Challenging Wolf Packs: Thoughts on Efficient Enforcement of Shareholder Transparency Rules

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Abstract: The key issue concerning shareholder transparency rules, and the related rules on acting in concert (Europe), or the voting group concept (U.S.) is enforcement. Rather than thinking about appropriate enforcement measures, jurisdictions such as the UK and Switzerland decided in favor of extensive disclosure rules. The current debate in the U.S., on the European and national level of some European jurisdictions is moving in the same direction. This paper examines a different option for the better enforcement of existing transparency rules. It draws an analogy between antitrust cartels and shareholders benefitting from secretly increasing their share in a company. In order to counter secret acquisition strategies, similar to antitrust leniency rules, governments are best advised to assign a premium for disclosure.

Under the self-enforcing model presented here, I argue that the initial stock price reaction reflects the value of the information previously hidden from the market. The first participant of a scheme who discloses the holdings of all scheme participants is to be assigned the difference between the price of the target's voting shares ex ante and ex post disclosure, calculated on the basis of the scheme members' joint holdings of target shares. Distinguishing between schemes based on the equity value of the parties involved (Equity Strategy) – commonly referred to as wolf packs - and schemes where an acquirer seeks to create a large stake based on derivatives (Service Strategy), assigning the announcement premium to the first entity disclosing the scheme's holding and intentions is likely to counter Equity Strategies efficiently. Although not perfect, the announcement premium also renders the Service Strategy less likely.

Keywords: Shareholder activism, hedge funds, private equity funds, hidden ownership, empty voting, enforcement, announcement effect, Premium Claim, derivatives, contracts of differences, equity swaps, cartels, leniency, antitrust, takeovers, mandatory bid, change of control, wolf pack.

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A. Introduction

This paper does not address the question of whether takeovers are beneficial. Takeovers are a legally accepted way in which control in an issuer may change hands and advanced jurisdictions provide for a procedural setting to that effect. Ethical or economic qualifications of takeovers are beyond the scope of this paper. **Nor does this paper discuss whether disclosure of shareholdings, or related conduct, is efficient or desirable.** While the criticism regarding shareholder transparency disclosure does not go unnoticed, it is not the aim of this paper to reconsider *Manne*'s arguments against mandatory disclosure, in general,[2] or other theories holding that market prices aptly reflect any – direct or indirect – increase in shareholdings by investors, or that disclosure rules on major shareholdings (alike other types of inside information[3]) cannot add any further benefit to market efficiency[4] and / or investor protection.[5] **In addition, this paper does not analyze how stock prices respond to disclosure of major shareholdings.** While previous research has shown significant abnormal (short-term) returns upon first-time disclosure of major shareholdings,[6] it is not the task of this paper to

[2] *Henry G. Manne, Henry*, Insider Trading and the Stock Market, New York: The Free Press, 1966.

[3] In a non-technical meaning, the discussion is about undisclosed inside information. See for the trading on negative vs. positive inside information *Kristoffel Grechenig*, The Marginal Incentive of Insider Trading: An Economic Reinterpretation of the Case Law, (2006) University of Memphis Law Review 37, 75; an overview of empirical analyses on trading patterns on inside information provide M. *King & A. Roell*, Insider trading, in: (1988) Economic Policy 6, 163; *Dolgopolov*, Insider trading and the bid-ask spread: a critical evaluation of adverse selection in the market setting, (2004) Cap. U. L. Rev. 33, 83.

[4] For example, this may be due to insiders voluntarily disclosing or forwarding inside information, or specialized analysts detecting inside information; for the former see *Stephen Bainbridge*, The Insider Trading Prohibition: A Legal and Economic Enigma, (1986) 38 U. Fla. L. Rev. 35, at 43 pp.; *Roberta Romano*, Empowering Investors: A Market Approach to Securities Regulation, (1998) 107 Yale L.J. 2359, 2373 pp.; for the latter *Meulbroek*, An Empirical Analysis of Illegal Insider Trading, (1992) 47 Journal of Finance 1661.

[5] For example, *Merritt B. Fox*, Civil Liability and Mandatory Disclosure (2009) 109 Colum. L. Rev. – forthcoming (on SSRN), at 17.

[6] Although the premium for passive investors is smaller, this is true for all types of investor types: **For potential buyers**: *WH Mikkelson & RS Ruback*, An Empirical Analysis of the Interfirm Equity Investment Process, (1985) J. Finan. Econ. 14, 523 (1985); *Clifford G. Holderness & Dennis P. Sheehan*, Raiders or Saviors? The Evidence

analyze the how and why of this stock price reaction. **Moreover, this paper does not address the question of how shareholder transparency rules are or should be designed**, in order to cover long positions stemming from the use of derivatives and other types of indirect shareholdings associated with the terms hidden ownership and empty voting[7] - a question that is widely discussed,[8] due to some high profile cases, inter alia, in the U.S.[9] and Germany.[10] **Finally, this paper does not make any suggestions as to which stock price is fair in the takeover context.** While there may be a significant level of (noisy) trading in the

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on Six Controversial Investors, (1985) 14 J. Fin. Econ. 555 (1985); Steven R. Bishop, *Pre-Bid Acquisitions and Substantial Shareholder Notices*, (1991) 16 Australian J. Manage 1 (1991); f**or activist investors / hedge funds**: *Along Brav, Wei Jiang, Frank Partnoy, Thomas Randall*, Hedge Fund Activism, Corporate Governance, and Firm Performance, ECGI Finance Working Paper No. 139/2006, London 2006 [published in * forthcoming]: abnormal returns of 5% - 7% within 20 days; *April Klein, Emanuel Zur*, Hedge Fund Activism, London 2007: abnormal returns of 10% within 30 days; *Mark Mietzner, Denis Schweizer*, Hedgefeonds and Private Equity: Differences in Value Creation, Oestrich-Winkel (EBS), 2008: abnormal returns with 2 times 20 days; *Robin M. Greenwood & Michael Schor*, Investor Activism and Takeovers (2008), at 29, available at SSRN: http://ssrn.com/abstract=1003792. **For passive investors**: *Christopher Clifford*, Value Creation or Destruction? Hedge Funds as Shareholder Activists (2007), available at SSRN: http://ssrn.com/abstract=971018, at 42 (comparing s. 13D and 13G filings, showing a premium of 1.74% for passive and 3.44% for active investors). These studies are confirmed by 2006 announcements surveyed by the Financial Services Agency, Disclosure of Contracts for Differences, Consultation and Draft Handbook Text (CP 07/20) (2007), annex 3, p. 14. For informed traders who are unlikely to pursue activist strategies (such as mutual funds): *See* Aslihan Bozcuk & M. Ameziane Lasfer, *The Information Content of Institutional Trades on the London Stock Exchange*, 40 J. Finan. Quant. Anal. 621, 631 (2005); *Bishop*, ibid, at 19.

[7] H.C. Hu and B.S. Black, 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership', 13 *J. Corp. Fin.* (2007) p. 343; 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership', 79 *South. Cal. L. Rev.* (2006) p. 811; 'Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms', 61 *Bus. Lawy.* (2006) p. 1011; 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 *U. Pa. L. Rev.* (2008) p. 625; 'Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications', 14 *Europ. Fin. Man.* (2008) p. 663; 'Empty Voting and Hidden (Morphable) Ownership', *M&A Lawyer* (March 2007) at pp. 9-12; 'Debt and Hybrid Decoupling: An Overview', *The M&A Lawyer*, Vol. 1 (April 2008) pp. 4-10.

[8] See, for example, the paper by *Michael Schouten*, The Case for Mandatory Ownership Disclosure in Europe - Empty Voting, Hidden Ownership and the Transparency Directive, Feb 2009 (on SSRN); European Parliament, Resolution of 23 September 2008 with Recommendations to the Commission on Transparency of Institutional Investors, European Parliament (2007/2239(Ini)) (2008).

[9] See U.S. District Court for the Southern District of New York, 11 June 2008, Case 1:08-cv-02764-LAK - *CSX* v. *The Children's Investment Fund (TCI)* -, confirmed by summary order No. 08-2899-cv (2nd Cir. Sept. 15, 2008). See also J. Coffee, 'Regulators Need to Shine a Light on Derivatives', *Financial Times* (30 June 2008) p. 13.

[10] See the Schaeffler –Continental Case *Zetzsche*, Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, EBOR (2009) - forthcoming.

vicinity of takeovers assuming the acquirer's willingness to raise the price of the first bid, it is not the task of this paper to question the *legal* assumption that transparency of major shareholdings supports fair market prices.[11]

Instead, this paper seeks to add insights as to how Goverment's decision in favor of mandatory disclosure of shareholdings can be enforced most efficiently. In doing so I develop a self-enforcing model for disclosure rules regarding major shareholdings.

