Developments

The Dilemma of Blind Spots in Capital Markets - How To Make Efficient Use Of Regulatory Loopholes?

By Armin J. Kammel[*]

A. Introduction

The following elaboration has two purposes. One is to invite further reflections on the recent incident of the German sports car manufacturer, Porsche, revealing its until-then unknown substantive holdings in Volkswagen, its much larger competitor. The Porsche incident provoked a host of reactions, ranging from satisfaction to outrage to consternation. The essay's second purpose is to stimulate considerations about likely policy responses and their implications. While the remarkable Porsche incident illustrates the particular nature of the embeddedness of global financial markets, meaning that while investors can inject and pull out of nationally located business opportunities in a seemingly uninhibited fashion, this activity is nevertheless occurring within a complex regulatory setting. As this intervention shows, such transnational settings often require sophisticated regulatory structures and responses. But it is crucial to ensure that – especially in times as the current financial crisis – no excessive accumulation of regulatory actions occurs. Consequently, blind regulatory spots as the ones revealed in this paper will ultimately occur. Nevertheless, it is important that market participants and potential investors are aware of them because then it those blind spots can be used efficiently.

B. The Evolving Transnational Nature of Corporate Governance and Securities Regulation

One of the most remarkable breaking news in late 2008 appeared in midst of uninterrupted media coverage of the current financial market turmoil, when Porsche, the manufacturer of the iconic 911 sports car, revealed that it actually held a great number of shares in the long coveted and former partner company, Volkswagen [VW]. On a Sunday late in October 2008, on the 26th to be precise, Porsche published a statement in which it informed the public that it had raised its stake in VW to 42.6 percent from before 35 percent, and that it held options for another 31.5 percent. In case of exercising those options Porsche would be put within spitting distance of the 75 percent threshold, at

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which it could control every major decision at its much larger rival, Volkswagen.[1] Along with this release of numbers, Porsche stated that it aimed to "give investors who had been short-selling Volkswagen stock, the opportunity to close their positions unhurriedly and without bigger risk."[2]

This statement had tremendous effects: VW shares shot up to a momentary high of $ 1,276, making it for one moment the most expensive share worldwide on Tuesday, 28 October 2008.[3] Yet, probably more astonishing was Porsche's announcement that it had effectively driven numerous hedge funds holding short positions in VW shares on the assumption that their price would fall, into the painful situation of frantically trying to meet their clients' demands, albeit at dramatically risen values. While regulators, investors and stakeholders are pondering over the lessons to be drawn from this event, the focus of the widespread concern remains anything but clear. For some, it is the satisfaction with the fulfillment of the perhaps long-time harbored hopes that hedge funds' aggressive operations be stopped or slowed. For others, the Porsche-VW event is merely the illustration of largely uncontrolled dynamics of capital markets including a brilliant legal coup by making efficient use of a blind spot in German capital market law. Others, still, recognize recent developments as part of a larger process of restructuring Germany's corporate economy, a process that has been unfolding with increasing speed over the last two decades.

The following observations aim to uncover a deeper layer of complexity, which is inherent in the regulation of capital markets.[4] After detailing the concrete circumstances of the recent coup, these observations seek to illuminate the context in which this coup occurred. This context is as historical as it is spatial: historically, Porsche und VW are emblematic instantiations of a particular trajectory of German corporate development, a trajectory that had come under tremendous pressure from domestic and foreign actors in recent times.[5] The other dimension of the observations involves the increasingly transnational

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[1] *See* the official Porsche website at www.porsche-se.com/pho/en/news/newsarchive2008/?pool=pho&id=2008-10-26 as well as the respective articles in the INTERNATIONAL HERALD TRIBUNE, the N.Y. TIMES, or the INDEPENDENT, Oct. 27, 2008.

[2] *See Porsche closes in on control of VW*, INTERNATIONAL HERALD TRIBUNE, Oct. 27, 2008.

[3] *Compare* the price of the Porsche stock on this day as well as the relevant articles commenting on this incident.

[4] Howard Davies & David Green, Global Financial Regulation, The Essential Guide (2008), chapter 1; Christian Bumke, *Kapitalmarktregulierung. Eine Untersuchung über Konzeption und Dogmatik des Regulierungsverwaltungsrechts*, 41 Die Verwaltung 227 (2008).

[5] *See* Peer Zumbansen & Daniel Saam, *The ECJ, Volkswagen and European Corporate Law: Reshaping the European Varieties of Capitalism*, 8 GERMAN LAW JOURNAL 1027 (2007), available at: http://www.germanlawjournal.com/pdf/Vol08No11/PDF_Vol_08_No_11_1027-1051_Articles_Zumbansen_Saam.pdf .

