (*Anlegerschutz- und Funktionsverbesserungsgesetz*) was promulgated in the German Federal Law Gazette (*Bundesgesetzblatt*) on 7 April 2011.

Along with a range of investor protection and capital market improvement issues, the Act also tightens up the existing provisions of the German Securities Trading Act ("**WpHG**") on shareholder transparency. This will help to combat the phenomenon of stealth takeover strategies aimed at listed companies.

The existing provisions only required the reporting of voting right holdings or possession of any financial instruments entitling the holder to acquire shares vested with voting rights. The new provisions now also require the reporting of previously unreported financial instruments entitling the holder to any kind of payment settlement and any transactions with a similar effect.

It is not yet possible to reach a definitive assessment on the impact of the Act in view of the fact that the Federal Ministry of Finance ("**BMF**") is entitled to issue legal regulations on key specific legal issues. The BMF is also entitled to transfer this authority to the Federal Financial Supervisory Authority ("**BaFin**"). No such regulations have yet been issued.

Johannes Perlitt +49 69 7199 1555
Dr. Arndt Stengel +49 69 7199 1486
Dr. Thomas Stohlmeier +49 211 4355 5778
Daniela Weber-Rey +49 69 7199 1551
Dr. Elisabeth Wagner +49 69 7199 1708

To email one of the above, please use:
firstname.lastname@cliffordchance.com

Clifford Chance
Mainzer Landstraße 46
60325 Frankfurt am Main

Clifford Chance
Königsallee 59
40215 Düsseldorf

Clifford Chance
Theresienstraße 4-6
80333 Munich

www.cliffordchance.com

1. Comparison with government bill

The Act which has now been promulgated contains a number of changes compared to the bill published on 22 September 2010:

- The reporting obligation set out in section 25a of the WpHG covers not only those financial instruments entitling the *holder* to purchase shares, but also those entitling *third parties* to do so;
- in the case of those instruments subject to reporting obligations under section 25a WpHG where no details are given of the number of shares which may be purchased by the holder or third party under such instruments, the number of voting rights to be reported is determined on the basis of the number of shares required to completely hedge the instrument, calculated using a delta factor of 1;
- the option open to BaFin to exempt domestic issuers domiciled in a third country from disclosure obligations under sections 26 and 26a WpHG does not apply to notifications pursuant to section 25a WpHG;
- the maximum fine for the infringement of reporting duties under sections 21 (1), 25 (1) and 25 a (1) WpHG has been raised to EUR 1 million;
- the new provisions on stealth takeover strategies come into force on 1 February 2012.

2. Overview of the new provisions

The existing reporting duty for those parties holding financial instruments entitling them to purchase voting shares which have already been issued (section 25 WpHG) will be extended. The scope of section 25 WpHG will now include both "financial instruments" as defined in section 2 (2b) WpHG and "other instruments" entitling the holder to purchase shares. This includes all instruments affording share purchase rights in binding terms. The extended scope of section 25 WpHG now includes:

- the lender's claim for return of lent securities and
- repurchase rights under a "repo transaction" (*repurchase agreement*: sale of securities with a commitment to buy those securities back at an agreed time).

Section 25a WpHG introduces a new reporting duty "in the event that further financial instruments and other instruments are held". Any party holding financial instruments or other instruments will be subject to a duty to report this (unless the instruments are already covered by section 25 WpHG) if the instruments due to their content may “enable” the holder or any third party to acquire issued voting shares. The explanatory statement to the Act indicates that "other instruments" are any instruments enabling the acquisition of voting shares which do not fall within the scope of the financial instruments defined in section 2 (2b) WpHG.

The explanatory statement does not state with regard to section 25a WpHG (as it does for section 25 WpHG) that the instrument needs to have arisen as part of a legally binding agreement.

Section 25 WpHG therefore covers instruments which

- *entitle*
- their *holder*

to unilaterally purchase voting shares.

Section 25a WpHG, however, covers instruments which

- *may enable*
- their *holder or a third party*

to purchase shares. A distinction therefore needs to be made as to whether the holder of the instrument has a unilateral right to purchase the shares (section 25 WpHG applies) or whether the holder or a third party may be able to purchase voting shares (section 25a WpHG applies).

As before, the new reporting duties also relate solely to (hypothetical) voting rights to domestic issuers and issuers whose home country is the Federal Republic of Germany and whose shares are admitted for trading on an organised market (section 21 (2) WpHG). This does not include Open Market trading.