While acquisitions by one party may be appropriately detected and sanctioned by enforcement agencies, given the paper trail associated with it, regulators face insurmountable difficulties when enforcing transparency rules in the case of certain hidden acquisition strategies. This paper identifies two of these different strategies subject to enforcement issues: the first strategy hereafter referred to as Equity Strategy is an equity-based technique, commonly referred to as 'wolf pack strategy': the acquirer teams up with other acquirers. Each of the team members purchases a share of the target's equity which is close to, yet below, the disclosure threshold for shareholdings. In most cases, regulators cannot prove the team effort since the coordination is based on oral agreements. In contrast, the second technique hereafter referred to as Service Strategy is based on service contracts with a multitude of investment banks. The acquirer enters into derivative contracts according to which the investment bank acquires a significant share in the target, but the economic exposure of these shares is vested in the acquirer. The rights stemming from these shares, if not in its favor, will not be used against the acquirer. At a point in time prior to, or following the takeover bid, the shares will be transferred to the acquirer. While the contracts reveal the economic characteristics of the

[11] Recital (1) of the Directive 2004/109/EC, OJ L 390/38 (2004) ('Transparency Directive') states: "The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency." Recital (2) refers specifically to disclosure of major shareholdings. To what extent the rules fulfill this assumption, is subject to debate among experts. See, for example, *Eilìs Ferran*, BUILDING AN EU SECURITIES MARKET (Cambridge University Press: 2004), at 127 pp.; *Michael Schouten*, The Case for Mandatory Ownership Disclosure in Europe - Empty Voting, Hidden Ownership and the Transparency Directive, Feb 2009 (on SSRN), at 5.

derivative, the documentation typically lacks any side agreement relating to how the investment bank is expected to vote, and how and when the shares will be transferred to the acquirer. Consequently, a lot of speculation surrounding the true content of the respective agreements is characteristic of the Equity and the Service Strategy.

While in many ways incomplete, regulators have made both of the above techniques subject to disclosure rules, for purposes of shareholder transparency rules of Artt. 9 et seq. of the Transparency Directive, and for the threshold prompting a mandatory bid under Art. 5 of the Takeover Directive, the equity-based strategies may meet the ‚acting in concert' test under the laws of the Member States. The service-based strategies may meet the requirements of an 'implicit agreement' under Art. 13 of the Transparency Directive according to which the acquirer may mandate delivery of the shares held by the investment banks, or may be qualified as shares 'held on behalf of' the target under Art. 10g) of the Transparency Directive.[12]

Some regulators intend to reduce the uncertainty with broad-phrased disclosure rules.[13] Extensive mandatory disclosure, however, has other downsides: Since any strengthening of the content of shareholder disclosure rules is likely to reduce investment in information about the true value of an issuer,[14] and consequently reduce the disciplining effect of takeovers, stricter disclosure rules improve life for management, yet leave

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[12] For details, see *Zetzsche*, Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, EBOR (2009) - forthcoming.

[13] Financial Services Agency, Disclosure of Contracts for Differences – Feedback and Policy Statement on CP07/20, CP08/17 (October 2008). See also *Disclosure of Contracts for Difference,* Consultation Paper 07/20 (November 2007) and *Policy Update on Disclosure of Contracts for Difference* (July 2008), available at: http://www.fsa.gov.uk; for Switzerland see Art. 20(2bis) BEHG of the Swiss law on Stock Exchanges and Securities Trading (BEHG) and Artt. 11, 13(1) of the Ordinance of the Swiss Banking Commission on Stock Exchanges and Securities Trading (BEHV-EBK); C.H. Von der Crone, E. Bilek and M. Hirschle, 'Neuerungen im Offenlegungsrecht' (New Developments regarding Disclosure Rules), 80 *Schweizerische Zeitschrift für Wirtschaftsrecht (SZW)* (2008) pp. 1 and 4; U. Bertschinger, 'Finanzinstrumente in der Aktienrechtsrevision – Derivate, Securities Lending und Repurchase Agreements' (Financial Instruments and the Reform of Corporate Law – Derivatives, Securities Lendung and Repurchase Agreements), *SZW* 80 (2008) pp. 208 et seq.; P. Nobel, 'Neues Aktienrecht' (The New Corporate Law), 80 SZW (2008) pp. 175 and 188 et seq.

[14] *S. Grossman & J. Stiglitz*, On the Impossibility of Informationally Efficient Markets, 70 Amer. Econ. Rev. 393, 405 (1980).

the shareholders in the cold.[15] This paper assumes the position that the key issue of shareholder transparency rules – and the creation of an efficient early warning system for future takeovers – is, in fact, one of enforcement.[16] Speculation about the true content of agreements reveals how little is known about the scheme's participants' true motives. This paper examines a different option by developing and analyzing a model that induces scheme members to reveal the content of the respective agreements.

Part C shows that disclosure of major shareholdings **runs counter to the scheme participants' incentives.** Upon disclosure, the target's stock price is expected to experience significant abnormal returns. I refer to this effect as Announcement Premium. Acquirers who otherwise need to pay a higher stock price for further acquisitions avoid paying the Announcement Premium to the sellers by maintaining secrecy. The investment banks financing the deal have reason to be concerned that the transaction will fail if the Announcement Premium is significant and the acquirers' stake is small, due to a higher price for the target's shares. In addition, investment banks can be expected to lose clients in future transactions if they disclose the acquisition on their own.

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[15] Other arguments against broad-phrased disclosure rules include potential law suits and discouragement of overall monitoring: European Commission, Report on More Stringent National Measures Concerning 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, SEC (2008) 3033 final (2008), at 10; *H. Fleischer and K. Schmolke*, 'Kapitalmarktrechtliche Beteiligungstransparenz nach 21 ff. WpHG und "Hidden Ownership"' (Securities law-based Transparency of Shareholdings under ss. 21 et seq. WpHG and Hidden Ownership) 29 (33) *Zeitschrift für Wirtschaftsrecht* (*ZIP*) (2008) p. 1501 et seq.; *Jonathan R. Macey & Jeffrey M. Netter*, Regulation 13D and the Regulatory Process, 65 Wash. U.L.Q. 131, 144 (1987); *Bernhard Black*, Next Steps in Corporate Governance Reform: 13D Reuls and Control Person Liability, in: K. Lehn & R. Kamphuis eds., MODERNIZING US SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES (1992), at 201 (raising concerns that institutional investors may be discouraged from monitoring).

[16] *Reinhard H. Schmidt, Gerald Spindler*, FINANZINVESTOREN AUS ÖKONOMISCHER UND JURISTISCHER PERSPEKTIVE (transl. Financial investors from an economic and legal perspective), Nomos: 2008, at p. 250 ¶198, arguing that proving acting in concert is "incredibly difficult."; *Michael Schouten*, The Case for Mandatory Ownership Disclosure in Europe - Empty Voting, Hidden Ownership and the Transparency Directive, Feb 2009 (on SSRN), at 34, 37 et seq. (highlighting the issues surrounding the application of existing rules).

Part D holds that traditional enforcement of shareholder transparency rules is ineffective. Effectiveness of ex ante enforcement relies on ex post enforcement. The available sanctions either deprive shareholders of a bid altogether, or of the market test that a lawfully disclosed acquisition would provide. Most importantly, traditional enforcement does not overcome issues associated with the burden of proof. Since documentation is scarce, regulators are limited to speculation which rarely withstands a critical review in court.

Part E presents an incentive-based system for the enforcement of shareholder transparency rules.

Due to inefficient enforcement, refraining from disclosure is inexpensive, in relative terms. An efficient regime is to increase the costs for participants' remaining silent to a level where it matches the costs of early disclosure. At the same time, the scheme participants have the best knowledge about the scheme, they avoid the cheapest costs; yet they have the weakest incentives to disclose. In that regard, the situation is analogous to antitrust cartels. In contrast to cartels, however, participants in the Equity and the Service Strategy do not benefit more the longer the strategy has been undetected. At a certain point in time, the acquirers need to go public in order to profit from their strategy. Since this limited period of time for making the respective strategy work makes it harder to detect the hidden activities, the incentives for going public must be greater, in relative terms, than antitrust leniency programs.

In order to overcome the adverse incentives, I propose a self-enforcing enforcement model based on three assumptions. Pursuant to that model, the Announcement Premium from the joint shares of all scheme participants is assigned to the first party who discloses the scheme and the related intentions of the scheme members (hereafter referred to as Premium Claim). The larger the share collectively held by scheme participants, the greater the incentive for disclosure. The Premium Claim creates a Prisoner's Dilemma among scheme members (albeit that communication among them is possible).

For the Equity Strategy, my model most likely results in an equilibrium under which no participant is willing the scheme's holdings to surpass disclosure thresholds for fear of being cheated upon by other members that seek to cash-in the Premium Claim. The law can render counter-measures such as requiring security for participation void at low costs. **For the Service Strategy,** my model is less effective than the Equity Strategy. Due to reputational restraints, the financial intermediaries involved are in a certain way closest to *Robert Axelrod*'s perennial players. Banks cheating on their clients by early disclosure is unlikely. However, two side effects may nevertheless further disclosure: 1) One bank may seek to harm a competitor by demanding the Premium Claim. Anticipating this probability, other banks may be unwilling to take the risk and avoid participation. 2) Some banks not associated with the scheme may be willing to disclose well-substantiated rumors (i.e. rumors founded on evidence proprietary to the bank), in order to capitalize on the Premium Claim and in order to gather business from target's management. Although not perfect, my model increases the costs of secrecy and the likelihood of disclosure for both the Service and the Equity Strategy.