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scope of regulating corporate affairs. From this spatial perspective, both corporate governance and securities regulation have come to be among the most dynamically evolving regulatory arenas in recent history.[6] Against the background of a global debate over the convergence or divergence of corporate governance standards, a debate that gained full momentum since the early 1990s and that has become increasingly intertwined with concepts and building blocks of securities regulation, I will argue that in order to 'understand' the relevance of Porsche-VW, it is necessary to situate the arising regulatory questions into a larger context of transnational corporate and securities regulation. From this perspective, these regulatory fields can no longer be seen as domestically constituted or as resulting from a mere interaction of supranational (for example EC) regulation with domestic legal orders in the member states. Instead, corporate governance and securities regulation are instantiations of an emerging *transnational legal pluralism*.[7] Besides growing out of complex hierarchical and heterarchical interventions and irritations between different legal orders, the emerging transnational legal pluralism is importantly marked by a proliferation of actors that are engaging in norm production. The evolving mixed, public-private nature of corporate governance and securities norm-entrepreneurs – including standardization bodies, expert committees, self-regulatory bodies, the currently heavily scrutinized rating agencies, and hybrid bodies such as the Organization for Economic Co-operation and Development (OECD), the Basel Committee or the International Organization of Securities Commissions (IOSCO) – is mirrored by a remarkable transformation of the norms that govern corporate behavior and capital markets.[8] No longer easily identifiable as the 'law', the relevant norms are comprised of statutes, recommendations, codes of conduct or best practice guidelines, standards and benchmarks.[9] It is this background that any plan for 'tougher regulation' in this complex regulatory landscape must keep in mind.

C. Porsche's Billionaire Poker and What to Learn from It

In light of the above, different layers of the Porsche case begin to become visible. For example, it was well known that Porsche had long been harboring an interest in VW, especially since Porsche over the last three years had been steadily increasing its stake in

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[6] *See* recently Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 JOURNAL OF ECONOMIC PERSPECTIVES 117 (2007), and Eddy Wymeersch, *Corporate Governance and Financial Stability*, University of Ghent Financial Law Institute Working Paper Series WP 2008-11 http://ssrn.com/abstract=1288631 (2008).

[7] This is further developed in Peer Zumbansen, *'New Governance' in European Corporate Governance Regulation as Transnational Legal Pluralism*, 15 EUROPEAN LAW JOURNAL 246 [available at http://ssrn.com/abstract=1128145] (2008).

[8] Kern Alexander, Rahul Dhumale, & John Eatwell, GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE INTERNATIONAL REGULATION OF SYSTEMIC RISK, chapter 2 (2006).

[9] *See* in more detail *Id.*, chapters 4 and 10.

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the Wolfsburg-based car manufacturer. It was also known that VW remains the much larger yet significantly less profitable unit in comparison with its sporty counterpart from Stuttgart. Nevertheless, VW's shares had been rising above the level at which it would have made any economic sense for Porsche to still pursue further holdings in VW.[10] It is in this light that hedge funds were subsequently focusing on VW in order to exercise shorting strategies, essentially by betting on a decline in the price of the VW stock.

The ensuing story is even spicier, given that derivatives markets continued to watch Porsche's actions with regard to VW with growing suspicion. There is evidence that a number of analysts had insistently warned investors of the dangers of playing "billionaire's poker" by betting against Porsche.[11] Despite Porsche keeping a poker face in all this, even dismissing such concerns as unwarranted "fairy-tales", the announcement of 26 October 2008 surprised almost everybody. Porsche's announcement of its substantive acquisitions of VW stock brought the involved hedge funds into the highly uncomfortable situation of a so-called 'short squeeze', in which they were forced to buy the VW shares at any price in order to meet their obligations to buyers to whom they had short-sold. While the true number of losses remains subject to speculation – somewhere between 10 and 15 Billion Euros[12] - they were staggering. This is even more remarkable in light of hedge funds' previous impressive performance, owed at least in part to the financial engineering genius of the funds' managers in charge. It quickly became apparent, that there were not enough VW stocks on the market to meet the heavy demand, as only roughly 6% of VW were still trading freely, with the remainder being held by Porsche and the state government of Lower Saxony.[13] The control stake held by the state government of Lower Saxony based on the Volkswagen statute has resulted in some controversies. Both, the European Commission and Porsche criticized the statue against the background of the free movement of capital dogma in European law. Since the Federal Government in Germany has so far not followed the European Court of Justice's (ECJ) Volkswagen decision, another decision by the ECJ can be expected. However, on 27 November 2008, another respite to adapt the statue had been given to the Federal Government by the European Commission. It remains to be seen how this deadlock can be solved.