Sections 25 and 25a WpHG only relate to those instruments based on shares which have been issued and which offer voting rights and/or which *can* be satisfied with shares which have already been issued. This means that convertible bonds and warrants which can only be satisfied with new shares are still not subject to a reporting requirement (although reporting requirements do apply to those

instruments which can be satisfied using own shares).

The lowest threshold for reporting requirements under sections 25 and 25a WpHG to apply is 5% of the issuer's voting rights. The other thresholds are identical to the 10, 15, 20, 25, 30, 50 and 75% issuer voting right thresholds applicable to voting right notices under sections 21 and 22 WpHG. Reporting requirements apply each time any such threshold is reached, exceeded or fallen below.

As is the cases with the instruments falling under section 25 WpHG, the hypothetical voting rights covered by section 25a WpHG are not taken into account when calculating the control threshold of 30% of the voting rights provided for in the German Securities Acquisition and Takeover Act ("**WpÜG**").

3. Reporting duty under section 25 WpHG

a) Definition of instrument

Section 25 WpHG states that any party directly or indirectly holding financial or other instruments entitling their holder to unilaterally purchase issued shares affording voting rights under a legally binding agreement is required to report this when the relevant threshold is reached, exceeded or fallen below. The relevant transaction therefore needs to be tailored to the actual delivery of voting shares, as has previously also been the case.

The inclusion of "other instruments" means that the scope of section 25 WpHG has been significantly extended compared to the previous provisions (which only referred to "financial instruments", section 2 (2b) WpHG).

- Delivery claims under a purchase agreement which are to be met at a point in time later than two days after the conclusion of the agreement will now be regarded as an "instrument".
- The lender's claim for return of lent securities as specified above and
- the repurchase rights under a "repo transaction" will also be regarded as "instruments" according to the explanatory statement.

b) Unilateral purchase right

Another requirement for a reporting duty under section 25 WpHG to arise is that the instrument provides its holder with a *unilateral* right to acquire the shares under a legally binding agreement. There is no reporting duty under section 25 WpHG if the share purchase right is conditional on certain circumstances or possible future events over which the holder of the instrument does not have exclusive control.

However, any such cases now have to be reported under section 25a WpHG (see below).

c) Combining shares and instruments

The (hypothetical) voting rights which are subject to a reporting requirement under section 25 WpHG need to be added together with those under sections 21 and 22 WpHG. This means that the lower threshold of 5% for reporting duties under section 25 WpHG is reached more quickly. If the financial or other instrument is an *in rem* option as defined in section 22 (1) sentence 1 no. 5 WpHG, it should only be counted once in any such adding together (section 25 (1) sentence 4 WpHG).

The exception under section 25 (1) sentence 4 WpHG, under which the reporting duty under section 25 WpHG was limited to those cases in which due to the aggregation of voting rights a further statutory threshold is reached, exceeded or fallen below, no longer applies. The explanatory statement indicates that this is a way of preventing the concealment of actual holdings of financial and other instruments and increasing the transparency of holdings.

The individual amounts of holdings in different areas – i.e. under sections 21, 22 WpHG and section 25 WpHG – must be given.

Example:

A company acquires a 6% voting right holding and reports this in accordance with the requirements of section 21 WpHG. The company simultaneously or subsequently acquires financial instruments under section 25 WpHG through which it may acquire a further 2% of the voting rights.

The company has a reporting duty under section 25 WpHG. The company has a total voting right share of 8% and thereby exceeds the 5% threshold specified in section 25 WpHG. The fact that the 5% threshold being exceeded has already been reported

under section 21 WpHG is irrelevant under the new provisions.

In the example given above, the company acquires additional financial instruments as defined in section 25 WpHG entitling it to acquire a further 1% of voting rights.

In this respect, the company does not have a reporting duty under either section 21 WpHG or section 25 WpHG. The acquisition of the additional financial instruments does not result in any of the relevant thresholds being met, exceeded or fallen below under either section 21 WpHG or section 25 WpHG.

There is no *de minimis* provision. Any party having already reported voting rights of 5% or more, is required to report again (under section 25 WpHG) if it purchases an instrument under section 25 WpHG – even if it only entitles that party to purchase one single share.

There is some doubt over the applicable reporting requirements in the event that the instruments cease to apply. The safest course of action in the above example would be for the party to report that it no longer holds instruments subject to a reporting requirement under section 25 WpHG, despite the fact that the lapse of the instruments has not affected any relevant thresholds.

d) Precedence of the WpÜG

The new paragraph 2a states that a bidder is not subject to reporting requirements under section 25 (1) WpHG if the voting rights are afforded by shares for which a public offer has been accepted in accordance with the WpÜG and which are to be reported in the status reports and final notifications for the takeover offer (section 23 (1) WpÜG).

e) Non-consideration of voting rights and notification by group companies

As has been the case up to now, instruments do not need to be reported under section 25 WpHG if the shareholding does not need to be reported (under section 23 WpHG), particularly in the case of being held for trading or in the case of settlement, safe custody and market making, or where a group company has already met any reporting duty on behalf of the relevant party (section 24 WpHG).