B. The Dilemma – Adverse Incentives in a Multiparty Environment

In order to secretly build up a significant stake in an issuer whose shares are traded at regulated markets, acquirers employ - separately, or jointly, as the case may be -[17] two strategies: the Equity Strategy (infra B.I.), or the Service Strategy (infra B.II.).

I. The Equity Strategy: Wolf Packs

The first strategy is an equity-based technique.

[17] In CSX ./. TCI (supra note 9), TCI held a large stake of up to 14% indirectly based on the Service Strategy, while TCI was acting in concert with another hedge fund (G3) that held approx. 5% of CSX shares.

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1. Key Driver: Equity Value

Its key feature is that each participation is driven by an expected increase in the value of its equity share in the issuer. This increase may be the result of the announcement effect,[18] a potential restructuring of the firm pursued by existing management under pressure exerted by the scheme participants,[19] or by new management following the takeover of the target by scheme members.[20]

The participants accrue additional benefits if they seek to take over the company. Under the European mandatory bid-rule of Article 5 of the Takeover Directive[21] upon assembling a stake that carries control (which is, in most cases, defined as the acquisition of 30% or one-third of the issuer's voting rights),[22] participants are required to issue a mandatory bid for all outstanding shares at a price that relates to the weighted average stock price for a certain period of time prior to the bid, and that is at least as high as the highest price previously paid to another seller (at the stock exchange or beyond).[23] Given that the share price increases upon

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[18] See references supra note 6.

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[19] This was the likely driver of TCI's strategy in CSX ./. TCI (supra note 9).

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[20] Please note that takeovers do not constitute the usual behavior of hedge funds.

[21] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids; OJ L 142/12-23 (30 April 2004).

[22] See Article 5 (3) of Directive 2004/25/EC, supra note 21: "The percentage of voting rights which confers control for the purposes of paragraph 1 and the method of its calculation shall be determined by the rules of the Member State in which the company has its registered office." For details across Member States see European Commission, Report on the Implementation of the Directive on Takeover Bids, SEC (2007) 268, at Annex 2 (acquisition of 30% of voting rights required by Austria, Belgium, Cyprus, Germany, Finland, Ireland, Italy, The Netherlands, Spain, Sweden, UK; one-third of the voting rights require Portugal, Slovakia, Luxembourg and France).

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[23] See Article 5 (4) of Directive 2004/25/EC, supra note 21: "The highest price paid for the same securities by the offeror, or by persons acting in concert with him/her, over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid referred to in paragraph 1 shall be regarded as the equitable price. If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired. Provided that the general principles laid down in Article 3(1) are respected, Member States may authorise their supervisory authorities to adjust the price referred to in the first subparagraph in circumstances and in accordance with criteria that are clearly determined. To that end, they may draw up a list of circumstances in which the highest price may be adjusted either upwards or downwards, for example where the highest price was set by agreement between the purchaser and a

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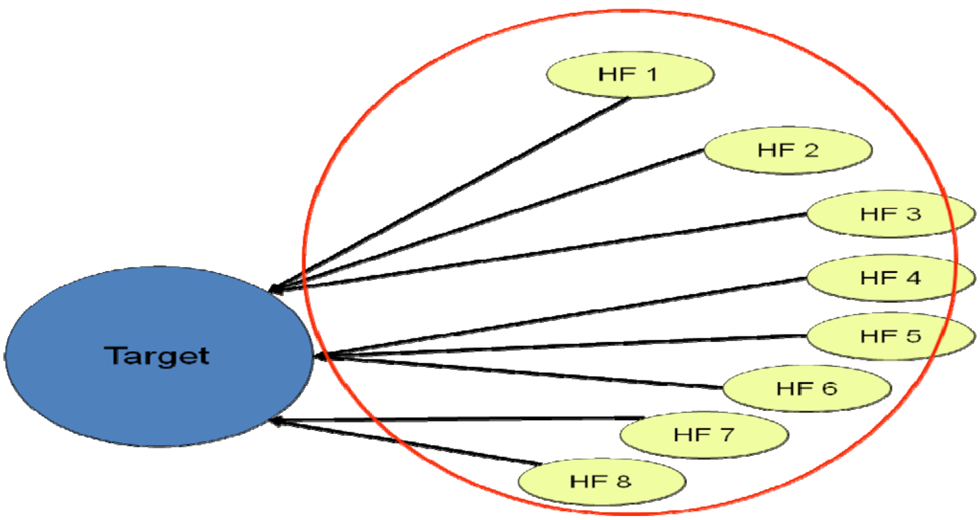
announcement of the major shareholding, creating a large stake prior to disclosure reduces the minimum price for the mandatory bid. In the U.S., where acquisition of control does not prompt a mandatory bid, the same is true if the secretly assembled stake grants control over the company. Given that control has changed hands and that enforcement is inefficient, defensive measures are useless. Management can be expected to step aside with no further opposition.

2. Co-ordinated Efforts

In order to secure the above benefits, the acquirer teams up with other acquirers. Each of the team members purchases a share of the target's equity which is close to, yet below, the disclosure threshold for major shareholdings.

Fig 1: The Equity Strategy



This paper is not about drafting new rules but enforcing existing ones; it does not take a stand in the discussion surrounding the beneficial or harmful effects regarding mandatory disclosure of acting in concert, or voting groups. While not all jurisdictions subject all forms of cooperation to

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seller, where the market prices of the securities in question have been manipulated, where market prices in general or certain market prices in particular have been affected by exceptional occurrences, or in order to enable a firm in difficulty to be rescued. They may also determine the criteria to be applied in such cases, for example the average market value over a particular period, the break-up value of the company or other objective valuation criteria generally used in financial analysis."

mandatory disclosure,[24] the conduct hereafter referred to as Equity Strategy describes a situation in which the cooperation among acquirers of shares must be disclosed under the respective national laws if it is to meet the disclosure threshold while each member's stake stays below the disclosure threshold.

II. The Service Strategy

1. Co-ordination by Derivatives

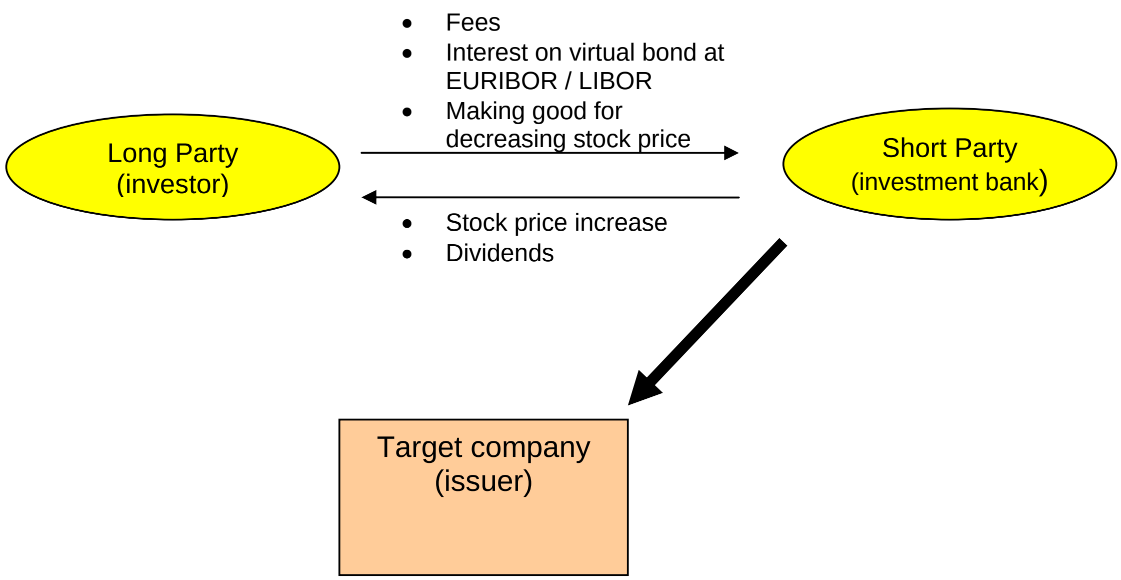
Under the Service Strategy the acquirer enters into derivative contracts with investment banks which lead to a legal situation in which the share hedges held by the investment banks count as shares held by the acquirer. Again, while the total accumulated stakes held by different investment banks exceed the disclosure threshold, each bank's stake stays below the disclosure threshold.

