Takeover Bids and Insider Trading

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Abstract

This paper analyses the law and economics of insider trading in the context of takeover bids, focusing on the European regulatory framework. We distinguish between trading by the bidder, by the target and by classical insiders and first address the issue of precisely when information about potential offers qualifies as inside information. Next, we address the prohibition on selectively sharing inside information with third parties, the prohibition on tipping and the obligation to make public disclosures. We then analyze the extent to which bidders are permitted to build a stake in the target prior to the offer and the prohibition on target companies and classical insiders to trade on information regarding a pending offer. Finally, we address reporting obligations in respect of share transactions by those who have access to inside information, showing that these obligations serve multiple purposes including facilitating enforcement of the prohibition on trading on inside information, improving informational efficiency of the stock market and notifying target management of pending takeovers.

Keywords: takeover bids, public offers, mergers and acquisitions, stakebuilding, insider trading, market abuse, securities fraud, securities regulation, financial markets

JEL Classification: G10, G14, G34, K14, K22, K42, N2

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I. INTRODUCTION

No information is as price sensitive as information on pending takeover bids, rendering takeover bids a prime context within which insider trading occurs. The sentencing of former Goldman Sachs board member Rajat Gupta and of Raj Rajaratnam, the hedge fund manager, for example, was partly based on illicit trading on information regarding pending takeover bids. This chapter offers a positive analysis of the European regulatory framework with respect to insider trading in the context of takeover bids. We distinguish between trading by the bidder, by the target and by classical insiders such as officers and employees. Where relevant, we draw a comparison between EU law and US federal securities laws. The analysis suggests that European insider trading laws are insufficiently tailored for corporations, and that significant uncertainty remains as to the precise scope of the prohibition on insider trading in the context of takeover bids.

We start by addressing the issue of precisely when information about potential takeover bids qualifies as inside information (section 2). From that particular moment onwards, the prohibition on insider trading applies and an obligation to disclose the information without delay is triggered. Those who are in possession of inside information are generally prohibited from selectively sharing this information with others or giving recommendations (tipping), causing difficulties for potential bidders who wish to reach out to major shareholders of the target to obtain irrevocable undertakings or to their own shareholders to gauge whether they are willing to support the bid. We identify the
circumstances under which information can be shared with such parties, and the conditions that need to be met. We also address the important question of when issuers are no longer entitled to keep inside information private and need to make public disclosure (section 3).

The fourth section of the chapter analyzes the extent to which bidders are permitted to build a stake in the target prior to announcement of the offer. Stake building is common and yields important financial benefits for bidders, as well as strategic advantage vis-à-vis other potential bidders and, in the case of hostile offers, target management. This section also addresses the prohibition for target companies and classical insiders to trade on information regarding a pending bid. Bidders can also have inside information relating to their own shares, potentially preventing them from repurchasing shares or issuing new shares in a secondary offering.

In the fifth section of the chapter, we discuss reporting obligations in respect of trades, distinguishing between reporting obligations for bidders and for classical insiders. We show that these obligations serve multiple purposes, including facilitating enforcement of the prohibition on insider trading and notifying target managers of pending offers. Perhaps most importantly, these reporting obligations serve the purpose of improving informational efficiency of the stock market, yet in doing so restrict potential bidders’ profits from stake building, thereby negatively affecting their appetite to launch an offer. The chapter concludes with a brief discussion of policy implications.
II. WHEN DOES INFORMATION ON A TAKEOVER BECOME INSIDE INFORMATION?

For the bidder, target and insiders it is essential to understand exactly when information about a potential offer qualifies as inside information. From that particular moment onwards, the prohibition on insider trading applies, as does the prohibition on selectively sharing inside information and tipping. At the same time, an obligation to publicly disclose the information to the market is triggered. Persons involved in the potential offer should thus be especially vigilant in their dealings from then on. Under EU law, inside information is defined as information (1) of a precise nature, (2) which, if it were made public, would be likely to have a significant effect on the price of financial instruments, and (3) that relates, directly or indirectly, to one or more issuers or financial instruments.\(^1\)

We briefly discuss each of these elements below.

A. The “Precise Nature” Test

The basic idea behind the “precise nature” test is to exclude premature information from the definition of inside information. The test requires that an event such as a takeover bid should reasonably be expected to occur before it constitutes inside information.\(^2\) The US federal securities laws contain a comparable condition to filter out premature information.

\(^1\) Section 2(1) Directive 2003/6/EC. We refer to the directive as “EU law”; however, directives need to be implemented by Member States and actual rules in force at the national level may therefore vary slightly.

from the prohibition on insider trading: materiality, according to SEC v. Texas Gulf Sulphur, “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”³ In Basic v. Levinson, this has been confirmed in a merger context: “materiality in the merger context depends on the probability that the transaction will be consummated, and its significance to the issuer of the securities.”⁴ Thus, under both EU law and US law, the probability that a future event such as a takeover bid will occur should exceed a certain minimum threshold.

