Final Dissertation

Personal and confidential

14 May 2010

The EU Issuer-Disclosure Regime: An Analysis of its Objectives and Proposals for Reform

-comparative and interdisciplinary approach-

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Acknowledgements

Producing a dissertation is a long process in terms of the hours spent researching, reading, thinking, discussing and writing about the specific subject. It is a restless process, in the sense that ideas and thoughts do not necessarily emerge during working hours. It is also a process that requires discipline to remain focussed on the topic while ensuring that all related issues are properly investigated. Lastly, being a PhD student requires some attraction to solitude.

I say this not to congratulate myself for having gone through this process, as you will be the only judges of whether it was worth the effort.

But rather to stress the gratitude that I have for all those who have accompanied me - either for brief periods of time or constantly - on this journey over the past three years. Each and every exchange of views with academics, practitioners, European Commission civil servants or other researchers have helped develop my thinking. Each and every word of support from family, friends and colleagues was worth its weight of gold.

There are, however, a few individuals to whom I am particularly grateful and I would like to mention them here by name.

Of course, I could not start this non-exhaustive list without addressing my sincere thanks to my director of thesis, who put his confidence in my research and this resulting piece of writing. For his humanity and open mindedness, for making the work place an enjoyable environment, for taking care of all the many administrative matters that cropped up, as well as for our discussions about Belgian company law, I would like to thank Professor Yves De Cordt.

I am also deeply indebted to two of the greatest academics in my field of research, each having a view from a different side of the Atlantic - Professor Eddy Wymeersch, a member of my advisory committee, and Professor Merritt Fox, who kindly sponsored me as a visiting scholar at Columbia Law School. I benefitted from their insights and took heart from their expressions of confidence in my work .

I am also very grateful to have had, as a member of my advisory committee, Philippe Lambrecht, who challenged me to find a good balance between theoretical accuracy and practical necessity.

I was privileged to have particularly fruitful discussions with top lawyers, including Arnaud Coibion, François De Bauw, Matthieu Duplat and Jacques Richelle, from the Brussels office of Linklaters and Patrick della Faille from the Brussels office of Liedekerke. For the comparative law aspect of my dissertation, I drew on the expertise of local attorneys and would like to thank the following individuals for the speed and accuracy of their responses to my many questions: François Colin de Verdière from Cleary Gottlieb Steen & Hamilton, George Cotter from Field Fischer Waterhouse, Steven Hijink who was then working at De Brauw Blackstone Westbroek, Bettina Kluewer and Ugo Orsini from Linklaters, and Sam Wolff from Akin Gump.

Among the other researchers in my area with whom I had very stimulating exchanges of views and who have provided useful advice about how to go about researching and writing a PhD, I would like to mention the great and constant support of my friend, Michael Schouten, from the Duisenberg School of Finance.

I am also delighted to have had the opportunity to discuss my thesis with my father, who provided some commentary based on his personal experience and introduced me to some key individuals.

Last but by no means least, I am extremely grateful to my husband, Jean Baptiste, who has been endlessly understanding and accommodating; who has supported me through bouts of anxiety; and been a source of never-ending intellectual and technical support.

To all and to each of you, including those who I did not name but with whom I had discussions about my researches over the last three years, and including my friend David who kindly let me work from a wonderful peaceful place when it was strongly needed, and my friend Nikla, who helped me improve my British English, my heartfelt thanks.

In conclusion, I would like to dedicate this dissertation to my loving mother, who, while distant from the thoughts you are about to read, is always close to me.

Abbreviations

€:	Euro
Belgian CBFA:	*Commission Bancaire, Financière et des Assurances*
Brussels Regulation:	Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ, 16 January 2001, L 12/1
Capital Requirements Directive:	Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJEU, 30 June 2006, L177/1, together with directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), OJEU, 30 June 2006, L177/201, as amended
CAPM:	Capital Asset Pricing Model
CESR:	Committee of European Securities Regulators
Chapter Corporate Governance:	Chapter 3 of Part II of the dissertation
Chapter Investor Protection:	Chapter 1 of Part II of the dissertation
Chapter Issuer-Disclosure Addressees and Consequences:	Chapter 1 of Part III of the dissertation
Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets:	Chapter 2 of Part III of the dissertation
Chapter Market Efficiency:	Chapter 2 of Part II of the dissertation
CSES:	Centre for Strategy and Evaluation Services LLP
Directive 2009/101/EC:	Directive 2009/101/EC of the European Parliament and of the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second

	paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent, OJ L 258, 1 October 2009, at 11–19
Directive on Investment Recommendations:	Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, OJEU, 24 December 2003, L339/73
Dutch AFM:	*Autoriteit Financiële Markten*
E.U.:	European Union
ECMH:	Efficient Capital Markets Hypothesis
Eighth Company Law Directive:	Directive 2006/43 of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/ 660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ, L 157/87, 9 June 2006, as amended
ESME:	European Securities Markets Expert Group
EU issuer-disclosure regime:	Disclosure requirements as defined in the General Introduction to the dissertation
European Commission Recommendation:	Commission Recommendation 2007/657/EC on the electronic network of officially appointed mechanisms for the central storage of information referred to in the Transparency Directive, OJEU, 12 October 2007, L267/16
European Regulation:	Regulation of the European legislator as provided under Part III:Chapter II:II.B in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets
Fourth Company Law Directive:	Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC), OJ L 222, 14 August 1978, at 11, as amended