4. Reporting duty under section 25a WpHG

Any party directly or indirectly

- holding (*What constitutes "holding"? See (v) below*)
- financial instruments or other instruments (*What are these? See (i) below*)
- which are not already covered by section 25 WpHG and which
- because of their content (*What relation does the instrument need to have to the share purchase? See (iv) below*)
- enable (*What does "enable" mean? See (ii) and (iii) below*)
- the holder or a third party (*When is a third party involved? See (vi) below*)
- to acquire voting shares which have already been issued,

is now required under section 25 a WpHG to report when any relevant threshold is reached, exceeded or fallen below.

In the case of options or similar transactions, the assumption is made that they will be exercised. The explanatory statement indicates that holding financial instruments entitling the holder to acquire other financial instruments (chain purchase) is also covered.

a) Details of reporting duties

(i) Other instruments

The scope of the requirements extends to financial instruments under section 2 (2b) WpHG and to "other instruments".

The explanatory statement merely refers to "other instruments" as all instruments enabling the acquisition of voting shares which are not "financial instruments". Unlike with section 25 WpHG, it is not necessary for the other instruments to be part of a legally binding agreement or even for them to be legally enforceable. This means that virtually all economic and *de facto* positions can be regarded as "other instruments".

(ii) Statutory "enabling" norms

According to the examples given in the relevant statutory texts, an acquisition of shares is made possible in the two following cases in particular:

- The other party in the transaction with the holder could exclude or reduce the risks which may arise under the instruments by holding shares.
- The instruments entitle or require the holder to acquire shares.

The first group covers those instruments where it is possible for the other party to use the underlying shares to hedge the transaction. The explanatory statement says that the issue of whether such hedging takes place and the amount thereof is irrelevant. This group primarily included instruments with a cash settlement clause.

The second group covers those cases in which the shares may be acquired as a direct consequence of the content of the instruments. This includes option writer positions for put options with physical delivery and call options which have not already been taken into account under section 25 WpHG, possibly because the acquisition of the shares underlying the instrument are conditional on certain circumstances or possible future events (such as stock market performance) over which the holder of the instrument does not have exclusive control.

The explanatory statement to section 25a WpHG specified the following positions in particular:

- contracts for difference,
- cash-settled forwards,
- call options with cash settlement,
- option writer positions for put options,
- swaps, including cash-settled equity swaps.

The explanatory statement notes that BaFin may draw up and publish a non-exhaustive list of financial instruments and other instruments as defined in section 25a WpHG to assist with the application of the provisions.

(iii) "Enabling" beyond the statutory norms

The explanatory statement says that instruments make it possible to acquire shares if they are structured in such a way as to enable the holder or any third party to acquire issued voting shares of a given issuer in a *de facto* or *economic* sense.

The instrument does not necessarily need to be based on a legally binding agreement. The explanatory statement makes it clear that the possibility to purchase is deemed to exist regardless of whether the initiative is to come from the holder of the instrument, its contracting partner or a third party, but simple calls to submit offers or promises of a reward do not constitute a "purchase option".

Contrary to the requirements applicable to section 25 WpHG, a report needs also to be made if the beneficiary is only in a position to acquire shares if circumstances occur which are beyond its control. This raises the question of the level of probability which needs to exist so that the beneficiary will actually acquire shares or be in a position to do so.

Does a report also need to be made in the event that it is extremely unlikely that the necessary circumstances will actually arise (option may only be exercised if the DAX rises above 20,000 this year)? If the level of improbability is set high enough, the beneficiary has "no possibility" of making an acquisition in the literal sense.

The provisions on what needs to be reported (*see b below*) demonstrates the need for a restrictive interpretation: the amount to be reported is not linked to the likelihood of an acquisition actually taking place.

(iv) Content of instruments

The content of an instrument must be such that it renders an acquisition of shares possible. The explanatory statement notes that the instrument needs to relate to the relevant shares. This is particularly the case if the existence of the instrument or the potential associated yield is linked to the performance of the relevant shares.

This is the case where the relevant shares are the underlying for the instrument. The broad wording means, however, that this type of transaction may also be subject to reporting requirements in the future even if their performance is only partly based on the price of a particular underlying. The new provisions therefore also cover financial instruments based on baskets or indices. It remains to be seen how closely a share needs to be linked to an instrument in order to trigger any reporting requirements.