In the European context, the “precise nature” test serves a particular purpose. Since EU issuers are bound by an affirmative disclosure obligation (discussed in the following section), they may be required to disclose ongoing merger negotiations.⁵ The “precise nature” test precludes issuers from having to disclose information regarding takeovers if the information is not (yet) sufficiently precise. Indeed, the first purpose of the test is to confine the amount of information that issuers have to produce and the investors need to process before making an investment decision. As is well known, the adage “the more, the better” does not apply to information disclosure. At some point, the marginal benefits of increased availability of information no longer weigh up against the marginal costs of producing more information. In addition, information overload may make it more difficult for investors to make informed investment decisions. The second

⁵ Section 6(1) Directive 2003/6/EC.
purpose of the test is to prevent issuers from having to make premature disclosures about possible events and then becoming exposed to claims that they have misinformed the market if such events do not materialize.⁶

According to the “precise nature” test, information on a future event such as a potential takeover bid should meet two conditions: (1) as noted earlier, it should reasonably be expected to come into existence or occur; and (2) the information should be sufficiently specific to draw a conclusion on the potential impact of the information on the share price.⁷ As to the first condition, it is unclear when exactly an event may reasonably be expected to occur and whether the minimum probability is closer to, say, 30 percent or 70 percent.⁸ This leaves market participants with a high degree of uncertainty. The European Securities Markets Authority (ESMA, formerly CESR) has so far done little to remove this uncertainty.⁹ As a result, national regulators could be led to believe that any stage in a takeover process may qualify as sufficiently precise, even if the probability of a takeover at that time is close to zero. Contributing to this risk is that

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⁶ To avoid this, issuers tend to provide the least amount of information possible, thereby exposing themselves to a different type of claim, based on the allegation that they have provided incomplete information.


⁹ ESMA has so far only provided negatively framed guidance, stating that precise information may exist even if a proposed takeover might not actually occur, and that information can be of a precise nature even if a potential bidder has not yet decided the offer price or even if it has not finally decided which of two possible targets to make an offer for. CESR, supra note 8 at 5.
regulators’ ex post assessment could be subject to hindsight bias. Regulators may be tempted to conclude that on T=1 the takeover must have been reasonably expected to occur, merely because of the fact that on T=2 the takeover actually occurred.

The second condition of the “precise nature” test prescribes that the information should be sufficiently specific to draw a conclusion on the potential price impact. This condition overlaps with the requirement that the information should be price sensitive (discussed below), and therefore is often not given full weight by regulators and sometimes simply ignored. Nevertheless, it does have meaning in and of itself: the information should form a sufficient basis for drawing a conclusion on the possible impact on price. This may be the case if (1) the information allows a reasonable investor to make an investment decision without, or at very low, financial risk; or (2) when it concerns information that is likely to be exploited immediately by the market. Consequently, the information should enable an assessment of how the information, once publicly known, would affect the price. Since the investment decision should be almost


\[\text{See CESR, supra note 8 at 5.} \]
riskless, it seems that the information should at least indicate a potential impact on the price and also provide insight into the direction thereof.\textsuperscript{12} 

Given the uncertainty on when information is to be considered of a precise nature, it is not surprising that the EU Court of Justice (ECJ) has been requested to provide clarity on the issue.\textsuperscript{13} In the case of \textit{Markus Geltl v. Daimler AG}, the ECJ has held that information relating to future circumstances or events can only be of a precise nature if “there is a realistic prospect that [the future circumstances or events] will come into existence or occur [emphasis added].”\textsuperscript{14} It is remarkable, and commendable, that the ECJ has not followed the Advocate-General’s opinion on this point. According to the Advocate-General, it would have been “sufficient that the occurrence of the future set of

\begin{itemize}
\item[\textsuperscript{12}] Of course, investors can also benefit from price changes without knowing the direction of expected price movements, e.g. by purchasing straddles.
\item[\textsuperscript{13}] On January 14, 2011, the German Bundesgerichtshof referred a request for a preliminary ruling to the EU Court of Justice in the case Markus Geltl v. Daimler AG, revolving around the resignation of a CEO preceded by a series of consultations that were not disclosed to the market. The question was whether issuers have an ad-hoc disclosure duty for information on intermediate stages that precede a future event and whether information can be of a “precise nature” if occurrence of a particularly significant event is not unlikely. See also Katja Langenbuccher, \textit{Insider Trading in European Law}, Chapter 22 of this volume, at 436-440.
\item[\textsuperscript{14}] Case C-19/11, Markus Geltl v. Daimler AG, 2012. The ECJ also ruled that certain intermediate steps of a process to bring about a particular circumstance or event may qualify as precise information. However, this presupposes that the ultimate event is reasonably to be expected and at least not implausible. Otherwise, there is no ground for concluding that the information on the intermediate step is sufficiently specific and would have an impact on the price. Indeed, the second condition of the “precise nature” test would not be satisfied. According to the ECJ, “precise information is not to be considered as including information concerning circumstances and events the occurrence of which is implausible,” because otherwise “issuers could believe that they are obliged to disclose information which is not specific or is unlikely to influence the prices of their financial instruments.” See consideration 48.
\end{itemize}
circumstances or event, albeit uncertain, be not impossible or improbable,” provided that “the potential of the information for affecting share prices is significant.” Obviously, many potential events and potential takeover bids, regardless of how uncertain they are, may qualify as “not impossible or improbable,” and the resulting disclosure obligation would therefore have likely been overbroad. This would have resulted in additional costs for issuers as well as increased liability risk, while the benefits for the investor community would have been doubtful given the information processing efforts that would need to be made and the risk of information overload. Importantly, it would also have affected the European public merger and acquisition market by hindering exploratory talks between public companies regarding potential business combinations.