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[10] *See Squeezy Money*, THE ECONOMIST, Oct. 30, 2008.

[11] Adam Jones of Morgan Stanley on October 8, 2008. See *Id.*

[12] *See, e.g., Porsche in $20bn 'sting'*, THE INDEPENDENT of October 29, 2008, or *Hedge funds make GBP 18bn loss on VW*, www.new.bbc.co.uk dated October 29, 2008.

[13] Here reference shall be made to the ECJ's *Volkswagen* decision, Case C-112/2005, dated 23 October 2007, *Commission v. Federal Republic of Germany "Volkswagen"*, which dealt with the Volkswagen statute, which effectively gave the Federal Government and the federal state of Lower Saxony a veto against majority acquisition while only holding a fifth of all shares. *See* in more details Zumbansen & Saam (2007). It is interesting to note that just recently the premier of Lower Saxony, Christian Wulff expected another decision of the ECJ in this regard. *See Eine VW-Aktie für 1000 Euro!*, www.boerse.ard.de dated Oct 28, 2008.

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However, in order to appreciate the reasons for such a surprise on the part of fund managers, it is essential to briefly revisit the features of the so-called short-selling. Moreover, it is important to stress that there are – aside from the Volkswagen statute saga – some remarkable differences in the regulatory set-up in Germany in comparison to other European jurisdictions.[14] The troublesome loophole in the regulation of German capital market rules as well as the lack of transparency of which Porsche made efficient use in what has been referred to as "one of the most brilliantly conceived wealth transfers ever"[15], must be studied in more detail, particularly in light of the already mentioned, wide-spread calls for better regulation. [16]

D. "Locusts" and the Nature of Short-Selling

Even though the consequences of Porsche's announcement caused plenty of *Schadenfreude*, in particular since numerous of the now negatively affected foreign investors previously acquired German companies, thereby resulting in thousands of lost jobs,[17] the first step in the quest to explain how this could happen from a technical point of view must be to explain the practice of short-selling.

A common practice in finance, short-selling[18] involves the sale of a financial instrument that the seller does not own at the time of sale.[19] The rationale behind the practice is to

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[14] The best contrast can be given when reflecting the UK situation. In the UK, the concept of "creeping control" has long been regulated by the UK Takeover Panel since the issue of transparency has a different status on the island. The adoption of the Transparency Directive and the Disclosure Rules and Transparency Rules (DTR) are a good example for this. DTR require disclosure of voting rights attached to shares, so notification has to be made once a shareholding of 3% or more is acquired as well as for every 1% increase above the 3% threshold, regardless of whether a takeover is contemplated.

[15] *See Squeezy Money* (note 10).

[16] *See Porsche takeover loophole drives calls for new code*, THE INDEPENDENT, Nov. 1, 2008, referring to a statement made by Thomas Möllers, a capital markets law professor of Augsburg University.

[17] *See The Day of the Locusts*, TIME MAGAZINE, May 15, 2005 available at: www.time.com/time/magazine/article/ 0,9171,901050523-1061439,00.html.

[18] In finance the term short-selling is interchangeably used with the term "shorting". For a comprehensive overview on short-selling, see *Fabozzi* (2004), 7-59. A good introduction is offered by LAWRENCE GITMAN & MICHAEL JOEHNK, FUNDAMENTALS OF INVESTING 62-65 (2005).

[19] However, the term is also often used in general for practices allowing investors to gain from a decline in the price of a financial instrument by making use of strategies such as put options. A put option is a financial contract between two parties being the seller and the buyer, giving the buyer the right but not the obligation to sell a commodity or financial instrument to the seller of the respective option at a certain time for a particular price, the so-called strike price. The seller however has the obligation to purchase the underlying asset, being the respective commodity or financial instrument at that strike price in case the buyer makes use of his option.

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later purchase the respective financial instrument at a lower price, thus attempting to profit from an expected decline in the price of this financial instrument. Technically speaking, the short-seller borrows securities that it will sell, only to repurchase[20] them later in order to be able to return them to the lender. The main premise here is that in case of a decline in the value of shares involved in the short-selling, the benefit for the short-seller is to have sold the financial instruments for a higher price than he later has to pay for those shares. However, if the opposite were to happen, namely that the stock price would soar, the short-seller would be exposed to tremendous risk. Where the price rises exorbitantly, the short-seller's losses might even exceed his or her net worth.