An obligation incumbent on a shareholder to submit an "irrevocable undertaking to tender" in a public offer is also of relevance as regards a possible share purchase. This could lead to a reporting obligation of

the beneficiary under section 25a WpHG even prior to the publication of the offer document (the specific reporting obligations set out in the WpÜG apply after this point; *see d) (i) below*).

The wording of section 25a WpHG may also cover purchase rights under share option plans based on specific performance targets, provided that existing shares may be used to satisfy such claims.

We do not believe that the following should be classed as instrument in view of their lack of relevance to share performance:

- agreements on the acquisition of a company holding shares in listed companies where the value of the company is not dependent on the value of the shares in any material way;
- rights of pre-emption and drag/tag-along rights in consortium agreements;
- bequeathment of shares in a will;
- letters of intent.

(v) Holding instruments

Instruments must be "held". "Holding" assumes that that some kind of formal arrangement must have been entered into by the parties concerned, even if this need not necessarily relate to the acquisition of shares. Mere awareness of the existence of an instrument does not mean that such instrument is being "held" by the party concerned.

A "cash-settled option" constitutes an instrument. If a beneficiary is simply offered this kind of agreement, such beneficiary is not regarded as "holding" anything. If, however, the offer is binding for a specific period of time or if the offer is irrevocable, the opportunity to accept this would constitute an option to purchase an instrument and, according to the explanatory statement, this would be viewed as a chain purchase.

Unilateral third-party transactions are difficult to classify as instruments as this might give rise to reporting obligations without any involvement of the party required to meet those obligations.

(vi) Third parties

Another new aspect compared to the government bill was that the reporting obligation also extends to any instruments enabling a *third party* to purchase shares. This further extends the scope of section 25a WpHG. There is, however, a question mark as to whether this aspect will have any independent significance in practice. In view of the broad understanding of "other instrument", which does not need to be based on a legally binding agreement, the assumption can quite often be made that an alleged third party should in fact be regarded as the holder of an "other instrument".

b) Calculation of voting rights

A distinction needs to be made between two different cases when calculating the number of voting rights to be reported under section 25a WpHG.

If the content of the instrument means that it is based on a specific number of shares which the holder of the instrument or a third party is enabled to purchase, this figure will generally be taken as the basis for calculating voting rights.

In all other cases, the number of voting rights to be reported is based on the number of shares which the other party to the transaction would need to hold at the time of the acquisition of the instrument in order for it to be fully hedged. Contrary to the original bill, the new Act interprets this principle to the effect that a delta factor of 1 needs to be applied in accordance with section 308 (4) sentence 2 of the Solvency Regulation (Solvabilitätsverordnung) when calculating the requisite number of corresponding shares.

This means that it is not just "delta 1 products" (forwards, swaps and contracts for difference) which require 100% hedging, but also "volatility products" (options). This runs contrary to the standard practical approach where the scope of hedging required for volatility products is often based on how likely it is that the option will be exercised. The explanatory statement indicates that the issue of whether or not the other party to the transaction has actually hedged the transaction and to what extent is irrelevant in terms of calculating the number of voting rights which need to be reported. Any subsequent adjustments are excluded in view of the fact that the time of acquisition is the key time as regards such calculation.

If the instrument is based on baskets or indices, the number of voting rights to be reported should be calculated on the basis of the weighting of the share in question within the relevant basket or index.

c) Adding together shares and instruments

The voting rights to be reported under section 25a WpHG should be added together with those subject

to reporting requirements under sections 21, 22 and 25 WpHG. The individual holdings in the different categories – i.e. under sections 21, 22 WpHG, section 25 WpHG and section 25a WpHG – must be specified. In view of such aggregation of voting rights, bidders will only be able to build up a holding of shares and (financial) instruments of just under 5% without having to disclose it.

d) Conditions of the reporting duty

(i) WpÜG takes precedence

As with section 25 WpHG, there is no reporting obligation under section 25a WpHG as regards voting rights arising from shares for which a public offer has been accepted under the WpÜG and which are subject to reporting requirements under section 23 (1) WpÜG.

Section 25a (1) sentence 3 WpHG also states that in cases where a public offer is made to shareholders in accordance with the provisions of the WpÜG, this does not mean that an acquisition of such shares is made possible within the meaning of section 25a (1) WpHG.