For example, this situation may be achieved by entering into Contracts for Difference / Cash-settled Total Return Equity Swaps. Under a swap agreement, two cash flows stemming from reference values are exchanged, or 'swapped'. Typically, one reference value is that of a virtual bond whose yield refers to state bank lending terms – in Europe at the Euro Interbank Offered Rate (EURIBOR) or the London Interbank Offered Rate (LIBOR) + x% – while the other reference value is cash flow from a quoted stock (e.g. the target's shares) reflected in its stock price and dividends respectively. One swap party – the 'Short Party' – pays out the difference between the cash flows to the other swap party – the 'Long Party' – when the stock price increases, while the Long Party makes good to the short party any loss in value when the stock price decreases. Normally, investment banks function as professional swap counterparties. The banks are not interested in bearing the risk stemming from the derivative contract. In order to even out its risk, the Short Party may enter

[24] Seefor Europe European Commission, Report on More Stringent National Measures Concerning 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, SEC (2008) 3033 final (2008), at 10; CESR, Summary of responses to Questionnaire on Transposition of the Transparency Directive,CESR/08-514b (2008).

into derivative contracts with other banks, or purchase the underlying shares. In addition to the Long Party's obligations stemming from the swap itself, an investment bank receives interest on the capital invested for its hedges, and swap fees for running the swap (*infra* Figure 2).

Fig 2: Contracts for Differences ('CFD') / Cash-settled Total Return Equity Swap:



Under this scheme, the Long Party bears the economic risk, while the Short Party holds the shares. The Short Party is generally deemed shareholder under the respective disclosure rules. As of now, most disclosure rules do not cover the Long Party's sole economic exposure;[25] instead, they require some additional influence over the voting power of the underlying shares.[26] While the legal qualification may vary, the same

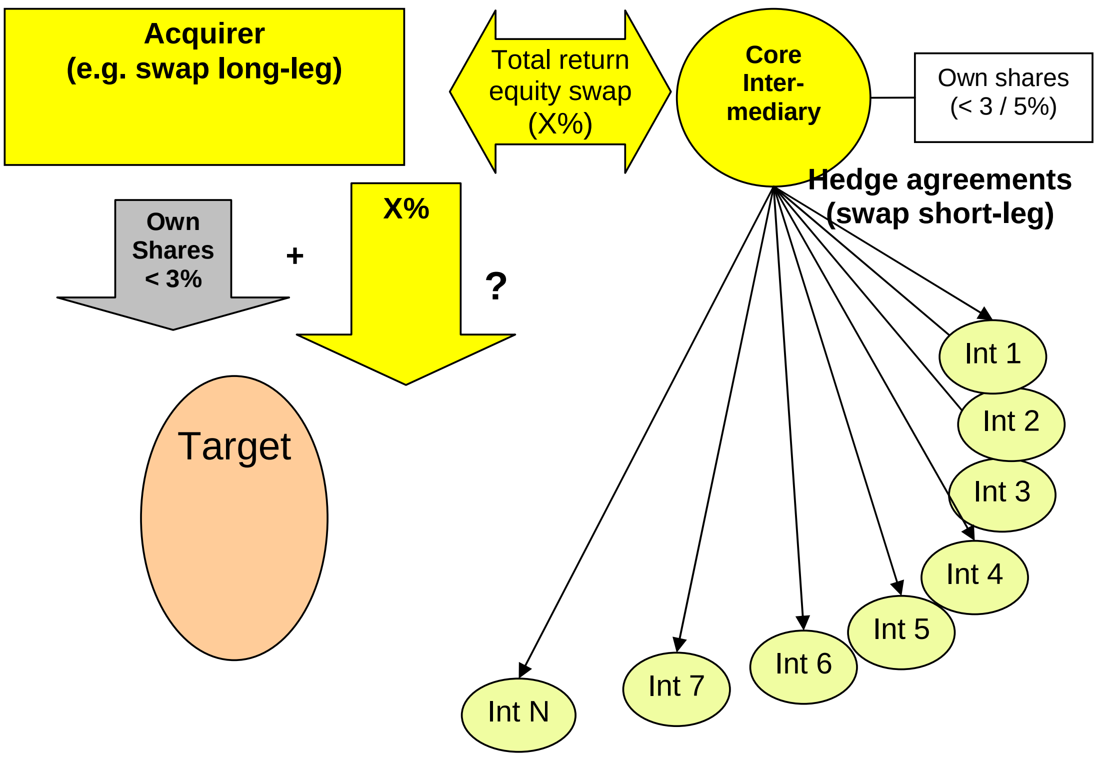
2525 Exceptions apply to Switzerland; the British FSA announced an integrated disclosure regime coming into force for Fall 2009, see supra note 13.

26 For the U.S., see Rule 13d-3(a) under the Securities Exchange Act, 17 C.F.R. 240.13d-3(a): "A beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding relationship, or otherwise has or shares: (i) voting power which includes the power to vote, or to direct the voting of, such security; and/or, (ii) investment power which includes the power to dispose, or to direct the disposition of, such security; the accepted interpretation of Art. 7 sent. 1 No. 1 of the (first) Transparency Directive 88/627/EC and Art. 10g of the (second) Transparency Directive among German securities lawyers is that a contractual scheme will lead to the short counterparty holding shares on the long counterparty's behalf if the long party (1) bears the economic risk of the underlying shares, and (2) is capable of influencing how voting rights are exercised, see Koppensteiner, Appendix to s. 20 AktG,

economic characteristic may be achieved with any type of derivative contract, in particular with put and call options.

If the acquirer seeks to avoid disclosure rules, it may create a derivative scheme for a significant part of the target's shares with one investment bank (hereafter referred to as Core Intermediary). The Core Intermediary holds a stake below the disclosure threshold itself, and is hedged by derivative contracts with other investment banks, which in turn hold stakes below the disclosure threshold (*infra* Figure 3).

Fig 3: Service Strategy with Cash-settled Total Return Equity Swap / CFD[27]



Commentary to ss. 21 et seq. WpHG, in U. Noack and W. Zöllner, eds., Kölner Kommentar zum Aktiengesetz, 3rd edn., at n. 18; U.H. Schneider, Commentary to s. 22 WpHG, in H.D. Assmann and U.H. Schneider, eds., Wertpapierhandelsgesetz, 4th edn. (Cologne, Otto Schmidt, 2006) at n. 45; for Portugal see the interpretation of s. 20a of the Portuguese Securities Code by the Portuguese securities regulator CMVM in re Portugal Telecom and Semapa, see http://web3.cmvm.pt/sdi2004/emitentes/docs/FR3120.pdf.

[27] Based on Schaeffler's scheme preparing for the takeover of Continental AG.

Please note that the investment banks do not need to know what is happening. However, it is likely that the core intermediary is aware of what is happening; this is particularly true if the derivative position exceeds certain limits.[28] While the Long Party could enter into derivative contracts with all intermediaries itself, it needs to manage multiple hedging relationships and make sure that none of the positions, together with the proprietary trading positions, and the positions of other clients of the respective intermediaries, do not exceed the disclosure threshold. Handling this requires skill and effort, both of which exist at investment banks.

2. Key Drivers

The originators' incentives are essentially the ones provided by the equity scheme (supra B.I.1.); however, the incentives to maintain secrecy are greater when compared to a straight-forward acquisition based on the fact that the originator's position in the target's share is leveraged due to the derivative contracts.

In contrast, the intermediaries' position regarding the target is hedged (supra B.II.1.). They benefit neither from an increasing, nor a decreasing stock price. Being involved in, or running, a derivative scheme constitutes a viable business strategy itself. The investment banks' benefits comprise of four factors:

1) Swaps fees are typically a fraction of the swap value at the beginning and at the termination of the swap. Given that the value of the swapped stock is greater in the future (because a lesser number of shares are available for trading at the markets when compared to a state without the scheme), the longer the derivative scheme is maintained, the greater the investment bank's profit is. Moreover, please note that creating the derivative-based scheme will require time. It is estimated that an acquirer can purchase up to

[28] It is said to be customary in the City in London that the Long Party explains its motives to the Short Party when the long positions exceed a stake of 15% of the issuer's equity.

a third of the daily trading volume without significantly impacting on the market price, and without the markets and the issuer noticing. Consequently, the total of swaps entered into at the beginning is less than the swap total at a point in time in the future. The more stocks are subject to the swap scheme, the greater the investment bank's profit. Finally, also note that drafting the respective derivative contracts is costly; negotiating these contracts for the first time induces the largest share of transaction costs. From the bank's perspective derivative schemes exhibit significant economies of scale.

2) The same argument applies to the interest that the Long Party pays: in the absence of defaults and deteriorating credit risk, the longer the derivative contract is maintained and the larger the overall swap volume, the greater the investment bank's profit is.

3) During or following the takeover, most acquirers need acquisition finance. While we currently experience difficulties in the market for acquisition finance due to the subprime crisis,[29] acquisition finance was a profitable banking market in the past, and it may be one in the future.

4) Finally, client-orientation adds to the bank's reputation as service-oriented entity. The advantages of client-orientation may exceed the circle of clients, since the people involved can be expected to be intertwined with other business entities. For example, we frequently see the names of Merrill Lynch[30] and Deutsche Bank[31] in large-scale derivative transactions.