15 See also Langenbucher, supra note 13 at 438-439.


17 At least, companies engaging in such talks would be at risk that they have to make an unwanted, early disclosure should there be rumors or indications of a leak (see Section III.B. below on mandatory public disclosure). It is even conceivable that major shareholders or third parties, such as hedge funds, would intentionally release rumors on supposed merger talks if they had an interest in expediting the takeover or eliciting a takeover battle. This is because if the rumor were true, the target company would be required to make a public disclosure on its merger talks, thereby bringing the company in play.
B. The “Price Sensitivity” Test

Once it has been established that information is of a precise nature, the next step is to determine whether the information is likely to have a significant price effect were it made public.\textsuperscript{18} In doing so, it should first be verified that the information is not already in the public domain. If it is, the information cannot qualify as inside information under EU law (the same applies in respect of US law). After all, public information is stale information without (news) value and disclosure therefore cannot be expected to have a price effect, at least not according to the efficient capital market hypothesis, which posits that public information will already be reflected in current market prices. As a result, it should be impossible for insiders to misuse such information.\textsuperscript{19}

When should information be deemed price sensitive? There is no minimum threshold above which a price effect qualifies as “significant,\textsuperscript{20}” nor is there a sub-definition that offers guidance in this respect.\textsuperscript{21} As a result, market participants are confronted with another layer of uncertainty, in particular when they become involved in processes with intermediate stages preceding a future event, such as takeover negotiations, and need to assess at what particular moment information starts to become

\textsuperscript{18} Section 1(1) Directive 2003/6/EC.


\textsuperscript{21} Attempts to do so have merely resulted in tautological expressions and ambiguous guidance. See CESR, supra note 8 at 5.
likely to have a significant price effect and thus starts to qualify as inside information. The European Commission, in an attempt to shed light on the issue, has stated that information should be considered likely to have a significant price effect if “a reasonable investor would be likely to use the information as part of the basis of his investment decisions.”\textsuperscript{22} While this criterion shows strong resemblance to the reasonable investor criterion that applies under US federal securities laws,\textsuperscript{23} the Commission’s approach ignores the fact that when reasonable investors consider information relevant in making their investment decisions, this does not necessarily imply that the disclosure of such information would have a significant price effect. After all, the information may for example confirm the validity of expectations regarding the firm’s prospects that are already reflected in the current share price. What is more, not all revaluations of the firm’s prospects will result in a “significant” price effect.

Predictably, national regulators often rely solely on the “reasonable investor” criterion, since this criterion is met more easily than the “significant price effect” criterion. Sometimes, they treat the two criteria as if they were interchangeable, as the Commission has done. A case in point is the FSA’s recent imposition of a fine on hedge fund manager David Einhorn for having traded on non-public information relating to Punch Taverns, Inc. shares. The FSA’s decision was based in part on the reasoning that

\textsuperscript{22} Section 1(2) Commission Directive 2003/124/EC.

\textsuperscript{23} TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (holding that there must be a substantial likelihood that a reasonable shareholder would consider the information important when buying or selling a financial instrument).
the information was likely to have a significant effect on price (merely) because a reasonable investor would likely have used the information as part of the basis of his investment decisions.24

In sum, the current state of play in the EU is that it may not require a lot for information to qualify as inside information and for the prohibition on insider trading and the disclosure obligation to kick in. Given the negative consequences of an overly broad scope of the disclosure obligation, the Commission arguably should consider abandoning the “reasonable investor” criterion and resorting only to the significant price effect criterion. Alternatively, the Commission could reframe the “reasonable investor” criterion such that it becomes clear that the information should at least cause the reasonable investor to significantly revalue the share.

C. Information Relating to an Issuer of Shares or to Shares

The condition that the information should relate, directly or indirectly, to an issuer of shares or to shares is easily met.25 Among other things, the condition implies that a bidder and a target can have inside information relating to one another’s shares. To begin with, a potential bidder will often be in possession of information that is highly price sensitive as


25 Section 1(1) Directive 2003/6/EC.
to the target’s shares. As Figure 23.1 illustrates, the announcement of a takeover bid typically causes the target’s share price to increase strongly.26

Figure 23.1 EU target abnormal returns


The strong positive price effect is primarily due to the anticipation of a bid premium to be paid by the bidder, and also to factors such as expected synergies between the companies, tax benefits and changes in board composition.27 To be sure, the same


27 See Sayan Chatterjee, Sources of Value in Takeovers: Synergy or Restructuring—Implications for Target and Bidder Firms, 13 Strategic Manage. J. 269–272 (1992); Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 163 (1991); Michael C. Jensen & R.S. Ruback, The Market for Corporate Control, 11 J. Fin. Econ. 23 (1983). The post-announcement share price typically remains below the offer price, reflecting the risk that the offer might not succeed. This is different when the market expects a competing offer to be launched, in which case the target’s share price may exceed the offer price to reach a level that
price effect would not necessarily occur at an earlier stage, when parties are merely exploring the possibility of a business combination and a takeover bid is not (yet) reasonably to be expected. What matters for present purposes, though, is that the potential bidder will possess information that, once it becomes sufficiently precise, may be highly price sensitive as to the target’s shares and therefore qualify as inside information.

At the same time, the bidder may possess inside information regarding its own shares. As one would expect, the effect of a takeover announcement on the bidder’s share price is far less pronounced than the effect on the target’s shares, and the direction of the movement in the share price is not as predictable (see Figure 23.2).

Nevertheless, in individual cases regulators may well conclude that the bidder was in possession of inside information regarding its own shares, especially when the takeover is accompanied by a significant issuance of shares, either because it concerns an exchange offer or because the bidder will need to raise equity capital to finance the bid.