The considerably complex[21] practice of short-selling has received vociferous critique – particularly in the context of the recent financial market turmoil. Critics maintain that short-sellers make gains on the costs of others. Attaining considerable fame, financial actors involved in short selling, notably hedge funds, have been labelled as "locusts", a term originally attributed originally to private-equity firms (PE), but later used to denounce a list of other types of businesses as well. Phrased by former German Vice-Chancellor Franz Müntefering, who in April 2005 criticized PE and Hedge Fund activities in the German economy,[22] the term sought to scandalize what had by then already become a breathtaking global investment enterprise. With hedge funds during the Porsche incident losing an estimated 6 to 12 Billion dollars, many observers could hardly mount honest compassion. Instead, worries soon emerged around rumors indicating that Morgan Stanley, Goldman Sachs or Société Générale might also be exposed to VW.[23] Even to the degree that some rumors were later revealed as unsubstantiated, iterations about setbacks or obstacles in the otherwise breathtaking ascent of hedge funds are representative of the very sensitive mood regarding financial actors these days.

In the face of what continues to unfold as perhaps an unprecedented crisis of the financial system, in the context of which the Porsche incident is even more remarkable and peculiar, the public opinion continues to form in considerable distance from the technical questions that surround financial innovation.[24] Nevertheless, recent financial turmoil, and collapsing

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[20] Such repurchasing is also referred to as closing the respective position.

[21] *See* in details TOM TAULLI, WHAT IS SHORT SELLING? (2004) or alternatively, WILLIAM O'NEIL & GIL MORALES, HOW TO MAKE MONEY SELLING STOCKS SHORT (2005).

[22] *See The Day of the Locusts* (note 17).

[23] *See Squeezy Money* (note 10).

[24] *See*, for example, Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds and Financial Innovation*, in NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 101 (Yatsuyuki Fuchita & Robert E. Litan eds., 2007); and Ewald Engelen, *The Case for Financialization*, 12 COMPETITION AND CHANGE 111 (2008). On the pros and cons of Short Selling instruments, see Charles M. Jones & Owen A. Lamont, *Short Sale Constraints And Stock Returns* (2001), CRSP Working Paper No. 533, available at SSRN: http://ssrn.com/abstract=281514 or DOI: 10.2139/ssrn.281514 or

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stock prices in particular, strengthened calls for regulatory actions regarding short-selling. However, it seems that the callers have overlooked the fact that short-selling has been ”business as usual” for decades and that as far back as 1938 the U.S. Securities and Exchange Commission (SEC) issued the so-called “uptick rule”[25] (Rule 10a-1) in order to regulate the short-selling in financial markets.

E. Recent Regulatory Responses on Short-Selling

Since the SEC issued the “uptick rule” in 1938, numerous amendments of short-selling regulation have been released in the U.S., primarily reflecting financial innovation in this field.[26] It is interesting to note that these amendments were *per se* technical in nature. On July 6, 2007, the SEC eliminated the uptick rule due to extensive studies carried out concluding that such price restrictions reduce liquidity and do not appear necessary to prevent manipulation.[27] However, things changed in July 2008. Since short-selling was at record levels in the U.S.A. and needed immediate action of the SEC, Congressman Gary Ackerman, Congresswoman Carolyn Maloney and Congressman Mike Capuano introduced H.R. 6517, "A bill to require the Securities and Exchange Commission to reinstate the uptick rule on short sales of securities.” The SEC subsequently announced emergency actions to limit ‘naked short selling’, an advanced practice of short-selling by which the sale transaction of a stock is done without first borrowing the respective shares or ensuring that the shares can be borrowed as it is done in a conventional short sale, of government sponsored enterprises – in particular Fannie Mae and Freddie Mac – in order to limit market volatility of financial stocks.[28] Soon after, on September 17, 2008, the SEC issued another set of extensive rules against naked shorting, which also included a ban on market makers in naked short selling.[29] However, Senator John McCain criticized the SEC for

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Jennifer Fancis, Mohan Venkatachalam, & Yun Zhang, *Do Short Selles Convey Information About Changes in Fundamentals or Risk?* (2005), available at SSRN: http://ssrn.com/abstract=815668.

[25] Rule 10a-1 basically states that a listed security when sold must either be sold short at a price above the price at which the immediately preceding sale was affected or at the last sale price if it is higher than the last different price. See for more details www.sec.gov/rules/concept/34-42037.htm#P49_9887.

[26] These amendments, especially from regulation SHO in 2005 onwards, primarily focused on naked short selling practices. Available at: www.sec.gov.

[27] Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348 (July 3, 2007) (to be codified at 17 CFR § 240.10a-1, 17 CFR § 242.200, 17 CFR § 242.201). Available at: www.sec.gov/rules/final/2007/34-55970.pdf.

[28] Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action To Respond to Market Developments, Exchange Act of 1934 Release No. 58166, (July 15, 2008). Available at: www.sec.gov/news/press/2008/2008-143.htm. However, there was an exception released for market makers.