French AMF:	*Autorité des Marchés Financiers*
FSAP:	Financial Services Action Plan
GDP:	Growth Domestic Product
German BaFin:	*Bundesanstalt für Finanzdienstleistungsaufsicht*
IFRS Regulation:	Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ, 11 September 2002, L 243/1
IFRS:	International Financial Reporting Standards
Investment Recommendations Directive:	Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest,OJ, 24 December 2003, L 339/73
IOSCO:	International Organisation of Securities Commissions
IPO:	Initial Public Offering
Italian Consob:	*Commissione Nazionale per le Società e la Borsa*
Key Investor Information:	Key investor information as provided under articles 78 to 82 of UCITS IV (also called Key Information Document)
MAD Implementing Directive:	Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, OJEU, 24 December 2003, L339/70
MAD:	Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJEU, 12 April 2003, L96/16
MD&A:	Management Discussion and Analysis of financial

	condition and results of operations as provided under item 303 of Regulation S-K
Member State:	any member state of the E.U. and the additional states of the European Economic Area (Iceland, Liechtenstein and Norway)
MiFID Implementing Directive:	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ, 2 September 2006, L 241/26
MiFID:	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJEU, 30 April 2004, L145/1
OAM:	Officially Appointed Mechanism, as defined under article 21.2 of the Transparency Directive
OECD:	Organisation for Economic Cooperation and Development
OFR:	Operating and Financial Review and Prospects, as defined under the Prospectus Directive
Prospectus Directive:	Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJEU, 31 December 2003, L345/64
Prospectus Regulation:	Commission Regulation (EC) no 809/2004, 29 April 2004, OJEU, 30 April 2004, L149/1
Remuneration Recommendations:	Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of

directors of listed companies, (2004/913/EC), OJEU, 29 December 2004, L385/55, together with Commission Recommendation of 30 April 2009 on Remuneration policies in the financial services sector, 2009/384/EC, OJEU, 15 May 2009, L120/22

Rome II:	Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II), OJ, 2007, L1999/40
Seventh Company Law Directive:	Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts, OJ, 18 July 1983, L 193/1, as amended
Shareholders Rights Directive:	Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJEU, 14 July 2007, L184/17
SME:	Small and Medium-Sized Entreprise, as this term is defined in article 2.1(f) of the Prospectus Directive
Spanish CNMV:	*Comisión Nacional del Mercado de Valores*
Take-Over Directive:	Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ, 30 April 2004, L 142/12
TEC:	Treaty Establishing the European Community
Transparency Directive:	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation 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, OJEU, 31 December 2004, L390/38
Transparency Implementing Directive:	Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain

	provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, OJEU, 9 March 2007, L69/27
Treaty on the Functioning of the European Union:	Consolidated version of the Treaty on the Functioning of the European Union, OJEU, 9 May 2008, C 115/01
U.K.:	United Kingdom
U.S.:	United States
UCITS IV:	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJEU, 17 November 2009, L302/32
UCITS:	Undertakings for Collective Investment in Transferable Securities
UK FSA:	Financial Services Authority
UK FSMA:	Financial Services and Markets Act 2000
US PSLRA:	Private Securities Litigation Reform Act, Pub. L. 104-67, 109 Stat. 737, codified as amended in scattered sections of 15 U.S.C.
US Regulation FD:	Regulation Fair Disclosure 17 CFR Parts 240, 243, and 249
US SEC:	Securities and Exchange Commission
US Securities Act:	48 Stat. 74, enacted 27 May 1933, codified at 15 U.S.C. § 77a et seq.
US Securities Exchange Act:	48 Stat. 881, enacted 6 June 1934, codified at 15 U.S.C. § 78a et seq.
US SOx:	Sarbanes-Oxley Act, i.e., Public Company Accounting Reform and Investor Protection Act of 2002 (Public Law 107-204, 116 Stat. 745-810) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.)

USD:	US Dollar
Walker Review:	Walker Review of Corporate Governance of UK Banking Industry (26 November 2009)
XBRL:	eXtensible Business Reporting Language

Executive Summary

Part I consists of the general introduction.

The general introduction aims to set out the general context of the work. It also explains why it is a particularly appropriate timing for researches in disclosure matters in the European Union. It sets out the scope of inquiries, i.e., what I call the "EU issuer-disclosure regime" and the objectives the dissertation tries to meet. It then details the specific approach adopted, i.e., a comparative law and interdisciplinary perspective. It touches upon the impact of the financial crisis on the reasoning and the points of view adopted throughout the work. Lastly, it explains my position on the goal a corporate issuer should try to achieve, as this specification is important for the purposes of the dissertation, and sets out the case for mandating disclosure.

Part II discusses the objectives of issuer-disclosure and assesses whether issuer-disclosure can effectively achieve them. The two first chapters concern the objectives of the EU issuer-disclosure regime as set out by the European regulator, i.e., investor protection (hereafter Chapter Investor Protection) and market efficiency (hereafter Chapter Market Efficiency). The last chapter of Part II identifies another objective of issuer-disclosure not mentioned by the European Commission, i.e., corporate governance (hereafter Chapter Corporate Governance). Part II suggests a new taxonomy of objectives for the EU issuer-disclosure regime and suggests that investor protection is effectively achieved once the two immediate objectives of issuer-disclosure are met, i.e., market efficiency and corporate governance.

Part II starts with investor protection as investor protection enjoys a place of choice in the mind of the European Commission.

As a preliminary step, I identify the "investors" that the regime aims to protect. These are especially so-called "unsophisticated retail investors".

I acknowledge the importance of unsophisticated retail investors' participation in European equity markets, on economic and political grounds, even if they form only

15% of the investing public in listed shares in Europe. Consequently, I am not in favour of prohibiting their access to equity markets.

Since they usually lack financial literacy, unsophisticated retail investors require minimum protection when they invest in equity markets. In that respect, I argue that issuer-disclosure should not be considered as an effective means to protect them. The needs of unsophisticated retail investors in terms of disclosure were not identified prior to enacting the EU issuer-disclosure regime. No impact assessment was conducted. Unsophisticated retail investors do not seem to have the necessary will and the required competence to read, and make use of, the information that is disclosed to them. As a logical consequence, I also contend, without any further inquiry being required, that investor protection is not a cost-efficient objective of issuer-disclosure. In sum, I believe that investor protection could be considered as the historical objective of the EU issuer-disclosure regime but that it should not be seen as one of its immediate objectives.

I close Chapter Investor Protection by sketching regulatory implications, some of which are further developed in other chapters of the dissertation, like directing disclosure to more sophisticated actors.

Chapter Market Efficiency suggests that issuer-disclosure effectively improves market efficiency. That is important because market efficiency has a positive impact on the economy as a whole.