28 Martynova & Renneboog, supra note 26. See also Jovanovic & Braguinsky, supra note 26 at 46. As Figure 23.2 shows, there can be upward and downward price pressure. There are various explanations for this. Downward price pressure can be caused by investors who believe that the bid premium is too high compared with potential synergies and that the bid would thus result in a wealth transfer from the bidder’s shareholders to the target’s shareholders. Upward price pressure can be attributed to investors who believe the present value of the synergies (and possibly of the strategic benefits) exceeds the premium.

reflects the expected premium of the competing offer, again discounted for the probability that such offer may not succeed (or may not be launched after all).
III. DISCLOSURE OF INSIDE INFORMATION

A. Sharing Inside Information with Outsiders

A primary purpose of the prohibition on selectively sharing inside information is prevention of leakage. Leakage increases the number of people in possession of inside information and thereby the probability of insider trading. If there were not a sufficient downside to disclosing inside information, insiders could even start selling inside information to persons who would not be deterred by the risk of being prosecuted for
insider trading violations. However, as a practical matter these prohibitions may also constitute obstacles in the preparation of a takeover, for example by preventing potential bidders from reaching out to the target’s major shareholders to obtain irrevocable undertakings. In the USA, insiders disclosing inside information to outsiders can be held liable under Section 10(b) of the Securities Exchange Act 1934 and Rule 10b-5 if they do so for an improper purpose.\(^{29}\) In terms of takeovers, pursuant to Section 14(e) and Rule 14e-3, it is unlawful for the bidder or target to communicate inside information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in insider trading. Likewise, Regulation FD prohibits directors from disclosing inside information to certain recipients including shareholders, if it is reasonably foreseeable that they will purchase or sell the company’s securities on the basis of that information (see Chapter 7 of this volume for a detailed discussion of Regulation FD).\(^{30}\)

EU law similarly prohibits those who are in possession of inside information from selectively disclosing this information to others. They are also prohibited from recommending or inducing another person to purchase or sell shares on the basis of inside information (tipping).\(^{31}\) A distinction is made between primary and secondary insiders.\(^{32}\)


\(^{31}\) Section 3 Directive 2003/6/EC.

\(^{32}\) Section 4 Directive 2003/6/EC.
Primary insiders are persons who possess inside information on a regular basis, including executive or non-executive directors and major shareholders. Persons who do not qualify as primary insiders qualify as secondary insiders. Primary insiders are deemed to be aware of the fact that they are in possession of inside information. By contrast, in cases where a secondary insider is suspected of selectively disclosing information or tipping, proof is required that he knew, or ought to have known, that he was in possession of inside information.

Absent nuances or exemptions, the prohibition on disclosing inside information would severely hinder issuers and their employees in conducting activities in the ordinary course of business. For example, a business secretary would not be able to circulate the minutes of a meeting when they include inside information. Also, the press officer would not be able to disclose inside information to the market. Since there is no reason to prohibit such activities, EU law permits disclosure of inside information “in the normal course of the exercise of employment, profession or duties.” The scope of this exemption is not fully clear. In the matter of Grøngaard & Bang, the ECJ held that EU Member States should interpret the exemption in a restrictive manner. Further guidance is typically offered at Member State level.

As a practical matter, when parties intend to share information with outsiders they typically enter into a confidentiality agreement prior to granting access to the

33 Case C-384/02, 2005 E.C.R. I-9939. There should be a close link between the disclosure and the employment, profession or duties, and the disclosure should be strictly necessary for the exercise thereof. See Langenbucher, supra note 13 at 434.
information. The imposition of a duty of confidentiality on the receiving party is vital, for otherwise the disclosure to that party would trigger an obligation to publicly disclose the information without delay. 34 Yet even if a confidentiality agreement is put in place, the key question remains whether an exemption applies. Disclosing information to major shareholders of the target with a view to obtaining a commitment that they will tender their shares under the offer is allowed in most EU Member States, provided that the support of such shareholders is actually necessary for the offer to succeed and that no more information is disclosed than strictly necessary. 35 This exemption is justified from an efficiency perspective, since enabling the bidder to assess at an early stage whether major shareholders are willing to support the bid provides the bidder comfort that he will not waste resources (in the form of management time and advisors’ fees) in connection with the preparation of a bid that is doomed to fail.

There are several other situations in which bidders and targets may want to share inside information with outsiders. A bidder may wish to consult some of its own major shareholders, for example if the bidder will need to raise equity to finance the bid or if the bidder requires shareholder approval for the takeover. A bidder may also want to reach out to other companies to form a bidder consortium or to discuss the possibility of a back-to-back sale of certain assets of the target. Target management, for its part, may also wish

34 Section 6(3) Directive 2003/6/EC. The FSA seems to take a slightly more flexible approach to the duty of confidentiality. FSA Market Conduct Sourcebook, MAR 1, 1.4.5.

to reach out to its major shareholders to gauge their support or, in the case of a perceived threat of a hostile offer, to another preferred potential bidder (a so-called “white knight”). While there are efficiency reasons for facilitating the sharing of information for these various purposes, no specific exemptions apply under EU law and neither have the relevant authorities provided guidance in this respect, meaning that market participants rely solely on the use of confidentiality agreements. A certain degree of uncertainty therefore remains, which could restrain bidders or targets from sharing inside information, possibly resulting in fewer transactions than might be economically efficient. To the extent individual EU Member States have provided for exemptions, applicable standards may diverge across countries, discouraging cross-border acquisitions and thereby undermining the creation of a single European market.

B. Mandatory Public Disclosure

Under US federal securities laws, public companies do not have a general ongoing obligation to disclose material non-public information to the market.\(^{36}\) In principle, the acquirer and the target could therefore choose to make a public announcement only after they have reached final agreement on a deal. Disclosure at an earlier stage may, however, be required by stock exchange rules. The New York Stock Exchange’s listing rules, for example, require issuers to quickly release any news or information that might reasonably

be expected to materially affect the market for their securities.\textsuperscript{37} Issuers are also required to make an announcement if rumors or unusual market activity indicate that information on impending developments has leaked.\textsuperscript{38}

EU law contains an ongoing obligation for issuers to disclose inside information without delay.\textsuperscript{39} Consequently, from the moment information on a potential takeover bid qualifies as inside information, the issuer has an obligation to disclose the information—unless it is allowed to delay disclosure. Delay is permitted if three cumulative requirements are met, the first being that the issuer must have a justified interest in doing so. Such an interest may exist, for example, if disclosure could negatively affect the outcome of pending negotiations, or when decisions taken by executives are still subject to board approval.\textsuperscript{40} Accordingly, issuers will usually have a justified interest in delaying disclosure of the fact that merger negotiations are taking place.

