

March 2011 / Company Law

Intensification of Investment Transparency planned by the Draft of the Investor Protection Act and the Function Improvement Act

*This client information document refers in particular to the **proposed bill to strengthen investor protection and improve functionality of the capital market** (Investor Protection Act and Function Improvement Act), as passed by the Bundestag on February 11th, 2011. On March 18th, 2011 the Bundesrat has approved the proposed bill. The bill has not yet become effective, however, this should happen shortly.*

A.

Previous Regulation and Outline of the Problem

Sec. 25 of the Securities Trading Act (*Wertpapierhandelsgesetz/WpHG*) regulates the notification obligations with respect to the holding of financial instruments regarding shares in a listed company whose country of origin is the Federal Republic of Germany. In accordance therewith, anyone who is unilaterally authorized to acquire shares in the company through the financial instrument within the framework of a legal agreement is required to inform the company and the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht/BaFin*) whenever certain thresholds are reached. This serves to ensure that the company and the investing public are informed that the owner of the financial instrument has the possibility to acquire stocks and to exercise the voting rights resulting therefrom. The goal of this was to prevent an unnoticed “sneaking up” via a delayed acquisition of stocks.

The takeover of Continental AG by the Schäffler group as well as the Porsche’s attempt to takeover Volkswagen AG demonstrated, however, that the current regulation of Sec. 25 WpHG did not fulfill the

goal of investment transparency. During the preparation of the takeover, so-called “cash settled equity swaps” or “contracts for difference” were acquired in relation to the takeover target in these cases. Since the stock acquisition does not solely depend on the owner of the financial instrument, BaFin considers it nonobligatory to announce that certain thresholds have been reached in such cases. The investors could therefore unnoticeably build positions in such financial instruments to provide themselves with a better starting position in the takeover.

The legislator sees a loophole in Sec. 25 WpHG which allows the investors an unwanted and unnoticed “sneaking up”. In the legislative opinion, this can also lead to a reduction of the liquidity in the stock markets and to market distortions. This gap in the Securities Trading Act pertaining to investment transparency should therefore be closed by an alteration of the existing Sec. 25 WpHG as well as the insertion of a new Sec. 25a WpHG.

B.

The Planned Revisions

The revisions include that of Sec. 25 WpHG. This section shall be supplemented with a notification requirement for other instruments which unilaterally allow, within the framework of a legal agreement, the acquisition of shares in the company.

Additionally, the insertion of a new Sec. 25a WpHG is planned, which should fill the demonstrated gap left by Sec. 25 WpHG. According to Sec. 25a WpHG-E, holdings in “financial instruments and other instruments which are not covered by Sec. 25” and the terms of which allow the owner to acquire stock in the company should be disclosed when certain thresholds are reached.

I. Alteration of Sec. 25 WpHG

The notification requirement provided in Sec. 25 WpHG will be broadened to cover the so-called “other instruments”. Such instruments include all agreements which are not covered by the financial instrument term as defined in Sec. 2 Para. 2b WpHG and allow the acquisition of stocks carrying voting rights. Lenders’ reclamation claims from a securities loan and repurchase agreements in securities repurchase deals are included, according to the explanatory statement of the act.

The legislator has refrained from defining the new term “other instruments” as inserted into the WpHG. The legislator may intend to cover every thinkable constellation between two parties, as long as it provides one party with the possibility of acquiring stocks in the future.

II. Insertion of Sec. 25a WpHG-E

The new notification requirement in Sec. 25a WpHG-E includes an expansion of the notification requirements provided in Sec. 25 WpHG. This is relevant for financial instruments or other instruments which are not already covered by Sec. 25 WpHG, as long as their terms allow their owner the right to acquire stocks in a company whose country of origin is the Federal Republic of Germany.

1. Holding of Financial Instruments or Other Instruments which are not covered by Sec. 25 WpHG

A notification requirement applies to the holding of financial instruments and other instruments. This includes both a direct holding by the owner as well as an indirect holding, e.g. via a subsidiary or an administrative trustee; indirectly held financial instruments are attributed to the owner.

a) Financial Instrument or Other Instrument

The term “financial instrument” is legally defined in Sec. 2 Para. 2b WpHG and is the generic term for securities, money market instruments, derivatives and the right to draft securities.

The term “other instruments” covers all instruments which allow the acquisition of stocks carrying voting rights which are not covered by the financial instrument term as defined in Sec. 2 Para. 2b WpHG.

b) No Inclusion in Sec. 25 WpHG

Sec. 25a WpHG-E is to include those financial instruments and other instruments which were not included in Sec. 25 WpHG thus far. Consequently, it is no longer necessary for financial instruments and other instruments to unilaterally and legally bindingly provide the owner with the right to acquire stocks in the company.