The chapter starts by defining market efficiency, and its founding theory, the Efficient Capital Market Hypothesis (hereafter the ECMH), from a conventional point of view. It then suggests a better interpretation of the ECMH given the false assumptions of the conventional view. I term it the “relative market efficiency”.

Next, the chapter develops the main thesis, which can be summarised as follows: Improving market efficiency means improving price accuracy and liquidity. It is important to improve both price accuracy and liquidity for their positive impact on the economy through, *inter alia*, better allocation of resources and reduction of cost of capital. The extent to which price accuracy and liquidity can be improved is affected by issuer-disclosure.

I devote a large part of Chapter Market Efficiency to critically assess in a European context the analysis performed by Professor Merritt Fox who considers in a

US context that price accuracy's effect on project choice indirectly occurs as a result of its positive impact on the quality of two corporate governance mechanisms, i.e., the market for corporate control and equity-related compensation, which can be improved through disclosure.

Chapter Corporate Governance investigates whether issuer-disclosure could effectively improve internal corporate governance in the E.U.

Improving corporate governance in European firms means reducing agency problems faced by those firms. It is important to decrease agency problems as this will, *inter alia*, increase shareholder value, that I identify as proxy of firm value with some nuances. The type of agency problems faced by companies depends on their ownership structure. Tensions, if any, are likely to arise between a controlling shareholder or one or more blockholder(s) and minority shareholders in a concentrated ownership pattern. Tensions, if any, are likely to be between management and shareholders in a dispersed ownership structure. Therefore, ownership structures of European firms are analysed.

Reducing agency problems requires effective corporate governance devices duly fitted to the specific ownership context.

According to US and UK academics, which discuss the question mostly in a context of dispersed ownership, issuer-disclosure is helpful to improve the effectiveness of two corporate governance devices in particular, i.e., shareholder voting and shareholder monitoring beyond voting, with a view to reduce agency costs.

The critical question this chapter addresses is whether issuer-disclosure can play a similar role in enhancing shareholder voting and shareholder monitoring in concentrated ownership structures, typical of Continental European companies. The chapter gives a positive answer to this question. It shows that shareholders for whom issuer-disclosure is relevant (i.e., more sophisticated investors) have the right incentives and the right tools to exercise their monitoring and their voting rights. Consequently, information disclosed is of value to them. The comparative law aspect of Chapter Corporate Governance is important: it takes the national laws of seven European jurisdictions as benchmarks.

The reasoning of Chapter Corporate Governance gives me an opportunity to state my views on shareholders' engagement in Europe, the limits of the directive relating to shareholders' rights (hereafter the Shareholders Rights Directive),[1] and the state of affairs in European national laws regarding enforcement of directors' and the controlling party's duties.

Chapter Corporate Governance also suggests that issuer-disclosure should be considered as the necessary feedstock for shareholders to take their own "responsibilities" as stock owners, including by voting or delegating someone to vote their shares and monitoring or delegating someone to monitor management or the controlling party. This chapter stresses the fact that if we cannot manage without transparency in the form of disclosure to inform shareholders on the adequacy of corporate decisions, and, generally speaking, as a source of confidence to distant others, we cannot manage only with transparency. But rather we should see disclosure as a complement to more substantive obligations and context specific accountability. Our instinct to invest in yet more disclosure obligations as the only remedy for the failures of existing disclosure requirements can be misplaced. What is actually important is transparency beyond disclosure, i.e., quality/effective and efficient disclosure.

Part III explains, sometimes in much details, at other times by only sketching the general ideas, policy and regulatory implications that I derive from the new taxonomy of objectives suggested in Part II. Part III is sub-divided into two chapters. The first one (hereafter Chapter Issuer-Disclosure Addressees and Consequences) flows from the contention that issuer-disclosure is meant for more sophisticated actors, as they are the ones likely to impact what I identified in Part II as the sole immediate objectives of issuer-disclosure, i.e., market efficiency and corporate governance. The second one (hereafter Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets) is based on the assertion that disclosure has equal social value on primary markets and on secondary markets as it impacts market efficiency and corporate governance on both markets, i.e., whether or not the issuer is offering equity at that time. Important to keep in mind is that the regulatory modifications I suggest should pass a thorough costs-benefits test before being seriously considered. I do not pretend to have completed that exercise. But at least I have started it. Besides, each regulatory

[1] See Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJEU, 14 July 2007, L184/17.

implication could be considered separately by the European regulator, without one necessarily triggering the others.

In Chapter Issuer-Disclosure Addressees and Consequences, I suggest to direct issuer-disclosure to “informed traders”, i.e., sophisticated (retail or institutional) investors, and “information traders”, i.e., securities analysts, corporate and securities regulation lawyers, auditors and the financial media, as they are the ones likely to act upon the information they receive in a way that positively impacts market efficiency and corporate governance. This further duly takes into consideration the fact that institutional investors, who qualify as more sophisticated actors, are very much present on European equity markets. It may at first sight seem politically unrealistic to expect that the European Commission would, notwithstanding the theoretical logic, adopt a rule that would require disclosure to be aimed at more sophisticated actors. But what lies behind this suggestion is the strong belief that disclosure is valuable for more sophisticated actors, and, as a general rule, not for unsophisticated retail investors. And this fraction of the market impacts the most critical aspect of the process of efficient market pricing, i.e., the relative efficiency of the market’s response to particular information, as well as corporate governance of issuers. To the same extent that reducing the costs relating to acquisition of information calls for mandatory disclosure, reducing the costs relating to processing of the information received calls for addressing the information to people duly skilled with expertise and duly incentivised to value the information received.

After deconstructing possible objections to my policy recommendation, including any criticism relating to equal treatment of shareholders or more sophisticated actors’ heuristic biases, I draw specific regulatory implications from directing issuer-disclosure to more sophisticated actors.