The second requirement is that the delay of disclosure may not mislead the public. In theory, any delay of disclosure of material non-public information could result in the market being misled. This suggests that delay should never be possible, which is not the case.\textsuperscript{41} It is generally understood that non-disclosure may mislead the market if the issuer discloses information that contradicts, or relates to, information that is being withheld.

\begin{footnotesize}
\begin{enumerate}
\item NYSE Rule 202.05.
\item NYSE Rule 202.03.
\item Section 6(1) Directive 2003/6/EC.
\item Section 3(1) Commission Directive 2003/124/EC.
\item CESR, supra note 8 at 11.
\end{enumerate}
\end{footnotesize}
Also, the market could be misled if an issuer withholds information that would shine a different light on previously disclosed information. In determining whether the issuer is allowed to delay disclosure, previous disclosures will therefore have to be taken into account.

The third requirement that needs to be met for delay to be permitted is that the issuer guarantees the confidentiality of the information by controlling access to the relevant information and taking adequate measures (including preparing an insiders’ list) to ensure access is limited to persons who need to have access as part of the normal exercise of their work, profession or responsibilities. The issuer should also take measures to be prepared to make the information generally available without delay as soon as confidentiality can no longer be guaranteed, such as drafting press releases.\(^{42}\)

While there should normally be clear rumors to warrant the conclusion that confidentiality is no longer guaranteed,\(^{43}\) courts sometimes consider irregular trading activity sufficient. For example, a Dutch court held that deviant share price movements or

\(^{42}\) Section 3(2) Commission Directive 2003/124/EC.

\(^{43}\) In general, if a bidder is preparing a hostile bid and rumors would cause the target's share price to increase, it is still only the bidder that has actual information on the potential hostile bid. The target, obviously, cannot make a disclosure in this respect for lack of information. If a bidder and target are negotiating a friendly deal, and rumors cause the target's share price to rise, the target may have a disclosure obligation. The information on the potential friendly deal should then at least qualify as inside information regarding the target's shares. The bidder may as well be required to make a disclosure if rumors were to spread. This can be the case if the bidder is a listed company and the information on the potential bid qualifies as inside information regarding the bidder's shares.
deviant trading volumes could be a signal that confidentiality is no longer guaranteed.\textsuperscript{44} In the case at hand, the target, a Dutch supermarket chain, had received a bid letter from a potential bidder. Within a few days, trading volumes and the share price started to increase, without there being any clear rumors. A minority shareholders’ association initiated civil proceedings and successfully claimed that the issuer had failed to make prompt disclosure. While ostensibly sound, the difficulty with this approach is that it seems to ignore the fact that price and volume movements could be caused by information or trades \textit{unrelated} to the takeover. If the court’s decision, which is currently pending in appeal, were to be upheld, Dutch issuers may feel compelled to go public unless they have clear indications that the price and volume movements are caused by news or rumors unrelated to the takeover. In practice, this would result in a high degree of uncertainty. Issuers would have to monitor rumors unrelated to the takeover and, if there are any, determine whether these form a sufficient explanation for the price and volume movements. Also, major shareholders or hedge funds who wish to expedite a takeover or elicit a bidding contest may cause price and volume movements with a view to forcing the issuer to disclose any pending negotiations, thereby putting the company in play.

The current ad-hoc disclosure obligation is expected to become subject to changes in the short term. The European legislator has proposed several amendments to the

\textsuperscript{44} Super De Boer v. VEB, Utrecht District Court, LJN: BP9796, March 30, 2011.
current disclosure obligation. Yet, at this stage it is unclear whether the legislative efforts will result in a more lenient disclosure regime for European issuers or not.

IV. TRADING

A. Trading by the Bidder

The acquisition of a minority stake, or “toehold,” prior to announcing a bid may yield important financial benefits for bidders, since the price against which such shares can be purchased will not yet reflect the anticipated bid premium. Stake building may also create a strategic advantage vis-à-vis other potential bidders and, in the case of hostile offers, target management. From an efficiency perspective, the bidder’s gains from stake building can be considered a reward for the effort of searching for potential synergies. Such gains can also be considered as a means to finance the relatively high bid premium that target shareholders will expect due to the free-rider problem associated with takeover bids. As a result, the bidder will be able to profit from his monitoring efforts upon


acquisition of the firm even after paying the premium. Even if the bidder does not succeed and a competing bidder were to end up realizing the synergy gains, sale of the toehold by the initial bidder to its competitor will ensure that search costs are covered.

In practice, bidders often do acquire a toehold. An empirical study by Betton et al. (2009) shows that in the period 1973–2001, 26.3 percent of bidders in their US sample acquired a toehold, with an average size of 20.3 percent. For hostile offers, the percentage is much higher, with 50.3 percent of bidders acquiring a toehold. As Figure 23.3 shows, the number of bidders for US companies that have been acquiring toeholds has been decreasing over time, which Betton et al. (2009) suggest may be explained by the availability of the “poison pill” as a defense mechanism for US target companies. While we are not aware of similar data regarding EU takeovers, it could well be that such data would show a different picture, given that in some jurisdictions such as the UK, target companies are limited in their ability to respond to stake building by taking defensive measures.