[29] See *Kaplan/Stromberg*, Leveraged Buyouts and Private Equity (2008), online http://www.ssrn.com/abstract=1194962; as a result, acquirers seek to avoid living up to their promises which explains more cases coming to court than used to do. See for example *Hexion Specialty Chemicals, Inc., v. Huntsman Corp.*, C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008).

[30] FIAT-IFIL-EXOR (Italy); Schaeffler ./. Conti (Germany); Porsche AG's acquisition of Volkswagen AG (Germany).

[31] *Perry* v. *Ithaca (Custodians) Ltd,* Court of Appeal, New Zealand, *Perry Corporation* v. *Ithaca (Custodians) Ltd*, 4 November 2003, [2005] Part 4 Case 11 [NZCA]; *CSX* v. *TCI*. (supra note 9); the merger of Compaq and Hewlett Packard (U.S.): In August 2003, the SEC fined Deutsche Bank for failing to disclose to its mutual fund investors a material

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III. Disclosure vs. Economic Incentives

The above incentives depend, to a certain extent, on secrecy. Upon early disclosure, a sudden stock price that is greater than expected may lead to termination of the transaction. In this case, the acquirer's previous investments in information and acquisition finance (interests, swap fees etc.) are lost. Moreover, the announcement premium prompted by disclosure reduces the benefits of the overall transaction since the acquisition of additional shares requires a greater investment when compared to a state of non-disclosure. (Early) disclosure also impacts on the investment banks: if the risk of termination materializes, the profits from the derivative scheme end, and the bank is prevented from further capitalizing on the economies of scale associated with derivative schemes (supra C.II.). Moreover, unsuccessful transactions do not require acquisition finance and do not add to the banks' reputation to the same extent as successful transactions do.

Mandatory disclosure of major shareholdings runs counter to the incentives of all parties involved in the Equity or Service Strategy. All participants are better off if secrecy can be maintained, and the timing of disclosure is determined by the parties' plans rather than by law.

C. Inefficiency of Traditional Enforcement

The above considerations disregard one important aspect of the participants' calculations - enforcement. Regulatory risk may prove costly. These costs include expenses for legal defense, time and effort for dealing with regulators, and sanctions such as fines, criminal sanctions, or civil liability. However, only efficient enforcement is capable of countering the economic incentives for maintaining secrecy. Does traditional enforcement meet this requirement?

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conflict of interest with regard to its vote on the proposed HP/Compaq merger. The success of the merger depended on the vote. See 'SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with Its Voting of Client Proxies for Merger Transaction; Imposes $750,000 Penalty', *SEC* (19 August 2003), available at http://www.sec.gov/news/press/2003-100.htm.

I. Traditional Enforcement

Enforcement that seeks to detect secret acquisition strategies prior to their disclosure (**ex ante enforcement**) comprise of 1) market supervision by arithmetic models through which regulators seek to detect suspicious trading patterns in stock markets, 2) obligations imposed on investment firms and / or their managers to comply, or blow the whistle, and 3) case-specific examination of rumors. The latter may be pursued by questioning individuals who are deemed to be involved. Enforcement action after disclosure of significant shareholdings (**ex post enforcement**) may result in sanctions such as forfeiture of shareholder rights, civil damages, administrative and sometimes even criminal sanctions. Variants of ex post enforcement constitute **the cooling-off period**, i.e. a regulator bans the acquirer from issuing a bid, or further acquisition of shares. Regulators may also require the scheme participants to **sell their shares** (over the stock exchange, or to someone else, as the case may be). In addition, financial intermediaries and other entities subject to licensing may lose their license for financial services; the individuals involved may be subject to director disqualification and/or administrative or criminal sanctions.

II. Inefficiency

Traditional enforcement of shareholder transparency rules does not turn the incentives against disclosure into a pro-disclosure situation.

1. Co-relation of Ex ante and Ex post Enforcement

Under the strategies described above, the individual's intentions and the inter-personal relationship between different legal entities mandates disclosure. Even assuming that technical devices would provide for a perfect market oversight – which is not the case for a number of reasons relating to the chain of intermediaries that act worldwide on behalf of multiple clients -[32], without information on the subjective side, enforcement

[32] With respect to shareholder identification, I Gómez-Sancha Trueba, "Indirect holdings of securities and exercise of shareholder rights (a Spanish perspective)", (2008) 3 *Oxford University Capital Markets Law Journal* 32; M Kahan & E Rock, "The Hanging Chads of corporate voting,", (2008) 96 *The Georgetown Law Journal* 1227; Paul Myners, *Review of the impediments to voting UK shares – report to the Shareholder Voting Working Group*

reveals different entities acquiring a number of shares which may be related to each other, or not. Trading patterns rarely reflect these personal relationships clearly.

With respect to **whistle blowing**,[33] given that we do not see it in the context of acquisition strategies, the reputational loss associated with whistle blowing can be assumed to be greater than the threat provided by sanctions. There is good reason to assume that blowing the whistle will only come into practice if the unlawful behavior is likely to be (severely) sanctioned at a later point in time. In the absence of sanctions being provided in the future, from the perspective of the financial services firm, the risk-adjusted profit from whistle blowing the is zero, while the reputational loss is significant. The same is true on the individual level: unless actors are driven by morality, or conflicts with other people involved,[34] whistle blowing is unlikely to happen, or at least, it is unlikely to happen early. For the same reason, regulatory proceedings ex ante have little prospect of revealing relevant agreements if the respective behavior is unlikely to be sanctioned in the future. Effectiveness of ex ante measures depends on the effectiveness of ex post enforcement.

2. Ex post enforcement: No Market-Based Pricing

For the most part, the above sanctions do not change the fact that the acquisition has not been priced by the market, as it would have been if the acquisition was disclosed appropriately. Enforcement does not make the takeover subject to a true market test that enables market participants to

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(1/2004), while improvements are reported in the 2008 update; RC Nolan, "Indirect Investors: A Greater Say in the Company?", (2003) 3:1 *Journal of Corporate Law Studies* 73; *Matthias Siems*, Convergence in Shareholder Law (Cambridge University Press: 2008), at 133-138; D *Zetzsche*, Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive, (2008) 8:2 *Journal of Corporate Law Studies* 289.

[33] See on whistle blowing *James Fanto*, Whistleblowing and the Public Director: Countering Corporate Inner Circles, (2004) Oregon L. Rev. 83:2, 435; *Grechenig*, Positive and Negative Information - Insider Trading Rethought, in: Gregoriou/Ali, Insider Trading - Global Developments and Analysis (CRC Press 2009) 245, chapter 15.6. The 1998's British Public Interest Disclosure Act provides for "protected disclosures" cases involving investment banks include *Bhatia v Sterlite Industries* (2001) and two cases related to investment bank Nomura.

[34] This has caused psychologists to examine the topic, see *Sydney A. Fine*, Whistle Blowing and Industrial Psychology, (2006) The Industrial-Organizational Psychologist 43:3, at 21.

assess the consequences and the seriousness of the takeover attempt.[35] If these measures are applied, competitors are deprived of the time necessary for planning and issuing a competing bid. Both aspects result in a lesser number of competing bids than is desirable, from the shareholders' perspective. Moreover, once the acquirers' stake has passed the control threshold by virtue of hidden strategies, their interest in acquiring further shares may be limited. They may issue a mandatory bid at the minimum price.

Banning the acquisition altogether, or mandating a cooling-off, may deprive shareholders of a bid altogether. Although not on the market-adjusted terms, any bid provides an option to the shareholder and signals under-valuation to the market. In particular, in downward market cycles, a bid following a secret acquisition strategy may be the better option for shareholders when compared to a state in which there is no bid.[36] Moreover, while there may be signaling effects and a possible transfer of proprietary information to other acquirers, if the bid is prohibited from going through, the acquirers' investment in information and financing is reduced in value, which, from an overall perspective, may be wasteful.

3. Burden of Proof

Probably the most relevant downside of traditional enforcement measures is that these measures do not overcome issues associated with the burden of proof. Since documentation is scarce, regulators are doomed to speculate about the likely content of underlying agreements; speculation rarely stands a critical review in court. The difficulties with evidence have prompted commentators[37] to argue in favor of a shift in the burden of

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[35] Admittedly, demand created from Equity and Service Strategies can be expected to support the target's share price even in the absence of disclosure.

[36] This was the case in the Schaeffler's bid for Continental, see *Zetzsche*, Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, EBOR (2009) - forthcoming.