I start with cost-efficient modifications in the EU issuer-disclosure regime. With respect to the content of issuer-disclosure, I suggest to have a more realistic approach to summary prospectuses and advertisements, which are used for marketing purposes and not for investor protection, and to suppress the cross-reference list required under the Prospectus Directive. With respect to the use of languages, I recommend to make mandatory, and therefore not optional, a more extended use of English, especially to make comparisons possible. With respect to the means of dissemination of the information, I argue that the European legislator should mandate issuer-disclosure to be made available to the public at least on the web-site of the issuer as no other media presents benefits greater than the costs incurred and that regulated information service providers should be used. I make some additional regulatory suggestions in order to properly balance the goals of promoting the benefits of the Internet with the need to protect the integrity of the markets and market participants.

Participation of unsophisticated retail investors in equity markets is not to be banned. On the contrary, it has to be encouraged. My position in Chapter Issuer-Disclosure Addressees and Consequences encourages unsophisticated retail investors to either seek professional financial advice or to invest through more sophisticated actors. In other words, it promotes *indirect* unsophisticated retail investors' participation in equity markets. In that context, I suggest alternatives to issuer-disclosure as a means to protect unsophisticated retail investors. First, the relationship between investors and investment firms deserves increased attention further to my suggestions. The rules under the directives relating to investment firms[2] should be assessed with retail investor protection in mind. The same should be done with respect to the regulations related to European collective investment schemes (hereafter UCITS IV),[3] given the popularity of European collective investment schemes. Second, I briefly discuss additional measures to those provided under MiFID or UCITS IV with a view to ensure retail investor protection, including proper regulation of financial advisers, proper enforcement of

[2] See Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJEU, 30 April 2004, L145/1 (hereafter MiFID) and Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJEU, 2 September 2006, L 241/26 (hereafter MiFID Implementing Directive).

[3] See Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJEU, 17 November 2009, L302/32. The directive has to be implemented by Member States by 1 July 2011 at the latest and the European Commission, assisted by the Committee of European Securities Regulators (hereafter CESR), has to adopt relevant technical implementing measures by 1 July 2010.

existing regulations, proper education of unsophisticated retail investors, promotion of behavioural research and the involvement of retail investors in the law-making process.

Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets is restricted to large, thickly traded issuers acting outside the context of an initial public offering (hereafter IPO). It contains an important comparative law perspective as it draws from the developments of Professor Fox in the US context and makes comparisons with the US system where appropriate.

With respect to the content of issuer-disclosure, I suggest to introduce in the E.U. a well-functioning integrated disclosure system that applies similar disclosure requirements to offering prospectuses and subsequent disclosure. To that end, and for the sake of consistency, I suggest to draft a new single European regulation which would contain all issuer-disclosure requirements and all issuer-disclosure-related matters, like dissemination, storage, language, and liability issues. The integrated disclosure system is the first step to implement something closer to a company registration system to replace the existing transaction-based system of issuer-disclosure where any new issue requires in principle a new disclosure approval by the competent supervisory authority. But I do not suggest to move closer to the US-flavoured shelf-registration system given the specificities of European equity issues.

With respect to the level of disclosure to be mandated from issuers, I stress that the optimal level of disclosure to be mandated from issuers is context-specific. I suggest some considerations to be taken into account in any assessment of the optimal level of disclosure. I also emphasise that any regulation relating to the specific level of disclosure to be mandated from issuers needs to allow for some flexibility, as a one-size-fits-all approach is counter-productive, and that quality is more important than quantity. Lastly, I take position on the alleged difference in level of disclosure mandated from issuers between the U.S. and the E.U.

With respect to the format of disclosure, I suggest to suppress the separate drafting of (fancy) periodic reports and to replace them by periodic updates of the base offering document with previously disclosed MAD information as well as the latest version of (interim) management report and (condensed set of) financial statements. This should bring issuers' costs down while making comparisons by investors easier. In sum, I suggest that the great majority of disclosure documents further to the EU issuer-disclosure regime be replaced with a single-document-driven disclosure regime, based on the offering document, subject to mandatory updating according to a schedule defined by the European regulator, that could reflect what already exists. The only documents that would still be required to be separately drafted include a short-form offering prospectus, for each new issue, that incorporates by reference information contained in the up-to-date base prospectus, which should only be approved where securities of a type different than the ones already listed are offered. Otherwise, the competent supervisory authority should make reviews of the updated information on a rotating basis to avoid systematic approval procedures of short-form offering prospectuses.

Non-financial information on primary markets is checked by investment banks in their capacity as underwriters. I discuss the solution to have an independent third party to certify the non-financial information contained in periodic disclosure in order for information on secondary markets to be of the same quality as the one on primary markets.

I contend that civil liability provides a good incentive for compliance with issuer-disclosure. However, there is a perceived lack of enforcement of issuer-disclosure through civil liability actions in the Member States.[4] In this context, I suggest a more ambitious harmonisation of the liability associated with issuer-disclosure violations than the one already existing under the EU issuer-disclosure regime, to achieve the policy objectives one assigns to private enforcement, i.e., compensation and deterrence. I do not pretend to draw a full European civil liability regime for breach of issuer-disclosure, with all the concrete civil and procedural details and consequences. I suggest which court should be competent, i.e., the regime of conflict of jurisdictions. I recommend that the competent court be the court of the issuer's home Member State. I then consider which law should apply, i.e., the regime of conflict of laws rules. I recommend the conflict of laws rule to provide for the application of the law of the home Member State. Lastly, I discuss the issues to be resolved by the designated law that should be harmonised at European level, i.e., the scope and main characteristics of a specific

[4] Any reference to "Member States" in this dissertation means the Member States of the E.U. and the additional states of the European Economic Area (Iceland, Liechtenstein and Norway).

harmonised liability regime for issuer-disclosure. In that respect, I suggest to harmonise who should be the possible defendants. I do not think it would be appropriate to exonerate issuers from liability with respect to prospectuses. I do not think it would be appropriate to exonerate issuers from liability with respect to periodic reports and *ad hoc* disclosure either. I also recommend to hold directors accountable from a deterrence rationale. In order to make the threat of a civil lawsuit a useful complement to public enforcement to deter directors from making misleading statements or misleading omissions, directors should face actual diminishment in their wealth in case of disclosure violation. I suggest to let only past and present shareholders sue, provided that they entered a trade. Besides, I suggest that compensation be paid to the claimant. What concerns the civil liability standard at the time of a public offer, I suggest to apply a negligence standard to the issuer and the directors. Any time thereafter, a negligence standard is not warranted as it would act as deterrent to accept directors' positions and as issuers do not have an incentive not to comply with disclosure requirements as great as on primary markets. Instead, I favour a deceit basis of civil liability. This sketch of a standardised civil liability regime relating to the EU issuer-disclosure regime is believed to strike the right balance between plaintiff's and defendants' interests.