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Under US federal securities laws, a bidder acquiring a toehold while in possession of material non-public information regarding the target would violate Rule 10b-5. However, if the bidder acquires a toehold prior to having conducted due diligence, the bidder will merely have knowledge of its own intentions to potentially launch an offer for the target’s shares and the acquisition of a toehold generally does not constitute a breach of a duty of trust or confidence.\(^{50}\) Rule 14e-3 also does not prevent such acquisition, since this rule merely prohibits persons other than the “offering person” from insider trading in the context of tender offers. Thus, even though there is no explicit exemption available for toehold acquisitions under US law, such acquisitions are generally permitted.

Under EU law, corporations and natural persons are prohibited from using inside information when trading in shares to which that information relates. While this prohibition only applies to the extent inside information is actually “used,” the ECJ’s decision in the Spector case suggests that when a bidder trades while in possession of inside information with respect to the target, the authorities may simply presume that the bidder “used” the inside information. This means that it is up to the bidder to rebut this presumption, and Spector can therefore hardly be considered a safe haven for toehold acquisitions. Be this as it may, individual EU Member States often use another ground to exclude toehold acquisitions from the prohibition on insider trading. This exclusion is based on the recitals of the Market Abuse Directive, which states that EU Member States may apply a milder regime in the context of public offers and that transactions are allowed if the trader merely has knowledge of its own intentions. Indeed, most EU Member States have more or less explicitly allowed toehold acquisitions. In the UK, for example, the FSA has indicated that trading in the context of a public takeover bid to gain control does not in and of itself amount to market abuse. And in the Netherlands,

51 Section 2(1) Directive 2003/6/EC.
52 Case C-45/08, Spector Photo Group, 2009 E.C.R. I-12073.
53 Recitals 29 and 30 of Directive 2003/6/EC.
54 See generally Nussbaum, Martin & Perry, supra note 35.
55 FSA Market Conduct Sourcebook, MAR 1, 1.3.17–1.319.
legislators have declared that knowledge of one’s own intentions should not be considered inside information.\textsuperscript{56}

Again, once the bidder obtains material non-public information from the target, things become different and the bidder will generally be prevented from trading. This may be due not only to the statutory prohibition on insider trading, but also due to restrictions imposed by the target on the bidder through the confidentiality agreement that the parties will usually have entered into prior to the target granting the bidder access to information relating to the target. Obtaining such access is crucial for the bidder to conduct its due diligence and estimate potential synergies, but in exchange the target will typically insist on inclusion in the confidentiality agreement of a standstill provision, preventing the bidder from unilaterally purchasing target shares for a certain period of time. Indeed, as the Delaware Chancery Court’s recent decision in the matter of \textit{Martin Marietta Inc. v. Vulcan Materials Company} reminds us, a standstill provision may be found to exist even if it has not been explicitly included in the agreement.\textsuperscript{57}

Does this mean that the bidder has to cease the purchase of target shares upon approaching the target? We believe not necessarily, given that an approach in and of itself does not necessarily result in the bidder obtaining inside information. Indeed, EU law does not explicitly prescribe that the bidder should immediately cease purchasing target shares upon approaching the target, nor does it explicitly prescribe that the bidder

\textsuperscript{56} Parliamentary Papers II 1997/98, 25 095, no. 8, at 4, 8.

should do so once it gains an impression of the target’s willingness to cooperate (or lack thereof). This makes sense, given that a target’s unwillingness to enter into talks may influence the bidder’s course of action but not necessarily the outcome. After all, the bidder may carry on without the target’s support.

Alternatively, suppose the target’s CEO comes back with a specific, higher price at which the target board is willing to support a takeover. Again, this does not necessarily mean that the bidder has obtained inside information with respect to the target. Responding with a specific, higher price is often part of the target’s negotiation tactics. It does not necessarily imply that the bidder can only be successful by raising the offer since ultimately, it is up to the target’s shareholders to decide on whether or not to tender their shares. However, if it is apparent that the target’s valuation is based on material non-public information, for example on unpublished half-yearly financial results or a material contract, the bidder may have to cease purchasing target shares.

B. Trading by Classical Insiders and Corporations

Under the US prohibition on insider trading, “classical” insiders such as directors and officers are not allowed to trade if they have material non-public information, and it is generally understood that corporations, too, are subject to this prohibition.58 A major development in this regard has been the adoption of the misappropriation theory by the

Supreme Court in 1997. This has widened the scope of the prohibition by including outsiders who trade on the basis of material non-public information in breach of a duty of trust or confidence. Shortly thereafter, the “possession versus use” debate was settled. Until 2000, some courts took the view that the trader had to be in “knowing possession” of inside information while other courts required actual “use” of the inside information. In 2000, the Securities and Exchange Commission (SEC) effectively ended this debate by adopting Rule 10b5-1, which requires that the trader be “aware” of the inside information and which provides for a number of affirmative defenses.

Under EU law, persons are prohibited from using inside information when trading in shares to which that information relates. Accordingly, all legal and natural persons, irrespective of whether they are insiders or outsiders, are subject to the EU prohibition on insider trading. This already makes it a more sweeping prohibition than its US equivalent. The EU prohibition applies to the extent inside information is “used,” which triggered a “possession versus use” debate comparable to that in the USA. The ECJ settled this debate by ruling in Spector that, if a primary insider trades while in possession of inside information, the regulator may simply presume that the inside information has been used.

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60 Allan Horwich, The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1, 62 Bus. L. 913, 917–920 (2007). Under Rule 10b5-1, corporations and individuals have, for example, an affirmative defense if they trade in accordance with a pre-existing trading plan, which should have been adopted prior to receiving any material non-public information.