[29] Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action To Respond to Market Developments, Exchange Act of 1934 Release No. 58592, (Sept. 18, 2008). Available at www.sec.gov/rules/other/2008/34-58592.pdf.

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eliminating the uptick rule and that by allowing short-selling the SEC turned "[the] markets into a casino".[30]

Early in 2009, the Chairman of the Federal Reserve, Ben Bernanke, stated he favored the SEC to examine the restoration of the uptick-rule[31] and in March 2009, the SEC and Barney Frank, Chairman of the Financial Services Committee announced plans to restore the uptick rule. The SEC stated its plans to hold a hearing as early as April 2009 and that the uptick rule could be restored then within a month.[32]

However, almost immediately after the 2008 SEC actions, the British Financial Services Authority (FSA) and subsequently most European securities regulators agreed with the U.S. approach by also banning short selling in their respective countries in various forms.[33] Despite coordination efforts by the Committee of European Securities Regulators (CESR), no common European solution could be found, a fact that underscores the still prevailing unwillingness and inability of European regulators and governments to act in a concerted manner.[34] Moreover, doubts can be cast that the imposed – and in particular uncoordinated – restrictions on short selling contributed to a change in behavior of stock returns. This can further be underscored by the similar behavior of stocks subject to short-selling restrictions and those not being subjects to these restrictions.

Two decrees by the German regulator *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) dated 19 and 21 September 2008 are of particular importance here.[35] These restrictions, which were justified with the recent developments of the global capital markets, have been extended to March 31, 2009[36] since the situation of the global capital markets has not changed significantly yet. From a material point of view, BaFin's actions prohibit 'naked short-selling' in shares of eleven financial companies. Comparatively speaking, these actions are consistent with the actions of other major European securities

[30] Laura Meckler and Kara Scannell, *McCain Says Cox Should be Fired As SEC Chief Amid 'Casino' Markets*, THE WALL STREET JOURNAL, Nov 24, (2008).

[31] Greg Robb, *Bernanke: Uptick rule might have been useful during crisis*, MARKETWATCH, Feb 25, (2009).

[32] Ronald Orol, *Frank: Up-tick rule to be introduced in a month SEC Chairwoman Schapiro met recently with Frank to discuss regulations,* MARKETWATCH, March 10, (2009).

[33] The Committee of European Securities Regulators, MEASURES ADOPTED BY CESR MEMBERS ON SHORT SELLING, March 31, (2009). The European overview is available at: www.cesr-eu.org/popup2.php?id=5238.

[34] It is worth noting that Bulgaria, Czech Republic, Estonia, Iceland, Cyprus, Malta, Romania, Slovakia, Slovenia or Finland have not taken any actions in this regard yet.

[35] *See* www.bafin.de/cln_116/nn_720486/SharedDocs/Artikel/EN/Service/Meldungen/meldung_080919_leerverkauf. html?__nnn=true.

[36] Bundesanstalt für Finanzdienstleistungsaufsicht, *Restrictions Maintained on Short-Selling Financial Stocks.* Available at: www.bafin.de/cln_116/nn_720486/SharedDocs/Artikel/EN/Service/Meldungen/meldung__081219__leerv__verlaeng.html?__nnn=true.

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regulators. Therefore, the short-selling regulations and restrictions in Germany cannot be identified as the crucial link to the Porsche-VW episode from either a material or a regulatory views.

F. The Disclosure of Holdings According to German Law

Even though the practice of short-selling was at the center of the discussion due to the huge losses among hedge funds caused by the 'short squeeze', another strand of argumentation is worth considering, namely the disclosure of holdings according to German law. This strand also gained significant media attention due to clearly expressed rumors that Porsche might have infringed on the prohibition of market manipulation stated in the *Wertpapierhandelsgesetz* (WpHG — German Securities Trading Act).[37]

As a matter of substantive law, the question arises of whether Porsche had to disclose its holdings under the EU Transparency Directive[38] which generally intends to achieve greater harmonization within the EU member states relating to the provision of periodic and ongoing information requirements for securities' issuers. Such disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of a business' performance and assets. In addition, the EU Transparency Directive, in stating rules relating to periodic reporting requirements by addressing issues such as reporting deadlines, quarterly reporting requirements, contents of a quarterly report or the contents of the narrative report accompanying the half-yearly financial statements, aims to enhance both investor protection and market efficiency.[39]

G. Porsche and an Interesting Analogy

Against this background BaFin announced on 29 October 2008 – three days after the Porsche statement – to look more closely into these issues, in particular transparency requirements. Depending on the outcome, BaFin would then decide whether it would open a formal investigation of the trading in VW stock to determine if matters of fact in

[37] *See* in particular the massive critical statements by the CEO of DWS Klaus Kaldemorgen. Christiaan Hetzner and Jörn Poltz, *Porsche weist Kritik von Fondsanbieter DWS an VW-Geschäft zurück*, REUTERS DEUTSCHLAND, Nov 9, (2008). Available at: http://de.reuters.com/articlePrint?articleId=DEL945447220081109.