[37] For example, *Reinhard H. Schmidt, Gerald Spindler*, FINANZINVESTOREN AUS ÖKONOMISCHER UND JURISTISCHER PERSPEKTIVE (transl.: Financial investors from an economic and legal perspective) Nomos: 2008, at p. 250 ¶199.

proof, and some lower courts[38] as well as regulators[39] have followed suit. These institutions held that in certain situations a *prima facie* evidence suffices. Shifting the burden of proof has obvious disadvantages: generally speaking, the risk is imposed on the acquirer that any conduct is deemed unlawful. Such a scheme would render takeovers unlikely, and reduce incentives for information production about under-valued issuers. Moreover, the regulators' task is assigned to the acquirers. The fact that acquirers may be deemed to be culprits (with related administrative or criminal sanctions) in the absence of evidence or confessions prompts constitutional concerns. When subject to appeal, shifting the burden of proof partially or entirely to the acquirer has not withstood a critical review.[40]

D. A Self-Enforcing Model

A self-enforcing model may turn out to be the better option.

I. The Antitrust Analogy

The incentive structure of the actors participating in a scheme is similar to the incentives of cartel members prior to the detection of the cartel by

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[38] See the court of first instance in re *Perry vs Ithaca*, [2003] 2 NZLR 216 (*Potter J*), revised by Court of Appeal, New Zealand, *Perry Corporation vs Ithaca (Custodians) Ltd.*, [2005] Part 4 Case 11 [NZCA], No. 21, 25.

[39] This is true for the Portuguese securities regulator CMVM in the cases of Semapa and Portugal Telecom, where the CMVM concluded from voting behavior that agreements existed. Similarly, the Italian regulator CONSOB applied such as doctrine when concluding that an implicit agreement existed in the FIAT-IFIL / EXOR case, See L.Curran and F. Turitto, 'Fiat/ Ifil: The Securities Law Implications for Equity Derivatives', 21:7 *Journal of International Banking and Financial Law (JIBFL)* (2006) p. 298; G. Ferrarini, *Prestito Titoli e Derivati Azionari nel Governo Societario in Balzarini/Carcano/Ventoruzzo, La società per azioni oggi: Tradizione, attualità e prospettive.– Vol II* (The corporation today: tradition, presence and future), (Venice, Giuffrè 2007), at 629 and 663 pp.; S. Bragantini, 'Se l'equity swap dribbla la comunicazione', (When equity swaps dribble the communication) *(Lavoce)* (25 September 2005), with the response by Gabetti *(Lavoce)* (25 September 2005), available at: http://www.lavoce.info. For the CONSOB decisions against Ifil (market manipulation) see Delibera (decision) n. 15760, 9 February 2007; against Exor (wrongful disclosure) see Delibera n. 16068, 1 August 2007; and against Merrill (wrongful disclosure), Delibera n. 16248, 1 December 2007, available at: http://www-consob.it. Ifil, Exor and Merrill appealed to the CONSOB decisions at the Corte D'Appello di Torino [Torino Court of Appeal]. On 5 December 2007, the sanction against Ifil was upheld, while the sanction against Exor was rejected due to a procedural problem, see Case 214/07 VG, available at: http://www.consob.it/main/documenti/decreti_ca/2007/ca_20071205_torino_IFIL.htm.

[40] See references supra notes 38 and 39.

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antitrust authorities. When dealing with cartels, antitrust law provides for leniency, i.e. the first antitrust violator disclosing the scheme benefits from lenient regulatory treatment.[41] Leniency aims to destabilize cartels: if one cartel member can benefit from harming others, it may as well seek certainty in the arms of the regulator rather than continuing to bear the (uncertain) risk that others members cheat on the cartel. Equity and Service Strategies run an information cartel regarding major shareholdings. We may as well borrow the idea from antitrust that a premium is an apt measure for destabilizing the information cartel.

In contrast to cartels, however, the Equity and Service Strategy does not limitlessly benefit from secrecy. While secrecy is necessary for a certain period of time in order to assemble the significant stake in the issuer,[42] at a certain point in time, acquirers need to go public in order to profit from their strategy. The announcement premium, governance changes due to coercion by the acquirers, or strategic changes following a takeover require open activity. The secret informational advantage must be transformed in real-world premiums.

Given that it is more likely that one colluding scheme member deviates from the agreements the longer the scheme is run, when all other factors (the number of team members, the profits etc.) are equal, the short period of time required for successfully applying the Equity or Service Strategy makes it particularly hard to reveal hidden acquisitions. Therefore, the incentives for going public have to be greater, in relative terms, when compared to antitrust leniency programs.

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[41] *Maria Bigoni, Sven-Olof Fridolfsson, Chloe Le Coq, & Giancarlo Fines Spagnolo*, Leniency, Rewards and Organized Crime: Evidence from Antitrust Experiments (20/05/2008). SSE/EFI Working Paper Series in Economics and Finance No. 698 . Available at SSRN: http://ssrn.com/abstract=1134725; *Panizza*, ZEITSCHRIFT FÜR WETTBEWERBSRECHT 2008, 58; *Wouter P. J. Wils*, Leniency in Antitrust Enforcement: Theory and Practice. (2007) World Competition: Law and Economics Review, 30:1. Available at SSRN: http://ssrn.com/abstract=939399; *Wissmann/Dreyer/Witting*, KARTELL- UND REGULIERUNGSBEHÖRDLICHE ERMITTLUNGEN IM UNTERNEHMEN UND RISIKOMANAGEMENT (transl.: antitrust and regulatory proceedings and risk management) (2008), Chpt. 5 and 8; *Nicolo Zingales*, European and American Leniency Programme: Two Models Towards Convergence?. Available at SSRN: http://ssrn.com/abstract=1101803.

[42] In the case of TCI, the Derivative and Equity Strategy was pursued for as long as 18 months; albeit the level of disclosure varied. Schaeffler pursued its Derivative Strategy for approx. six months prior to disclose.

II. Key Assumptions

In determining which premium should be assigned to the first discloser, I make three assumptions:

First, I assume that there is **no hard evidence** regarding the specific violation of disclosure rules. Whether regulatory pressure is successful primarily depends on one scheme participant cheating on the others by admitting the existence of the scheme to regulators, or by publicly disclosing the major shareholding earlier than other participants expected. The relatively few cases in which backward-oriented regulatory diligence resulted in regulatory sanctions, provide a factual foundation for this assumption.

Secondly, I assume that the longer the acquisition strategy remains undisclosed, the larger the proportion of the target's share the members can assemble without the market noticing is.

Third, I assume that stock prices will respond to first time disclosure of major shareholdings by significant abnormal returns. I disregard any price adjustment resulting from the strategic or industrial logic of the takeover. While studies show significant abnormal returns in case of disclosure of hedge fund activity,[43] it is unclear what prompts these effects, given that the same studies show significant abnormal losses one year following these disclosures. One would expect markets to anticipate these long term losses and even out abnormal returns, in the first place. For the purposes of this model, this riddle is willfully disregarded.[44]

III. Defining the Premium

Given that all participants invest in the target's shares, the joint holding of the group exceeds the holding of each individual. If there is a significant stock price reaction upon announcement of the major shareholding, each individual scheme member benefits from the Announcement Premium to the same extent as it holds shares in the issuer. The group's collective

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[43] *Supra* note 6.

[44] For qualifications see infra E.

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profits are greater than each of the individual's profits; they are the sum of each member's profits.[45] I suggest that law assigns the Announcement Premium on the shares held by the group to the first scheme participant disclosing the scheme to the market. I hereafter refer to the discloser's claim stemming from this legal distribution of cash-flows as 'Premium Claim'.

The Premium Claim reflects the information value related to disclosure of major shareholding. If the market does not respond to disclosure, foregoing disclosure will not harm anyone; in this case, disclosure is not a valuable service to the market that warrants reimbursement. In other cases, the Premium Claim deprives the other scheme members of their benefits from secrecy. The remaining scheme members forego the abnormal returns associated with the Announcement Premium. In terms of return, the scheme members are back to the start. In the aftermath of such disclosure, traditional enforcement is likely to be more effective, since a Crown Witness provides the respective entities with good information. Civil action by people that sold their shares at the wrong price and administrative sanctions may impose further costs on the scheme members; regulators may require, ban or stand-by a takeover bid as the case may be. Facing the great divide between playing by the rules, and running the serious risk of losing it all, more investors than today will opt for a lawful strategy.

IV. The Equity Strategy

1. Limited Number of Repetitions

For the Equity Strategy, the Premium Claim creates a Prisoner's Dilemma among the scheme participants (albeit members can communicate). Given that there is a perennial game, it is most beneficial for all participants to apply a tit-for-tat pattern.[46] In a perennial game, as

[45] Let AP describe the announcement effect, p(i) the individual participant's share in the issuer, and p(g) the group's share. If p(g) > p(i), then [AP x p(g)] >]AP x p(i)].
[46] See *Robert Axelrod*, THE EVOLUTION OF COOPERATION, Basic Books: New York, 1984, at 54: "What accounts for TIT-FOR-TAT's robust success is its combination of being nice, retaliatory, forgiving, and clear. Its niceness prevents it from getting into unnecessary trouble. Its retaliation discourages the other side from persisting whenever

long no one else cheats on the others, we would expect no participant to cheat either.[47] However, the entities engaged in the Equity Strategy are not perennial players. Instead, they comprise of activist hedge funds[48] or private equity funds. These entities are set up for a limited period of time, due to tax reasons, and to determine the overall success of the fund (which is the determinative figure for the manager's carried interest). While some fund managers run more than one fund (and thus have reason to invest in a reputation as an honest player in the secret acquisition game), some funds do not belong to a fund family;[49] in addition, many of these funds are short-lived.[50] The managers of these funds find themselves under significant pressure. Bad performance may prompt investors' exercise of their redemption right. Whenever there is the chance of taking home a safe albeit large extraordinary return – which at the same time, impacts on the manager's carried interest – these fund managers may prefer the safe bet of early disclosure (even if it involves cheating on the other scheme participants) over honesty vis-à-vis the other members by maintaining secrecy. This is particularly true since honesty may come along with regulatory risks if one of the other members gives in to the incentives provided by the Premium Claim.