61 Section 2(1) Directive 2003/6/EC.
“used.” It is then up to the defendant to rebut the presumption and to motivate that he did not use the inside information for his trades, for example, if he sold shares when the inside information indicated a price increase.

The foregoing shows that the prohibitions on insider trading equally apply to corporations and natural persons, even though corporations operate in a more complex business environment than natural persons. In spite of this, EU law, and apparently also US, law lack constructive guidance on how corporations are supposed to act when they have material, non-public information, for example, on a takeover bid. There are no clear rules on trading by the corporation when having information on a takeover bid. Consequently, various questions may arise if a corporation wishes to make toehold acquisitions, obtain irrevocable undertakings, repurchase shares or issue new shares in a secondary offering. Of course, there are market practices and affirmative defenses, but these do not always provide the level of comfort that corporations seek.


63 Another potential defense exists if the contracting parties possessed the same information so that there was no information asymmetry (Case C-391/04, Georgakis, 2007 E.C.R. I-3741).

64 In the USA, corporations can limit the risk of insider trading liability by setting up a trading plan in accordance with Rule 10b5-1 prior to any share repurchases. See Loewenstein & Wang, supra note 58 at 71. And EU law provides a safe harbor for buy-back programs if certain transparency and trading conditions are met. Commission Regulation (EC) 2273/2003. These affirmative defenses, however, are rather limited. Besides, in terms of share offerings, neither the
V. REPORTING OF TRADES

A. Toeholds

As we have seen, acquiring a toehold can be an attractive strategy for potential bidders for a variety of reasons. Yet the extent to which a potential bidder may discreetly purchase shares in the market is limited. Pursuant to the European Transparency Directive, shareholders acquiring in excess of 5 percent (or such lower threshold as set at national level) need to report their position, just as shareholders in US listed companies need to pursuant to Rule 13-D.65 Once the market learns of the identity and stake of the potential bidder, the share price will rise in anticipation of a bid against a premium over the current share price (as illustrated in Figure 23.1), and the bidder will no longer be able to purchase shares cheaply. Thus, while ownership disclosure rules generally enhance market efficiency, they can also discourage bidders from making a bid in the first place.66

If the bidder intends to bypass target management and is covertly building a stake prior to launching a hostile offer, mandatory disclosure may also function as an early

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USA nor the EU rules stipulate under which conditions issuers may proceed with an intended secondary offering if they possess inside information. Indeed, Rule 10b5-1 may only be used in the context of certain secondary offerings. See also Horwich, supra note 60 at 929.


warning system to target management. By enabling target management to take defensive measures, mandatory disclosure potentially undermines the market for corporate control. At the same time, temporary defenses may benefit existing shareholders by strengthening the board’s bargaining position in the case of a bid that undervalues the target and by enabling the board to reach out to other potential bidders to encourage them to launch a superior bid. The challenge for policymakers is to set a threshold for initial disclosure that strikes an optimal balance between these interests.

One way to make it possible for potential bidders to obtain a financial gain from buying shares at the pre-bid price while preserving target management’s ability to adequately respond to an attempt to acquire control is by enabling bidders to obtain financial exposure to the target shares through cash-settled equity derivatives. The Transparency Directive currently does not require disclosure of cash-settled equity derivatives, only of physically settled equity derivatives such as call options. However, in many EU Member States, including the UK, France and Germany, the law has recently been amended to require disclosure of cash-settled equity derivatives as well. A major driver for these changes has been the desire to prevent creeping takeovers by bidders who enter into a derivative contract with a counterparty (usually a bank) stipulating cash settlement, yet upon termination of the contract nevertheless settle physically, thereby acquiring a sizeable stake while avoiding the price increases that open market purchases (and accompanying disclosure of the crossing of the 5 percent threshold) would have caused. Indeed, there have been several high-profile examples of this strategy, including
the controversial takeover of tire manufacturer Continental by Schaeffler in Germany and more recently LVMH’s acquisition of a large stake in luxury goods powerhouse Hermès.

The European Commission has recently proposed expanding the scope of the Transparency Directive along the same lines, and in the USA the SEC is considering doing the same. While there are strong arguments in favor of such a move, one possibly unintended effect is thus that it limits potential bidders’ ability to exploit the information they have regarding their intention to launch an offer, making takeover bids costlier and discouraging bidders from making a bid in the first place. This is especially true if expanding the scope were combined with a lowering of the initial disclosure threshold from 5 percent to 3 percent, as has been done in EU Member States such as the UK and as has been proposed by the European Commission.67

B. Insider Trades

EU law requires all transactions by corporate insiders in the company’s shares (or derivatives linked to them) to be reported to the national regulator, just as US law requires that transactions by corporate insiders be reported to the SEC.68 In each case, the information is publicly disclosed by the regulator, enabling the market to learn of insider trades, albeit with a delay: the European Market Abuse Directive requires trades to be reported within five days of the transaction date while in the USA trades are only


required to be reported within two days after the end of the month in which they occurred.

In its recitals, the Market Abuse Directive states that the publication of transactions by insiders can be a highly valuable source of information to investors.\textsuperscript{69} Indeed, as one of us has argued elsewhere, disclosure of transactions by insiders contributes to market efficiency by conveying to the market underlying fundamental information driving the transactions, thereby causing the share price to move closer toward the correct price.\textsuperscript{70} Absent such disclosure, insider trading may still contribute to market efficiency, yet the derivatively informed trading mechanism of market efficiency will operate at a slower rate. As explained in Chapter 1 of this volume, the mechanism will then affect market prices, first (and only marginally) because of the trading itself, and subsequently because of leakage, tipping, observation of the insider’s trades or by following the price fluctuations of securities. Mandatory disclosure of the insider’s trades enables the market as a whole to respond by trading on the information—at least to the extent the information is not yet fully incorporated in the share price, which is why the time window between the trade and the reporting obligation matters.