2. Enabling of the Acquisition of Stock

Sec. 25 WpHG-E states, however, that the terms of the financial instruments and other instruments must allow the owner or a third party to acquire stock in the company. If the financial instruments allow a third party to acquire stocks, the owner of the financial instruments must also disclose this information. This expansion was included in the revision based on the recommendation of the finance committee.

The legislator exhibits in its explanatory statement that it is sufficient for the owner or a third party to have a factual or economic possibility of acquiring stocks. This is understandable, since a notification obligation for financial instruments and other instruments that grant a legal right to acquire stocks already exists in the previous version of Sec. 25 WpHG.

It is decisive that the possibility of acquiring stocks is provided. The regulation is therefore intentionally general in nature to prevent circumvention. According to the explanatory statement, it is therefore irrelevant whether or not the agreement underlying the financial instrument or the other instrument dictates or allows for a cash settlement to take place instead of a delivery of shares. Precisely such transactions as contracts for difference, swaps such as cash settled equity swaps, call options with cash settlement, option writer positions in put-options and other transactions which allow, at least on the basis of commercial logic, the possibility of acquiring stocks should be included. In addition, financial instruments which apply to baskets or indices are also to be included. Lastly, the legislator intends to explicitly include cases of chain acquisitions of financial instruments as well as cases in which third parties are granted the acquisition of voting rights due to these instruments.

Sec. 25a WpHG-E contains, however, two examples for specification in Paragraph 1 Sentence 2 concerning when the enabling of such a stock acquisition exists. On the one hand, this is the case when the other party in the agreement with the holder of the

instruments is able to eliminate or reduce its risk from these instruments by holding stocks. This concerns constellations in which a hedging is possible for the opposite side. It is not necessary, however, for the opposite side to actually hedge the risk.

In particular, instruments with cash settlements such as cash-settled equity swaps are thereby included, which also played a roll in the Schaeffler/Continental takeover. In addition, stock acquisition should be enabled if the holder of the instrument is provided the right or a requirement to acquire stock. This is especially directed at option writer positions in put options and call options with physical settlements that are not already listed under the reporting requirements of Sec. 25 WpHG. In this concern, Sec. 25a Para. 1 Sen. 3 WpHG-E clarifies that the practice of options or such similar affairs is assumed. The legislator considers it sufficient altogether if the acquisition of stocks corresponds to the commercial logic deducible from the terms of the instrument. An entitlement to stock acquisition does not have to be arranged; however, the instrument must at least bear relation to the respective stock.

The broad regulation, which merely requires “an enabling of stock acquisition”, naturally leads to severe uncertainties when applying the law. The insertion of two example cases can only partially assist in removing these uncertainties. The explanatory statement is also of little assistance, since determining whether or not the commercial logic following the terms of the instrument indicates the possibility of acquiring stocks will be difficult in many cases. The possibility for BaFin to publish a non-exhaustive list of the financial and other instruments which are covered by the regulation, as provided in the explanatory statement, could possibly provide legal certainty.

3. Exceptions

According to Sec. 25a Para. 3 WpHG-E, financial and other instruments which are held by an investment service company are exempt from the notification obligation. It is, however, required that the instruments are held within the framework of an ongoing and repetitive issuance of bonds to multiple customers. This issuer privilege is not applicable, however, if the investment service company holds such instruments outside its business for the preparation of a takeover or to develop a strategic position in its own interest or in the interest of a customer.

According to Sec. 25a Para. 4 No. 2 WpHG-E, further exceptions can be laid down by statutory regula-

tions. The legislator is considering the inclusion of cases which, from the aspect of transparency, are either of little importance or even have a damaging effect.

III. Notification Obligations and the Calculation of Voting Rights

Notification obligations for the holder of such financial and other instruments exist upon reaching, exceeding and falling below the thresholds applicable to voting rights announcements with the exception of the 3% threshold. The entry-level threshold for notification is therefore the 5% threshold.

The legislator arranged for an addition of positions in accordance with Sections 21, 22 and 25 WpHG. The held voting rights in compliance with Sections 21, 22 WpHG are to be summed with the voting rights possibly obtainable due to held financial and other instruments according to Sec. 25 WpHG and, in the future, Sec. 25 WpHG-E. In doing so, the investments corresponding to Sections 21, 22 WpHG are only to be taken into consideration once. However, the notification must contain the values of not only the total sum of the (possible) share of the voting rights, but also each of the individual sums of the shares corresponding to Sections 21, 22 WpHG, the financial instruments and other instruments in correspondence with Sec. 25 WpHG and the financial and other instruments coinciding with Sec. 25a WpHG-E.