[38] EC Directive 2004/109 of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. As background information, the law of the EU is unique due to its supranational character. Various legislative acts of the EU such as directives, regulations or decisions are in place. An EU directive as a legislative act like the EU Transparency Directive requires member states to achieve the particular result dictating the means of achieving this result whereas an EU regulation is an self-executing act which does not need any implementation measures.

[39] *See* preamble to EC Directive 2004/109 of 15 December 2004.

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terms of market manipulation or insider trading were realized. Strikingly, no official result or statement has been released yet, meaning that BaFin has not opened any formal investigations. One could provokingly argue that this is pretty unlikely to happen at all since a potential legal loophole can be identified. As the following explanations reveal it is a clear loophole in German law which seems to be unique in Europe.

Market and media reactions to Porsche's action were devastating[40] but the arguments put forward in this regard are lacking a careful analysis of the legal framework in which Porsche acted. Starting point here again is Porsche's statement of 26 October 2008 in which Porsche stated that at the end of the preceding week it held 42.6 percent of the VW ordinary shares in addition to 31.5 percent in co-called cash-settled options in relation to VW ordinary shares with the consequence that "[u]pon settlement of these options, Porsche will receive in cash the difference between the then actual Volkswagen share price and the underlying strike price in cash. The Volkswagen shares will be bought in each case at market price."[41]

Such cash-settled options are option contracts where the settlement is done via the payment of cash equal to the difference between the market value and the contractual value of the underlying at the time of exercise or expiration. This implies that there is no requirement for the actual delivery of the underlying security. Nevertheless, such options can also be physically settled upon party agreement. Intermittently, rumors[42] began to spread that some investment banks might have potentially held actual VW shares below the disclosure requirement of 5% in order to hedge call options and to eventually deliver them to Porsche on exercise.

From a regulatory point of view, *Transparenzrichtlinie-Umsetzungsgesetz* (German Transparency Directive Implementation Act) extended the notification duties to cover the holdings of financial instruments which entitle the respective holder to purchase shares with attached voting rights, so-called financial instruments.[43] According to section 25 WpHG, all voting rights arising in both shares and financial instruments have to be aggregated if the holder has a stake in both such shares and financial instruments. Nevertheless, neither the financial instrument definition of section 2 WpHG nor the definitions of Art 2 of the Transparency Directive include cash-settled options as those

[40] Criticism arose from various political strands including the financial services industry, represented by DWS Investments, a member of Deutsche Bank Group, unions, represented by the CEO of the VW work council *Bernd Osterloh*, various analysts of the German stock market as well as voices from academia, all complaining a lack of transparency regarding Porsche's actions.

[41] *See Porsche Heads for Domination Agreement*, NEWS ARCHIVES 2008, Oct. 26, 2008. Available at: www.porsche-se.com/pho/en/news/newsarchive2008/?pool=pho&id=2008-10-26.

[42] *See Squeezy Money* (note 10).

[43] *See* Section 2 WpHG for the definition of financial instruments.

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used by Porsche. Consequently, they do not fall under the disclosure requirements set out in the WpHG and Porsche. Since these instruments are obviously out of the regulatory scope, Porsche brilliantly made use of this fact by explicitly referring to such cash-settled options in its statement of 26 October 2008.

The non-inclusion of cash-settled options with the consequence that they do not have to be disclosed under the WpHG seems to be the regulatory loophole Porsche used. The existence of such a loophole *per se* is remarkable but it is striking that in close time proximity to Porsche's action, though with less sky-rocking shares compared to the case of VW, attention has to be drawn to the € 12 bn takeover of tire giant Continental AG by Schaeffler Group in August 2008[44].

Schaeffler Group, which owned just below 3% of Continental's shares before the takeover bid, had built up a so-called cash-settled total return equity swap with Merrill Lynch International (London) for around 28% of the tire giant's shares between March and May 2008 on the basis of a contract for difference, under which two parties bet on prices rising or falling. However, there is no intention for an actual delivery of shares since the settlement is done by means of a cash payment of the difference. Here again, striking to note, key for the deal was a similar financial instrument, a cash-settled total return equity swap.

Regulatory response to this situation was – despite less public attention – similar to the later Porsche/VW case. BaFin also launched an investigation in the Schaeffler Group/Continental deal and found no breach of reporting requirements[45] of the WpHG or *Wertpapiererwerbs- und Übernahmegesetz* (WpÜG – German Securities Acquisition and Takeover Act") by means of the swap agreement with Merrill Lynch International (London).