Part IV of the dissertation concludes by summing up the main ideas of the dissertation along different themes to offer another perspective.

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Part I:

General Introduction

I. Context

Some authors believe that the importance of capital markets as a source of corporate finance is an article of faith not corroborated by strong evidence.[5] However, together with prominent academics and institutions like the World Bank, I believe that capital markets are useful social creations for entrepreneurs to finance the corporate projects that are important for economic growth.[6] They provide, *inter alia*, the necessary exit for private equity and venture capitalism, two other important sources of finance, in the form of IPOs and take-overs. And, contrary to the view stated above, I believe that there is empirical proof of the correlation between a nation's economic growth and its

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[5] See, *inter alia*, PETER L. ROUSSEAU, et al., Economic Growth and Financial Depth: Is the Relationship Extinct Already? (2005).; JAMES B. ANG, *A Survey Of Recent Developments In The Literature Of Finance And Growth*, 22 Journal of Economic Surveys 536, (2008)., at 543 and 553; FELIX RIOJA, et al., *Does one size fit all?: a reexamination of the finance and growth relationship*, 74 Journal of Development Economics 429-447, (2004).; JOHN DRIFFILL, Growth and Finance (2003). See also LAWRENCE E. MITCHELL, Who Needs the Stock Market? Part I: The Empirical Evidence (2008). (arguing that public equity has rarely been a significant factor in financing productive industrial enterprise, calling into question the desirability of a stock-market based economy, the corporate governance structure that provides the shareholder participation rights that are said to help support it, and the current US federal regulatory structure); LAWRENCE E. MITCHELL, Toward a New Law and Economics: The Case of the Stock Market (2010). (arguing that stock markets are not necessary to finance industrial production and may create distortions in production incentives that are detrimental to economic growth; however admitting two possible roles of stock markets: the role of stock markets in providing exit for investors through IPOs and their role in providing indirect financing for business by allowing financial institutions to raise public equity).

[6] See, *inter alia*, ROSS LEVINE, et al., *Stock Markets, Banks, and Economic Growth*, 88 American Economic Review 537, (1998)., at 538. For excellent surveys and analysis of this literature, see ROSS LEVINE, *Financial Development and Economic Growth: Views and Agenda*, XXXV Journal of Economic Literature 688, (1997).; ROSS LEVINE, *Finance and Growth: Theory and Evidence*, *in* Handbook of Economic Growth, (Philippe Aghion, et al. eds., 2005).; JAMES B. ANG, *A Survey Of Recent Developments In The Literature Of Finance And Growth*, 22 Journal of Economic Surveys 536, (2008).For a sample of additional literature on the subject, see RAGHURAM G. RAJAN, et al., *Financial Dependence and Growth*, 88 American Economic Review 559, (1998).; GERARD CAPRIO JR., et al., The role of long term finance : theory and evidence (1997).; ASLI DEMIRGUC-KUNT, et al., *Stock market development and financial intermediaries : stylized facts*, World Bank Econ. Rev. 291, (1996). The relationship between finance and growth largely has been ignored by legal scholars. But see, *inter alia*, BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001).; BERNARD S. BLACK, et al., *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 Journal of Financial Economics 243, (1998). For statistics of European markets in terms of sources of finance, see NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008). at 63 et seq. and numerous references therein cited (highlighting the still dominance of bank-finance in the European Union although stressing that recourse to market finance continues to strengthen); Oxford Analytica 2005. See also RICHARD A. BREALEY, et al., Principles of Corporate Finance (McGraw Hill Higher Education ed. 2005). (citing sources from the European Central Bank and the Federal Reserve and stating that banks loans in the U.S. are equal to 73% of GDP, almost half of the percentage of Germany, namely 132%. Meanwhile, the market value of US stock market is about 127% of GDP, being three times that of Germany, namely 45%).

development of sophisticated securities markets.[7] This is not to say that bank finance is not important for economic growth. Indeed, Germany, which is characterised as a bank-oriented system, is one of the most developed countries in the world.[8] But this means that market finance should be seen, at a minimum, as a useful complement to other financing sources.

European capital markets have been *growing* at unprecedented speed in recent decades.[9] This trend is likely to continue, notably as financial markets[10] could offer an alternative to publicly supported pensions in a context of an ageing European population.[11]

Over the last 30 years the locus of decision-making power for the regulation of financial markets in Europe has shifted significantly in favour of the *European* regulator. National laws relating to financial regulations are, for the most part, implementations of European rules. This is the reason why any reflection in the field of financial markets needs to start with the European regulations. Consequently, this dissertation is concerned with European securities regulation.[12]

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[7] *Accord* JOSEPH A. SCHUMPETER, The Theory of Economic Development - An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle (Harvard ed. 1911). and the work of, *inter alia*, Ross Levine.

[8] See that the national income per capita in the U.S., compared to Germany, in 2006, was 4.2 versus 3.5 (source: European Central Bank and Federal Reserve cited by RICHARD A. BREALEY, et al., Principles of Corporate Finance (McGraw Hill Higher Education ed. 2005).).

[9] See, *inter alia*, European Commission, European Financial Integration Report, SEC(2007) 1696, 10 December 2007, at 6; EUROPEAN COMMISSION, Commission Staff Working Document - European Financial Integration Report 2008 (2009)., at 76. See also LUIGI ZINGALES, et al., Banks and Markets: The Changing Character of European Finance (2003)., at 7 and table 2; LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 30; PHILIPP HARTMANN, et al., The Performance of the European Financial System (2006).; STAVROS GADINIS, *The Politics of Competition in International Financial Regulation*, 49 Harv. Int'l L.J. 447, (2008). See also BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007, at fig 40, at 99 (showing households' preference for equity compared to other investments). I believe that the still perceived dominance of bank-based financing in (Continental) Europe is, to a large extent, due to path dependency.