Empirical studies confirm that insiders tend to purchase stock prior to an abnormal rise in stock prices and sell stock prior to an abnormal decline in stock prices, which suggests that these trades are motivated by the possession of non-public

\textsuperscript{69} Recital 22 Directive 2003/6/EC.

information about the company’s prospects. For example, a recent study by Malloy et al. (2012) that distinguishes between routine trades (e.g., trades for liquidity reasons) and “opportunistic” trades found that opportunistic trades yield abnormal returns of about 8 percent over a 12-month period, with no reversal following the price rise (see Figure 23.4). The study further shows that opportunistic trades (primarily buys) predict analyst information releases (recommendations and earnings forecasts), analyst earnings forecasts by themselves, management forecasts and firm-level earnings announcements. This explains why markets tend to respond to the disclosure of such trades, as evidenced by this study and previous empirical studies. Thus, mandatory disclosure of insider trades accelerates the speed at which fundamental information is incorporated in the share price, thereby contributing to market efficiency.


Id. See also, e.g., Jana P. Fidrmuc, Marc Goergen & Luc Renneboog, Insider Trading, News Releases, and Ownership Concentration, 61 J. Fin. 2931, 2949 (2006) (finding that UK directors’ purchases and sales generate statistically significant abnormal returns of 3.12 percent and –0.37 percent respectively, measured over the two-day window starting with the announcement day); Jesse M. Fried, Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure, 71 S. Cal. L. Rev. 303, 354 (1998) (explaining how investors use information on insider trading to determine whether the company’s insiders believe (based on their inside information) that the stock is over- or undervalued).
Interestingly, Malloy et al. (2012) do not find that opportunistic trades have predictive power for merger announcements. A possible explanation for this may be that corporate insiders are well aware that trading on non-public information about pending takeovers is illegal, and the risk of being caught once the takeover has become public is significant given that it will be easy to link the trades reported by the insider with the subsequent announcement of the takeover. In fact, this is precisely one of the effects intended by the Market Abuse Directive, which in its recitals states that the trading information to be reported by insiders constitutes a means for regulators to supervise markets.\textsuperscript{74} This explanation is also consistent with a recent empirical study by Agrawal

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\textsuperscript{74} Recital 26 Directive 2003/6/EC; Recital 7 Commission Directive 2004/72/EC.
and Nasser,\textsuperscript{75} who look at trades reported by insiders at US listed companies. They find no evidence that insiders increase their reported purchases in the period preceding takeover announcements, and suggest that this may be explained by the fact that the ban on short-swing trading (Section 16b of the Securities Exchange Act of 1934) is vigorously enforced by private attorneys. Interestingly, Agrawal and Nasser (2012) do find evidence that insiders reduce their sales during this period, thus increasing their net purchases. This “passive” insider trading often does not constitute a violation of insider trading laws, and is impossible to observe by the market since the decision not to sell does not (and could not possibly) trigger any disclosure obligation.

VI. POLICY IMPLICATIONS

To facilitate a well-functioning market for corporate control, it is essential to have clear rules on how bidders, targets and classical insiders are supposed to act when in possession of inside information. Yet the present analysis has shown that the rules that are currently in place in the EU are insufficiently customized to corporations. Insider trading rules have historically been designed with classical insiders in mind, and as a result fail to take into account certain issues that arise when corporations possess inside information. While regulators sometimes attempt to alleviate this uncertainty with additional guidance, the guidance itself often leaves room for significant interpretation.

\textsuperscript{75} Anup Agrawal & Tareque Nasser, Insider Trading in Takeover Targets, 18 J. Corp. Fin. 598 (2012).
justified by regulators on the ground that they do not wish to exclude any unforeseeable situations that may require regulatory action.

To be sure, any type of regulation will be accompanied with a level of uncertainty. However, EU law and apparently also US law lack constructive guidance on how bidders and targets are supposed to act when in possession of inside information. To the extent regulators have provided guidance, they have often done so on an ad-hoc basis rather than on the basis of a broader policy. From a policy perspective, the challenge is to strike an optimal balance between, on the one hand, effectively combating insider trading, and, on the other hand, observing the particularities of corporations as insiders and facilitating the market for corporate control.

In the EU, policymakers seem to have yielded to the temptation of a more instrumental approach against insider trading, without sufficient regard of the interests of corporations and the market for corporate control. This is not surprising, since insider trading laws and takeover laws are to a large extent discussed separately: the regulation of insider trading is considered a securities law matter, while takeover bids are classified as company law and are highly politicized. The lack of an integrated approach creates legal blind spots and uncertainties for corporations. Obviously, corporations may rely on market practices and certain affirmative defenses, but these do not always provide the corporation with sufficient comfort.

As to recent EU law developments, we believe it is positive that the ECJ has not followed the Advocate-General’s opinion in the matter of Markus Geltl v. Daimler AG,
which would have resulted in a broader disclosure obligation. Still, it remains uncertain how national regulators will apply the ECJ’s judgment in practice and whether it will retain its relevance in light of the proposed EU market abuse regulation. This uncertainty comes on top of certain regulators applying the “reasonable investor” criterion and the “significant price effect” criterion as if they were interchangeable. Consequently, and given that deviating price and volume movements could be deemed a sufficient indication of a leak, corporations may still feel compelled to go public in premature situations, even if nothing really informative can be disclosed at such stage. Policymakers at the European and national level would therefore be well advised to ensure that they carefully consider the impact of contemplated changes to the current regulatory regime on the market for corporate control prior to making such changes.