H. Different After-Effects of Porsche and Schaeffler

Despite the fact that both Porsche/VW and Schaeffler/Continental deals were able to take place thanks to brilliant legal actions, their after-effects could not be more different. Against the background of the current financial turmoil, the realization of both deals already needed certain courage and risk. Now, a couple of months afterwards, it is interesting to watch the respective further developments.

At the beginning of 2009, Porsche informed[46] the public that it had increased its stake in Volkswagen AG to more than 50% which gave Stuttgart's sports car manufacturer also

[44] *See* i.e. Rowena Mason, *Schaeffler family buys out tyre giant Continental for € 12bn*, TELEGRAPH.CO.UK, Aug. 23, 2008. Available at: www.telegraph.co.uk

[45] *See* BaFin press release of 21 August 2008. Available at: www.bafin.de.

[46] *See* the official press release of Jan 5, 2009.

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indirect control of truck maker Scania AB. Under Swedish law, Porsche's announced 50.76% voting stake in VW required legal actions in terms of a mandatory takeover offer, since with 68.6% of the votes and 37.7% of the capital, VW was Scania's biggest shareholder. Despite making it clear in the statement that "it ha[d] no strategic interest in Scania and [that it] [was] not interested in acquiring Scania shares", Porsche will have to make an offer at "the minimum price prescribed by law." Ironically, VW is also the biggest single shareholder in Scania's German rival MAN AG. Therefore, a push for closer collaboration and more joint actions of the two truck manufacturer would not be a surprise.

Moreover, it was recently announced[47] that the financially strapped hedge funds are considering suing Porsche for provoking the substantial breaks of the VW share at the end of last year. In particular the by Porsche successfully applied cash-settled options could be the basis for such claims. Nevertheless, the hedge funds also seem to wait for the outcome of BaFin's closer look on the Porsche case.

Contrary to the continuous increase in stake by Porsche already having effects on other companies such as Scania, the Schaeffler/Continental deal does not seem to be as successful. The strong opposition by influential parts of Continental against the deal led to numerous struggles with the assumption of debt, various appointments in management positions or a multilateral agreement by investors monitored by former Chancellor Gerhard Schröder. At the end of January 2009, German business media[48] spread rumors that Schaeffler/Continental should receive financial state aid of € 1 bn. Both enterprises are plunged in debt and therefore the states of Bavaria and Lower Saxony would consider backing up the corporate group with € 500 mil each. In addition to this, ideas to separate parts of Continental made the beat. Meanwhile, rumors that the Canadian-Austrian automotive supplier Magna International might have an interest in Schaeffler-Continental had also officially been denied.[49]

I. Is There A Need for Regulatory Action?

As the discussion so far suggests, the tide of events from both, a market and regulatory perspective tends to raise more questions than give answers. In this regard, the different after-effects of the deals are less of an issue than the fact that such blind spots in capital markets exist. Both, the Porsche/VW and the Schaeffler/Continental cases indicate an obvious loophole in German capital market law, specifically in the WpHG regarding cash-settled options. Moreover, BaFin's investigations revealed that neither Porsche nor

[47] *See, e.g.,* FINANCIAL TIMES GERMANY, Mar. 16, 2009.

[48] *See, e.g.,* HANDELSBLATT, Jan. 26, 2009.

[49] *See* FRANKFURTER ALLGEMEINE ZEITUNG, Feb. 17, 2009.

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Schaeffler Group had violated the disclosure requirements. Therefore, Porsche's coup of making efficient use of regulatory loopholes has to be considered as "one of the most brilliantly conceived wealth transfers ever".[50]

However, the reputation of Germany's capital markets was commented with such heavy words as "[i]n any other country [such action] would be illegal. And this isn't some small firm, its Germany's biggest. It's a return to the wild west."[51] Although such statements do not detract from the legal brilliance applied in these cases,, the temporal and substantive relation between the two cases is striking. Consequently, the regulatory response to such incidents is crucial. In this regard, one could expect that due to the dispersed dust Porsche's coup caused in the international financial community as well as media landscape, the German legislators should react to close this obvious loophole. Surprisingly, the new *Risikobegrenzungsgesetz* (German Risk Limitation Act), which was passed on 27 June 2008 and took effect as of 1 March 2009, was not immediately amended or postponed in order to include cash-settled options despite the "sneaking up" strategy exercised by Schaeffler or Porsche. This means that in Germany under the new law, cash-settled options will continue to not trigger any notification requirements – even in the case of a takeover – since they do not include the entitlement to actually acquire the underlying shares.[52]

Apparently, the German legislators have not yet seen a need to close the obvious blind spot in capital markets law. Furthermore, the struggle about the Volkswagen statute seems to continue since another ECJ ruling on this matter is expected in 2009 or 2010. However, in the absence of a need for a regulatory and legislative response to the discussed German cases, attention will be paid to two crucial developments that exactly affect the respective reaction: financial innovation and the potential over-regulation.