2. Towards an Equilibrium

An ideal model would provide an equilibrium under which no participant is interested in the participant's joint share in the target surpassing a disclosure threshold without disclosure for fear of being cheated upon by other members that seek to capitalize on the Premium Claim. However, as long as the members assume that (1) **the size of the Premium Claim correlates with the size of the joint shareholding of all participants, and (2) all (other) members stay honest, any potential cheater in the team has reasons to maintain the strategy rather than disclose.**

defection is tried. Its forgiveness helps restore mutual cooperation. And its clarity makes it intelligible to the other player, thereby eliciting long-term cooperation."

[47] Axelrod, supra note 46, p. 12.

[48] A mere 3% of hedge funds pursues an activist strategy.

[49] Data on fund structure * [tbc],

[50] Data on fund insolvency* [tbc],

The first assumption – i.e. that the announcement premium is greater, the more shares the participants assemble – holds water only in the low digit range. The greater share of the pack signals greater commitment upon disclosure than in the earlier state; this in turn signals a more significant under-evaluation of the stock. However, this assumption may not hold if the joint share comes close to or even reaches de facto control.[51] After de facto control has changed hands, two key drivers of the stock price, defensive measures and a competing bid, are unlikely from the outset. Further stock price reactions may, however, stem from legal requirements, such as the mandatory bid rule or specific investor protection schemes.[52] Please note that secrecy beyond de facto control is rare; disclosure of de facto control is necessary for exercising control. If the members' joint stake is that large, regulatory scrutiny (albeit unsuccessful) will increase transaction costs. Moreover, in some cases, disclosure of new de facto control may reduce the stock price, since it ends speculation about possible acquirers.

If in the low digit range the Premium Claim grows by waiting, any potential cheater's further hesitation to disclose depends **on the second assumption** that other members do not cheat. Whether this will happen or not, is highly case-specific. A few assumptions may nevertheless be warranted:

(1) Members with a greater share in the scheme are more likely to remain honest than members with a minor share in the scheme, in relative terms.[53]

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[51] Please note that I distinguish between de facto control, which is the ability to decide corporate matters depending on shareholder votes, and legal control, which prompts the mandatory bid under Article 5 of the Takeover Directive (supra note 21).

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[52] Examples include the Evaluation Proceeding ('Spruchverfahren') where in the aftermath of corporate transactions, the consideration for minority shareholders is review by the courts.

[53] Assume two scheme members L and S, assume further that Sh(L) describes the greater share, Sh(S) the smaller share in the scheme, Sh(all) the overall share and that Sh(all) > Sh(L) > Sh(S) and that SH(L) + Sh(S) = Sh(all). ANN refers to the relative increase of the issuer's shares upon announcement. The Announcement Premium (AP) of the joint holding is ANN x Sh(all) = ANN x Sh(L) + ANN x Sh(M). The relative gain of Sh(L) by cheating is smaller than the relative gain of Sh(S).

(2) The risk of cheating increases in correlation with the number of parties involved.[54] Since each of the members' maximum share is limited by the respective disclosure rules, limiting the number of participants reduces the size of the members' joint share in the issuer prior to disclosure.

(3) Members with a reputation for being honest criminals, based on previous schemes, who are likely to be involved in further investment activity are more likely to stay honest. The number of potential scheme members meeting that test will be thinned out over time. They may be replaced by members of a fund family who either have incentives to establish a reputation, or are run by the same managers as funds with said reputation.

(4) Enforcing the Premium Claim in court requires substantive details on the scheme. Members with better information about the other team members' acquisitions are more likely to disclose the scheme than members not familiar with the details. The member with the best information is the organizer of the scheme. Members will respond by limiting the information provided to the organizer. This renders coordination of the scheme harder and increases the likelihood that the coordinated efforts fail. A greater probability of failure may induce members to disclose for capitalizing on the Premium Claim.

3. Bonding

As a likely response, the scheme coordinator may require other scheme members to provide security prior to being accepted as a team member. The law may render these counter-measures un-effective at low costs (for example, by declaring the underlying deposit agreement void). In any event, the self-enforcing model increases transaction costs for participants of an Equity Strategy, making it less profitable to violate disclosure rules than in the present state of inefficient enforcement.

[54] [tbc] *

V. The Service Strategy

Transferring the results for the Equity Strategy to the Service Strategy requires some qualifications.

1. Originator Unlikely to Disclose

The (industrial) originator of the Service Strategy does not experience the same incentives in favor of disclosure under the Service Strategy as equity investors in the Equity Strategy. Through derivative contracts, the investor has availed himself of the benefits from any return stemming from the shares that are held by the other shareholders (i.e. financial intermediaries) as hedges. A stock price increase by 1 leads to an investor's return of 1 x the number of underlying shares for the derivative contracts lesser transaction costs. The self-enforcing model developed here does not incentivize the originator in favor of disclosure.

2. Financial Intermediaries

From the intermediaries' perspective, an efficient self-enforcing model for the Service Strategy must consider a number of additional factors:

a) Perennial Players

The banks' most important asset is their reputation. Banks that disclose the hidden strategy may lose clients in future acquisitions. From a game theory perspective, the banks are the most similar to *Robert Axelrod*'s perennial players; generally speaking, these entities are unlikely to cheat.

b) Information Asymmetry

As was pointed out above, the person most likely to disclose the scheme may be the scheme organizer due to informational advantages. This may be true for the core intermediarycoordinating the multiple derivative contracts and hedging relationship. In fact, if there is a coordinator, only the coordinating bank may be in the position to cheat on the acquirer by disclosing the scheme effectively. However, the core intermediary suffers from disincentives to disclose. These disincentives are likely to be particularly severe since the fees associated with large-scale derivative schemes will be greater than the fees for minor hedging activity. Moreover, the core intermediary benefits the most from a client-oriented reputation in the banking market following a successful takeover attempt.

c) Taking Hostages

To a certain extent, the acquirer may hold the banks hostage if the acquirer alone is entitled to terminate the derivative contracts through which the acquirer holds its position in the target.[55] If the acquirer has assembled a large number of shares indirectly through the use of derivatives, its counterparties, or their counterparties, sit on a large portfolio of the target's shares, while their economic exposure is zero (and should remain zero) due to hedging. If the acquirer terminates all of the derivative agreements simultaneously (which may happen in the case of disclosure), the banks are suddenly exposed to risk from the underlying shares. At the same time, a large fraction of the overall number of shares may be put on the market, meaning the banks may accrue losses.

The law may respond by adding a mandatory minimum period of time for terminating the derivative contracts, and an extraordinary termination right for the discloser vis-à-vis its counterparties, as the case may require for freeing the intermediaries from the pressure imposed on them. However, an extraordinary termination right would expose intermediaries who are part of the hedging chain that are not involved in the Service Strategy to the risk of the transaction. Setting a minimum termination period would be equally arbitrary. An extraordinary termination right or a minimum termination period is not desirable.

3. Beneficial Side Effects

Two side effects may nevertheless further disclosure:

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[55] Such a one-sided termination right was, for example, disclosed in the documents on Schaeffler's bid for Continental, see *Zetzsche*, Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, EBOR (2009) - forthcoming.

1) One bank may seek to harm a competitor by demanding the Premium Claim.[56] Anticipating this option, the other banks may be unwilling to take the risk and avoid participation in the first place.

2) Some banks are unlikely to lose reputation upon early disclosure. These banks include intermediaries that do not serve the investor directly, and that are not directly involved in the scheme. One of these entities may get suspicious about certain hedging activities by the core intermediary and its hedging partners. Yet, these entities may have avoided investing in additional information due to uncertain returns. These banks may capitalize on “market rumors” by investigating these rumors, informing regulators, and side with target’s management. While some information is preferable to a state in which there is no information (which is likely to be the case in the present), this type of evidence as stand-alone solution is rarely reliable and is unlikely to withstand scrutiny in court. It may add, however, to an overall picture and thus increase the likelihood of ex post enforcement. When these entities add pieces to the overall picture necessary for disclosure, these entities should be assigned to Premium Claim.