[10] I refer to "financial markets" to designate markets for issuers and investment services.

[11] See for further discussion, Part II:Chapter III:II.C.3 in Chapter Corporate Governance.

[12] "Securities regulation" refers to the regulation of securities markets. Other authors would have referred to "financial regulation" and "financial markets regulation" to mean the same.

More in particular, this dissertation focusses on European *disclosure requirements*.

A disclosure regime seeks to reduce information asymmetries between investors and firms. It is thought indeed that entrepreneurs typically have better information than investors about the value of business investment opportunities. Moreover, it is believed that entrepreneurs' communications with investors are not completely credible as entrepreneurs have an incentive to inflate the value of their ideas. Therefore, there is a need for a regulatory framework that ensures transparent markets which inspire confidence in corporate reporting.

II. Why Now?

The timing of a dissertation addressing European disclosure issues, and more in particular the objectives of disclosure, seems to be right for the following reasons:

Disclosure obligations on financial markets are part of the "disclosure and transparency agenda" of the Financial Services Action Plan of 1999 (hereafter the FSAP).[13] Revisiting the objectives disclosure is said to pursue, beyond reducing information asymmetry, seems relevant at a time where the *European regulator is in the process of reviewing the main regulations* relating to disclosure obligations.[14]

Moreover, it seems a propitious time to reconsider the European disclosure regime with a view to reduce, where possible, the costs for issuers to enter European regulated markets.[15] It could contribute to reap the benefits of increased globalisation at a time where other important players are perceived to regulate too much and appear to be losing some of their competitive advantage.[16] One should *avoid* that ill-conceived

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[13] See EUROPEAN COMMISSION, Communication on Implementing the Framework for Financial Markets: Action Plan (11 May 1999).

[14] See, for instance, with respect to the Prospectus Directive, EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009).

[15] See CRA INTERNATIONAL, Evaluation of the Economic Impacts of the Financial Services Action Plan - Final Report to the European Commission (2009). (observing that there are increased costs of listing on European regulated markets from the Prospectus Directive and associated advisory costs and observing that there is a decrease in listings on regulated markets and an increase in listings on unregulated markets).

[16] See the perceived costly implications of the Sarbanes-Oxley Act (Public Company Accounting Reform and Investor Protection Act of 2002 (Public Law 107-204, 116 Stat. 745-810) (codified in

objectives and thereto related substantive provisions impose *unnecessary hurdles to issuers* who wish to access European capital markets.[17]

Lastly, more disclosure seems to (have) be(en) the immediate and the main regulatory response to financial market crises, including the current one.[18] However, more disclosure entails the *risk of costly over-regulation*. In that context, identifying the correct objectives of disclosure seems to be essential for any assessment of existing regulation and a first step for any costs-benefits analysis which should be performed prior to endorsing any particular regulatory path.

III. Scope

The scope of the dissertation is limited as follows:

As a general remark, this dissertation is *mainly* concerned with *securities regulation*. Therefore, the reader should not expect to see long and exhaustive developments concerning specific issues of company law.

I am only concerned with disclosure mandated from *issuers*. Consequently, disclosure mandated from shareholders[19] or from investment firms,[20] for instance, are excluded from the scope of enquiry.

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scattered sections of 11, 15, 18, 28 and 29 U.S.C)) (hereafter SOx) and of enforcement in the U.S. See the debate on the loss of competitive edge of US stock exchanges which discusses US (too) heavy information requirements: comp. Committee on Capital Market Regulation, Interim Report, 2006; The City of New York and the US Senate, Sustaining New York's and the US' Global Financial Services Leadership, January 2007; US Chamber of Commerce, Commission on the Regulation of US Capital Markets in the 21st Century, Report and Recommendations, March 2007; LUIGI ZINGALES, Is the U.S. Capital Market Losing its Competitive Edge? (2007).; CRAIG DOIDGE, et al., Why do Foreign Firms Leave U.S. Equity Markets? (2009). with Charles D. Niemeier, American Competitiveness in International Capital Markets, 30 September 2006; CHRISTIAN LEUZ, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 Journal of Accounting & Economics 146, (2007). Comp. with EUROPEAN COMMISSION, Commission Staff Working Document - European Financial Integration Report 2008 (2009). (for statistics on the competitiveness of European securities markets).

[17] See the popularity of private placements compared to public offers. This could be explained by the expenses associated with a public offer under current regulations. See also the success of the segment of the French regulated market reserved for professional investors established in 2008 whereby Paris enhanced its appeal, especially to foreign companies, as it streamlined and shortened the prospectus review procedure and scrapped the requirement to translate informational documents into French.

[18] See note 223 below and accompanying text.

[19] See, for instance, notifications of major shareholdings under Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency

Next, the issuers I am concerned with are solely *corporate* entrepreneurs. Therefore, I do not consider specific disclosure regulations applicable to non-corporate issuers, like mutual funds (and especially, Undertakings in Collective Investments in Transferable Securities (hereafter UCITS)), pension funds, insurance companies or financial institutions.

Besides, I focus on the disclosure obligations of issuers issuing *equities*. All disclosure duties relating to debt or debt-related financial instruments are therefore outside the scope of this dissertation.[21]

In addition, I focus on disclosure obligations of issuers (to be) listed and traded on a European "*regulated market*", as such term is defined under MiFID,[22] notwithstanding the fact that the importance of European regulated markets compared to unregulated ones is arguably small.[23]

Moreover, disclosure requirements *vis-à-vis* other parties than *investors* are not considered. Therefore, for instance, any disclosure toward the competent supervisory authority falls outside the scope of this dissertation.

I am concerned with primary markets' and secondary markets' disclosure obligations relating to prospectuses,[24] periodic disclosure[25] and *ad hoc* disclosure.[26] To

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requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJEU, 31 December 2004, L390/38 (hereafter the Transparency Directive).

[20] See requirements under the MiFID.