Financial product and service innovation increased tremendously over the last couple of years, thus linking it directly links to the overall structure of financial regulation and supervision. Concerns about the financial regulatory structure in individual economies have often been brought forward and the current financial turmoil will not let them die out. The Asian financial crisis in 1997-98 had already caused a substantial review of regulatory systems all over the world. One can bet that the current global crisis will have at least a similar impact. Nevertheless, product innovation and technological advances will continue to shape both, the financial industry and the regulatory structure. The focus of

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[50] See, *supra*, note 42.

[51] *See* Louise Armitstead, *Porsche crashes into controversy in the ultimate 'short squeeze'*, THE DAILY TELEGRAPH, Nov 3, 2008.

[52] Contrary to this, the new FSA rules which will come into force in September 2009 will require the disclosure of cash-settled derivatives.

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the industry will be to remain competitive whereas the supervisory authorities are enormously challenged by the monitoring of risks. This is valid for both the corporate and the financial spectrums.

Financial crises tend to have the effect of heavy, partly over-shooting regulatory responses, in particular in terms of securities regulation. Mostly such actions are justified by the need to protect consumers. Due to potential principal-agent situations, free-riding problems, the long-term aspects of many investment services and the general assumption that the public sector has a responsibility for some minimum living standards[53], the securities markets are the preferred targets for regulation. However, from a rather philosophical point of view it has to be questioned if regulation always benefits the consumer. Critical consumers taking informed decisions seem to be the better option than a mothering regulator or a legislator trying to justify all actions with the "overarching" need for consumer protection.

Against the background of these general thoughts and the discussion of the German situation, it is crucial that countries carefully examine the advantages and disadvantages of any changes in their regulatory structure. Traditionally certain models of structures exist in various countries. Therefore, a renunciation of such a tradition will only be done in case of serious defaults. Consequently, a broader scope of analysis has to be applied when judging a regulatory structure or legislative response because the key is the underlying infrastructure to develop both finance and the regulatory and supervisory capacity in line with international standards within a system of clear objectives, independence and accountability will be the way forward.[54] Consequently, no matter which structure or system is applied, a financial and regulatory mismatch has to be avoided.

J. Conclusions

Keeping the policy concerns of cases of Porsche/VW and Schaeffler/Continental in mind, it is questionable whether the possibility of changing control of large quoted public companies under the table in a country is healthy for the functioning of its capital market. Turbulent times, such as the current financial turmoil, tend to amplify skepticism towards such occurrences. Moreover, investor confidence, which is of utmost importance, cannot be boosted with a perforated regulatory framework, which only stimulates legal uncertainty.

[53] *See* Jonas Niemeyer, *An Economic Analysis of Securities Markets Regulation and Supervision: Where to Go after the Lamfalussy Report?*, *SSE/EFI Working Paper Series* in ECONOMICS AND FINANCE, No. 482 (2001).

[54] *See* DOUGLAS ARNER, FINANCIAL STABILITY, ECONOMIC GROWTH AND THE ROLE OF LAW 281 (2007).

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Additionally, an increasing number of blind spots in national capital markets and a continued defiance of supranational court rulings in some European member states, under the guise of ensuring freedom of capital movement at the expense of legal certainty and a level playing field, do not seem to be appropriate measures for a sound and solid financial system. On the contrary, acting in concert, international collaboration and exchange of information are crucial to take the right actions to meet the requirements of financial globalization. This also significantly diminishes the likelihood of unqualified, rushed and exaggerating regulatory responses.

However, regulation will always have a stimulating effect on product innovation and improve healthy criticism of consumers based on informed decisions. This implies that consumer "over-protection" is clearly not the way forward. However, if there is no direct regulatory response to the increasing number of blind spots in capital markets, which might be caused by tremendous product innovation and the professional brilliance of lawyers, it has to be ensured that both professional as well as retail investors are aware of these circumstances in order to make the necessary informed decisions.

At the end of the day it will be a political decision of each jurisdiction based on a careful examination of the advantages and disadvantages of any changes in their regulatory structure, what regulatory landscape will be put in place and thus be typical for the respective country.

In any case and no matter what decision in terms of regulatory response will be taken, legal brilliance, reliability coupled with legal certainty, have to be the way forward - any attempts of casino capitalism are definitely outdated.

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