In this regard, it is important to note that banks are particularly sensitive to potential liability, given that their profit from an individual transaction is small relative to the profit of the investor. If at least some banks seek to avoid the additional risk resulting from the Premium Claim (including personal liability of the banks’ management for unlawful waste of assets, director disqualification etc.) the self-enforcing model increases the costs of secrecy and the likelihood of disclosure also for the Service Strategy.

E. Facing the Real World

Applying the self-enforcing model to the real world necessitates further specifications.

[56] In light of the subprime crisis, this argument is likely to be seen less desirable as compared to a state of healthy financial institutions.

I. *Anticipating Early Disclosure*

One of my model assumptions is that disclosure of major shareholdings prompts significant abnormal returns. As was previously pointed out, it is uncertain what prompts these returns. If these returns reflect potential increases stemming from investor activism, or a future voluntary bid for the remaining shares of the issuer, the market may anticipate that disclosure is prompted by the Premium Claim. Whether activism or the voluntary bid will follow, is uncertain. Anticipation would reduce the size of the Premium Claim, if not fully erase it. In the absence of a significant Premium Claim, the prospect of capitalizing on the Premium Claim does not induce disclosure.

Other explanations may still hold water: If assembling of a major shareholding signals an under-evaluation detected by the scheme members, abnormal returns may remain. Given that there is uncertainty as to whether the Premium Claim reduces the incentives for the scheme members to a point where continuing the strategy is not profitable, if noise traders (i.e. uninformed investors) prompt the abnormal returns, these traders may continue to respond to disclosure. The same is true if the law requires a mandatory bid for all outstanding shares.

Assuming that the first mover discloses the shareholding and, if applicable, the members' intentions relating to the issuer or its shares,[57] (while hiding the fact that other scheme members are opposed to disclosure), the market may assess the information value of this major shareholding disclosure separately. Naturally, scheme members may feel inclined to issue an announcement to the contrary. Whether they are well-advised to issue an announcement to the contrary, however, requires careful consideration of the evidence available to the first discloser, and therefore time. Traditional enforcement punishes wrongdoers covering up

[57] These requirements exist in France and Germany upon passing a certain threshold. See s. 27a of the German Securities Trading Law ('Wertpapierhandelsgesetz'); the U.S. disclosure rules differ between disclosure by passive shareholders (Schedule 13g-filing) and disclosure by active shareholders intending to influence the issuer, or its management (Schedule 13D- filing). The later are mandated to disclose their intentions, s*ee Zohar Goshen & Gideon Parchomovsky*, On Insider Trading, Markets, and "Negative" Property Rights in Information, 87 Va. L. Rev. 1250, 1275 (2001).

their wrongful deeds more severely than wrongdoers admitting and correcting their mistakes. Furthermore, certain sanctions such as forfeiture of shareholder rights depend on the fact that violations of disclosure rules have not been corrected. If evidence is strong, the scheme members may be well advised to give in rather than resist.

II. Enforcing the Premium Claim

The self-enforcing model is designed to result in an equilibrium that does not need the enforcement of the Premium Claim since all scheme members opt in favor of disclosure if the joint holding surpasses disclosure thresholds. However, in the real world, transaction costs from enforcing the Premium Claim may hamper the incentivizing effect of the Premium Claim. If the individual benefits from remaining silent exceed the sum of additional benefits from (early) disclosure minus legal costs for enforcing the Premium Claim, disclosure is unlikely to happen. The premium claim must be enforced strictly, easily and inexpensively, while avoiding unnecessary involvement of parties with their own agenda. At the same time, in order to avoid perverse incentives, a critical review of the facts is a precondition to the Premium Claim being granted to the entity claiming the existence of unlawful acquisition scheme.

This necessitates three legal requirements:

1) Upon notification by the first discloser, regulators should be entitled to impose a lien on a fraction of the underlying shares held by scheme members in order to secure payment of the Premium Claim. They may only do so, however, if the facts provide for evidence as to the existence of an unlawful acquisition scheme.

2) In order to improve evidence, a fraction of the Premium Claim (let's say 10-20%) may be assigned to the second discloser.[58]

3) In a preliminary proceeding, a specialized court, with the regulator acting as claimant on behalf of the first and the second discloser,[59]

[58] A similar premium for the second discloser is known from antitrust leniency.
[59] Public prosecutors fulfill a similar function in traditional criminal proceedings.

establishes whether the disclosers are entitled to the Premium Claim and which size is appropriate.

4) The issuer and its management may have their own agenda. In particular, management may have an interest in avoiding a pending change of control and thus influence the outcome of the preliminary proceeding. Moreover, these entities are to focus on business rather than court proceedings. These entities and their associates should not participate in the court proceedings.

III. Perverse Incentives & Constitutional Concerns[60]

1. Benefits from Violating the Law?

One may argue that any wrongdoer participating in the scheme may not profit from his wrongful deeds; from the individual's perspective, violating the law may turn out to be efficient. This puts honest citizens at a disadvantage. This honorable concern disregards the fact that disclosing major shareholdings serves a purpose which is providing the market with information that it would otherwise miss. The disclosing member of the scheme is reimbursed for his information service; the reimbursement does not grant him benefits for wrongful deeds, but reimburses him for the reputational loss the member is facing due to disclosure. While one may argue that only criminals discount the disclosing members' reputation for its information production, while honest citizens of the corporate community would not, such an argument fails to reflect reality: Facing the alternative of rules without efficient enforcement, where all criminals get away, and of rules with efficient enforcement, where one criminal gets free while the others are caught, for society the latter alternative is the better option.

2. Benefits for the Originator?

This argument, however, does not apply to all scheme participants. The model presented herein may result in the organizer or ringleader, i.e. the worst criminal, benefitting from the Premium Claim and from the minor

[60] Please note that similar arguments are used in the discussions surrounding Whistle Blowing in securities law, Crown Witnesses in the criminal justice system, and Leniency Programs in antitrust law.

wrongdoings of the remaining participants. Granting benefits to the worst criminal for violating the law raises constitutional concerns, and is questionable in terms of morality. In addition, it may provide perverse incentives, by inducing the set-up of the scheme in order to profit from the Premium Claim, rather than from an overall increase of the stock price. In some jurisdictions, these paramount considerations account for exclusions of cartel organizers from antitrust leniency.[61] In light of this consideration, the law may exclude the originator from the Premium Claim. Excluding the originator is unlikely to impact on the self-enforcing power in case of the Service Strategy where the originator is unlikely to opt in favor of early disclosure anyway; in the case of the Equity Strategy, the organizer's exclusion weakens the self-enforcing power, since the scheme organizer avails himself to the best information; its exclusion would provide incentives to coordinate one's actions more closely with the organizer than with other team members. One may accept this loss in order to maintain higher standards than efficiency, and reduce perverse incentives.

IV. Other Types of Inside Information?

From a functional point of view (albeit not in a technical sense), the knowledge of undisclosed major shareholdings constitutes inside information. This raises the question of whether the model could be equally useful in enforcing other types of mandatory disclosure. The self-enforcing model is beneficial in the disclosure of major shareholdings, but not beyond.

The limited scope of the self-enforcing model is not due to the fact that disclosure of ordinary inside information may prompt a **negative** rather than a positive stock price response. While a positive stock price reaction is the model assumption, disclosure of major shareholdings may also prompt a negative stock price reaction. To the same extent as positive

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[61] *Maria Bigoni, Sven-Olof Fridolfsson, Chloe Le Coq, & Giancarlo Fines Spagnolo*, Leniency, Rewards and Organized Crime: Evidence from Antitrust Experiments (20/05/2008). SSE/EFI Working Paper Series in Economics and Finance No. 698 . Available at SSRN: http://ssrn.com/abstract=1134725 show that excluding the ringleaders goes along with reduced incentives to disclose.

announcement effects, a negative announcement effect enables an assessment of the value of previously undisclosed information.

However, two aspects render extending the scope of the self-enforcing model doubtful. First, in contrast to disclosure rules regarding major shareholdings, identifying the violator and the beneficiary of the Premium Claim is much more difficult; the issuer's management is most likely to violate disclosure rules. While one could consider civil liability claims against management, civil liability is often insured by the company (i.e. at the costs of the shareholders), or excluded in the corporate charter. Thus, the shareholders would pay the bill for management's misconduct. Furthermore, who should benefit? If one manager cheats on the others by early disclosure, the company and its shareholders are likely to suffer from the stress put on the managerial team. Secondly, while there are few viable excuses for violating major shareholding rules, there may be good business reasons (some of which the law accepts) for maintaining secrecy. The self-enforcing model is apt for clear cut rules, but creates more harm than good in a fuzzy legal environment.

F. Conclusion

With respect to the Equity Strategy, the self-enforcing model, if adjusted to real world requirements, results in a situation that is close to an equilibrium in which the secret acquisition of major shareholdings without disclosure is unlikely to happen. In the case of the Service Strategy, although not perfect, the self-enforcing model is likely to have minor beneficial effects in that fewer banks take the risk of participating in the scheme.

G. Annex: Mathematics

[tbc]