[21] It could not be practicable to design a disclosure regime with only equity in mind. This being said, the design of a disclosure regime for both equity and debt would need further analysis as other considerations might have to be taken into account given the specificities of debt issues and debt trading.

[22] See article 4.1 14) of MiFID (stating that a regulated market means "a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its nondiscretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III"). Note in addition that, as "public" companies are specifically defined in some jurisdictions (for instance, in the U.K., "public" companies refer to companies formed as plc's, and thus eligible to become publicly traded, while only a small minority of which in fact are), I use in this dissertation the term "publicly traded" or "listed" companies instead of "public" companies to refer to companies which shares are listed and traded on a regulated market (in the U.K., publicly traded companies are sometimes also referred to as "quoted" companies).

[23] European regulated markets are said to amount to less than 5% of all European markets. See bank for international settlements.

[24] See Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJEU, 31 December 2003, L345/64 (hereafter the Prospectus Directive); Commission Regulation (EC) no 809/2004, 29 April 2004, OJEU, 30 April 2004, L149/1 (hereafter the Prospectus Regulation).

the extent company law directives[27] also make for the apparatus of disclosure from publicly traded equity issuers to investors in European capital markets, they are also considered in this dissertation.[28]

In the remainder of this dissertation, disclosure rules so defined are referred to as the "*EU issuer-disclosure regime*".

Lastly, the directives relating to electronic commerce and distance marketing of financial services are not considered here.[29]

For the purposes of this dissertation, researches were made until 6 May 2010.

IV. Objectives

The aim of the dissertation is two-fold:

On the one hand, it identifies in Part II (Objectives of the EU Issuer-Disclosure Regime) effective objectives of the EU issuer-disclosure regime.

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[25] See the Transparency Directive, and especially articles 4 to 8 and 19 et seq.; and the Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, OJEU, 9 March 2007, L69/27 (hereafter the Transparency Implementing Directive).

[26] See Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJEU, 12 April 2003, L96/16 (hereafter the MAD), and especially article 6, and Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, OJEU, 24 December 2003, L339/70 (hereafter the MAD Implementing Directive).

[27] I use "company law" to refer to what other may call "law of business corporations" or "corporate law".

[28] See Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC), OJ, 14 August 1978, L 222/11, as amended (hereafter the Fourth Company Law Directive); Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, OJ, 18 July 1983, L 193/1, as amended (hereafter the Seventh Company Law Directive); Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies, (2004/913/EC), OJEU, 29 December 2004, L385/55, together with Commission Recommendation of 30 April 2009 on Remuneration policies in the financial services sector, 2009/384/EC, OJEU, 15 May 2009, L120/22 (hereafter the Remuneration Recommendations).

[29] See Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce'), OJ, 17 July 2000, L 178/1 and Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, OJ, 9 October 2002, L 271/16.

Disclosure is only a means to achieve certain goals, it is a regulatory tool in company law and securities regulation.[30]

In its early phase, European securities regulation was overwhelmingly preoccupied with integration.[31] In the rush to harmonise, little consideration was paid to the underlying regulatory objectives of the harmonised rules.[32] This explains why objectives stated by the Prospectus Directive, the Transparency Directive and the MAD are nebulous, referring primarily to investor confidence, investor protection and market integration. This makes *ex-post* assessment of the effectiveness of the EU issuer-disclosure regime difficult. But more importantly, there were no studies supporting the case that the objectives identified by the European regulator could be effectively achieved by the EU issuer-disclosure regime.

The above raises serious concern about the fact that the prevailing objectives of the EU issuer-disclosure regime are substantively ideal rather than politically driven.[33]

In this context, I question the objectives identified by the European regulator. In a nutshell, I argue for a new prioritisation of objectives where investor protection and investor confidence are best met through the achievement of the two sole effective, and therefore so-called "immediate", objectives of issuer-disclosure, i.e., market efficiency and corporate governance, as well as some ancillary measures. I support my reasoning by referring, to the greatest possible extent, to empirical studies relating to US

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[30] See the dissertation of Steven Hijink, Publicatieverplichtingen voor beursvennootschappen, University of Amsterdam, 2010 (forthcoming).

[31] See London Economics, Quantification of the Macro-Economic Impact of Integration of EU Financial Markets, Final Report to the EU Commission (2002).

[32] See however, final report of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexander Lamfalussy, 15 February 2001 (known as the Lamfalussy Report), at 22 ("[t]he Committee believes that all European financial services and securities legislation should be based around a conceptual framework of overarching principles. These principles should be consistently applied, and in the future could be either enacted in a framework Regulation jointly agreed by the Council of Ministers and the European Parliament or possibly in a future amendment to the Treaty at the next Intergovernmental Conference").

[33] On the importance of a considered approach to the rationales for a legal regime with a view to possible reform, see, *inter alia*, NIAMH MOLONEY, *Confidence and Competence: the Conundrum of EC Capital Markets Law*, 4 J.Corp.L.Stud. 1, (2004)., at 10; EILÍS FERRAN, *The role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions*, 4 EBOR 491, (2003).; STEPHEN J. CHOI, *Behavioral Economics and the Regulation of Public Offerings*, 10 Lewis & Clark Law Review 85, (2006).

disclosure requirements where similar evidence does not exist in the European context.[34]

This part of the dissertation, i.e., the identification of effective objectives, could be seen as the first step for a greater project that would separate substance from politics and that would critique the prevailing regulatory regime on the merits alone, i.e., the net of real costs and benefits. The second step, i.e., the efficiency test of the EU issuer-disclosure regime, is left for other research. Indeed, a costs-benefits analysis requires other tools.[35] However, this costs-benefits analysis is necessary to determine whether a particular provision of the EU issuer-disclosure regime is not only suitable to achieve the objectives but also proportionate to achieving them.

On the other hand, the dissertation suggests in Part III (Policy and Regulatory Implications) some policy and regulatory implications flowing from the new taxonomy of objectives. As already said, an efficiency analysis requiring a costs-benefits examination of the suggestions is left for other research although I am aware that it constitutes an essential step before endorsing any of the recommendations.