(ii) Issuer privilege

When calculating the voting rights to be reported under section 25a WpHG, any (financial) instruments held by an investment services company domiciled in a member state of the EU or the EEA are not taken into account, provided those instruments were created following the company's ongoing and repeated issuing activities aimed at many potential subscribers ("issuer privilege", section 25a (3) WpHG).

According to the explanatory statement, these companies often launch a range of these (financial) instruments as part of their business operations. The large number of instruments, whose holder would initially be the issuer, would mean that there would be a large number of notifications which would not help to improve transparency.

The issuer privilege only applies to instruments issued as part of normal business operations. It is stated in the explanatory statement that the privilege does not extend to any instruments entered into outside normal business, such as those issued in preparation for a takeover planned by the investment services company, the extension of a strategic holding or a takeover planned by a client.

The provisions on the issuer privilege leave a lot of unanswered questions. For example, the obligation to take a client's aims into account can only be complied with to the extent that the bank is aware of the client's aims. It is also unclear as to whether the hedging transactions entered into by the bank in order to hedge its risks under instruments issued as part of its normal business operations are also subject to the issuer privilege. Such an issuer privilege does not exist under either the existing provisions or the current version of section 25 WpHG.

(iii) Non-consideration of voting rights and reporting by group companies

Unlike section 25 WpHG, section 25a WpHG only provides for the analogous application of section 24 WpHG (Reporting by group companies). Analogous application of section 23 WpHG (Non-consideration of voting rights) is not provided for. Section 25a (4) WpHG instead provides for the authorisation to issue legal regulations to provide for exemptions from the reporting requirements and to regulate other issues. It remains to be seen how far any future regulations will provide for analogous application of section 23 WpHG.

e) Authorisation to issue legal regulations

The BMF is statutorily entitled to issue legal regulations setting out details of the following and/or to authorise BaFin to do so (section 25a (4) WpHG):

- form and content of the notification.
- the calculation of the number of voting shares pursuant to section 25a (2) WpHG.
- exemptions from the reporting obligation under section 25a (1) WpHG, including as regards those instruments which
  - are held by investment services companies as part of their trading portfolio,
  - are held by investment services companies for the purpose of executing client transactions,
  - are held for a maximum of three trading days exclusively for the purpose of settling and winding up transactions.

It would be preferable for any legal regulations issued in the future to clear up as many of the outstanding issues as possible.

5. Legal consequences of an infringement

Any infringement of the reporting obligations under section 25 WpHG or section 25a WpHG may now be subject to a fine of up to EUR 1 million. This is more stringent than was previously the case, with maximum penalties having been limited to EUR 200,000. Any infringement of sections 25, 25a WpHG will not lead to any loss of voting rights.

This increased fine limit will also apply to any infringements of the reporting obligations under section 21 (1) sentence 1 or 2 or section 21 (1a) WpHG.

6. Coming into force – steps to be taken

The new provisions on the transparency of shareholdings come into force on 1 February 2012.

The new reporting obligations will also apply to those (financial) instruments acquired prior to the new provisions taking effect and which were not previously subject to any reporting obligations.

There is a special, but somewhat unclear, transitional provision which applies to existing holdings of financial instruments and other instruments as defined in section 25a WpHG.

Any party holding on 1 February 2012 instruments within the meaning of section 25a WpHG, the content of which enables *their holder* to acquire voting shares of 5% or more, is required to notify the issuer and BaFin immediately of the (hypothetical) voting right share it may acquire under section 25a WpHG, but no later than within 30 trading days. Any such holding will be added together with holdings under sections 21, 22 and 25 WpHG (section 41 (4d) WpHG). A cautious interpretation of these provisions, as supported by the explanatory statement, suggests that existing holdings of those instruments specified in section 25a WpHG would need to be reported when the 5% threshold is reached as a result of these being added together with holdings under sections 21, 22 and 25 WpHG.

The fact that third parties are not mentioned in the transitional provision of section 41 (4d) WpHG appears to be a statutory oversight. The assumption can be made that the provision also applies to existing holdings of instruments, the content of which enables *third parties* to acquire voting shares.

No explicit transitional provision exists for existing holdings of *other instruments* as defined in section 25 WpHG. In view of the explanatory statement to section 41 (4d) WpHG, it seems to be advisable to report any such holdings on 1 February 2012.

The new Act poses a number of questions, some of which have been touched on above. They include the issues of a *de minimis* provision, reporting obligations where instruments are no longer held, low probability of an acquisition actually taking place, the derivative being loosely based on the reference value, enforced derivatives transactions, use of stock option plans, the significance of provisions extending to third parties, issuer privilege and a lot more. It can only be hoped that the upcoming regulation will provide clear answers.