In calculating the share of voting rights to be reported, the number of stocks in correlation to Sec. 25a WpHG-E to be taken into consideration corresponds to that which the owner of the instruments or a third party can obtain therewith. If this cannot be determined due to the terms of the instrument, the shares of voting rights can be calculated from the obligatory number of the respective stocks which would have to be held by the other side for its complete protection. Solely the time of the acquisition is of importance; a future adjustment due to changes of the actual hedge position is not to be carried out. In order to prevent circumventions, the legislator clarified, based on the recommendation made by the Finance Committee, that financial institutions which hold such financial instruments must apply a delta factor in the amount of 1 in accordance with Sec. 308 of the Solvency Regulation when calculating the amount of stock necessary for protection (cf. Sec. 308 Para. 4 Sen. 2 of the Solvency Regulation). The shares of voting rights to be reported consequently correspond to the necessary amount of stock that must be held for protection.

Regulations may further clarify the calculation of voting right shares.

IV. Sanctions

If the owner of the financial instruments or other instruments does not issue the required notification or does so incorrectly, incompletely or not in the prescribed form or within the prescribed timeframe, a fine due to administrative offense can be imposed on him in the amount of up to EUR 1,000,000.00. The Finance Committee again increased the threat of fines recommended by the legislator by EUR 500,000 in order to implement a truly rigorous penalty. This serves to meet larger business transactions and their concomitant profit opportunities and to effectively prevent the possibility of circumvention.

The legislator has refrained from the revocation of the voting rights from the stocks (should these actually be acquired in the future) in accordance with Sec. 28 WpHG.

V. Relationship to the Publication Requirements of the Securities Acquisition and Takeover Act

The owner of the financial instruments or other instruments is to be exempt from the notification obligation in accordance with both Sec. 25 Para. 2a WpHG-E and Sec. 25a Para. 1 WpHG-E, as long as he is to disclose of the voting rights from stocks for which an offer has been accepted due to an offer corresponding with the Securities Acquisition and Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz/WpÜG*) in accordance with Sec. 23 WpÜG.

The legislator formed another regulation regarding the relationship to WpÜG in Sec. 25 Para. 1 Sen. 4 WpHG-E, according to which the acquisition of stock within the meaning of Sec. 25 Para. 1 Sen. 2 WpHG-E should not be enabled if an offer corresponding to the WpÜG has been submitted to the shareholders of the target company.

The legislator thus considers the applicable publication obligations of the WpÜG, especially the so-called “status reports”, to be sufficient for the establishment of appropriate market transparency. A “sneaking up” should therefore only be prevented by the transparency requirements of the WpHG. In contrast, instruments which fall under the jurisdiction of Sec. 25 WpHG and Sec. 25a WpHG-E are not to be used in the assessment of whether or not a manda-

tory offer must be given in accordance with the WpÜG.

However, corresponding to the will of the legislator, the amount of the voting rights which are to be reported in accordance with Sec. 25 WpHG and Sec. 25a WpHG-E must also be recorded in the offer document according to the WpÜG. The shareholders should be provided transparency regarding any further commercial positions the bidder may have already established within the target company. The bill therefore also contains a corresponding change to Sec. 2 No. 2 WpÜG-AV.

C.

Digression: Further planned Changes by the Investor Protection Act and the Function Improvement Act

In addition to the regulations regarding investment transparency, the Investor Protection Act and Function Improvement Act contain further aspects, the key points of which will be briefly indicated in the following.

Investment service companies are required to register employees in investment counseling, sales directors and compliance representatives with BaFin. In addition, the issuance of product information sheets to investors is regulated. Lastly, the Investment Act is to be altered with regard to open-ended real estate funds.

D.

Conclusion and Prospect

The legislator intends to make “sneak-ups” from investors in the run-up to company takeovers more difficult with the alteration of the investment transparency in the Securities Trading Act. The commendable goal of market transparency is to be achieved, however, with a very general regulation, the application of which could cause severe legal uncertainty. For this reason, one can only hope that the possibility of making the regulation more concrete will be utilized in a timely and comprehensive manner.

If the regulations in the bill are adopted, however, the changes in Sec. 25 WpHG and Sec. 25a WpHG-E will only come into effect after a transitional period of nine months. This serves to provide those subject to notification obligations, issuers and also BaFin with an appropriate amount of time to prepare for these new regulations.

This client information document contains only a non-binding overview of its topic. It does not replace legal consultation. The following contacts are gladly and readily available for you in this regard and for your consultation:

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