In Part III, I trade details for comprehensiveness of the subject matters covered. In so doing, I risk a charge of superficiality. I decided not to drill down more deeply into each subject matter as the effort could be useless if not rewarded by catching the European regulator's attention. But more importantly, much more time (and human capital) would be required because of the numerous legal areas impacted by my recommendations and the complexity of comparative law analysis between selected Member States. This being said, I strongly believe that my suggestions are not unrealistic and that I make a strong case supporting them in the following pages by performing the first steps of a thorough comparative law examination.

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[34] See EMILIOS AVGOULEAS, What Future for Disclosure as a Regulatory Technique? Lessons from the Global Financial Crisis and Beyond (2009). (stressing the need for experimental studies to measure the actual impact of disclosed information and thus the effectiveness of disclosure rules).

[35] See ISAAC ALFON, et al., Cost-Benefit Analysis in Financial Regulation - How to do it and how it adds value (FSA. 1999).; ANDROMACHI GEORGOSOULI, *The Debate over the Economic Rationale for Investor Protection Regulation: a Critical Appraisal*, 15 JFRC 236, (2007). (on the difficulties to run costs-benefits analysis). See also CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008). (for a summary of (inconclusive) studies on the costs and benefits of financial reporting and disclosure regulation).

I suggest the reader to take each of my regulatory implications separately to assess its own merits. Thereby rejection of one particular suggestion would not trigger rejection of all the others.

V. Approach Adopted

The dissertation takes a comparative law approach with the U.S. as it ambitions to examine to what extent the reasoning of US regulators and US authors could be transposed to the European context when discussing issuer-disclosure requirements. For the reasons further explained below, this dissertation therefore refers to US legal rules, to discussions among US academics and to empirical evidence produced by US economists for several reasons:

The U.S. was the first to make disclosure the centrepiece of its regulatory armoury relating to financial markets. Already in 1913, US Supreme Court Justice Louis Brandeis stated that "sunlight is said to be the best of disinfectants", referring to the benefits of openness and transparency.[36] Since then, the U.S. is known to have developed a system of "full and fair disclosure" in securities regulation, centred around the Securities Act of 1933 (hereafter the US Securities Act)[37] and the Securities Exchange Act of 1934 (hereafter the US Securities Exchange Act).[38]

The early stages of the FSAP were greatly influenced by the US regulatory policy.

Besides, at a time of increased globalisation, the US supervisory authority, the Securities and Exchange Commission (hereafter the US SEC) exerts much impact on the development of international securities regulation given the size of US capital markets.[39]

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[36] Louis Brandeis, Other People's Money and How the Bankers Use It (1913), at 92. See also Harper's Weekly article, entitled "What Publicity Can Do", which later became Chapter V of his book Other People's Money. Interestingly, twenty years earlier, in a letter to his fiancé, Brandeis had expressed an interest in writing "a sort of companion piece" to his influential article on "The Right to Privacy" but this time he would focus on "The Duty of Publicity." He had been thinking, he wrote, "about the wickedness of people shielding wrongdoers & passing them off (or at least allowing them to pass themselves off) as honest men." He then proposed a remedy "[i]f the broad light of day could be let in upon men's actions, it would purify them as the sun disinfects."

[37] See 48 Stat. 74, enacted 27 May 1933, codified at 15 U.S.C. § 77a et seq.

[38] See 48 Stat. 881, enacted 6 June 1934, codified at 15 U.S.C. § 78a et seq.

[39] *Accord* KLAUS J. HOPT, *Comparative Company Law, in* The Oxford Handbook of Comparative Law, (Mathias Reimann, et al. eds., 2006)., at 1179 et seq.; CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008).

Moreover, I believe that mandatory disclosure serves similar functions in the U.S. as in the European Union (hereafter the E.U.).[40]

Finally, many of the studies of mandatory disclosure have focussed on the U.S. given the availability of data. Ignoring these contributions would be to ignore much of the available evidence on the effects of mandatory disclosure.

This being said, this dissertation ought also to compare, where necessary, the national laws of European Member States.

Indeed, it would not make sense to discuss only European securities regulation without a proper knowledge of the national laws of European Member States as, if, since the completion of the FSAP in 2005, the European Commission can be regarded as the primary regulator of European securities markets, the 27 jurisdictions that make the E.U. have to implement European securities regulation into their national laws, leaving opportunities for varying interpretations.

Besides, some fields in connection with securities regulation, like civil liability, are barely covered by European rules, leading to different applicable laws depending on the Member States concerned.

Therefore, where required, I focus on seven European jurisdictions, namely the U.K.,[41] Germany, France, Spain, Italy, Belgium and the Netherlands. These jurisdictions are indeed the most important European jurisdictions in terms of securities markets' capitalisation relative to GDP.[42] Besides, they are covered by a large number of existing comparative law studies.

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[40] By referring to the European Union, I mean the international system of governance established by successive treaties whereby sovereign states (at the time of writing, 27 jurisdictions) decided to divest specific competences and confer them upon international institutions holding legislative and executive powers of their own (among which the European Commission and the European Parliament), exercised under the control of an independent judiciary (called the European Court of Justice). The treaties applicable at the time of writing, further to the last amendments made in Lisbon, are the so-called Treaty on European Union and the Treaty on the Functioning of the European Union. Any reference to the Treaty on the Functioning of the European Union is a reference to the Consolidated Version of the Treaty on the Functioning of the European Union, OJEU, 9 May 2008, C 115/47, as it results from the amendments introduced by the treaty of Lisbon, signed on 13 December 2007 in Lisbon and entered into force on the 1st of December 2009.

[41] Technically, the United Kingdom of Great Britain and Northern Ireland is divided into three legal systems: England and Wales, Scotland, and Northern Ireland. These distinctions, however, may be safely glossed over for present purposes.

[42] See, as at 31 December 2007, CENTRE FOR STRATEGY & EVALUATION SERVICES LLP, Framework Contract for Projects relating to Evaluation and Impact Assessment Activities of Directorate General for Internal Market and Services - Study on the Impact of the Prospectus Regime on EU

The above suggests that although I am Belgian, this is not a dissertation about Belgian law. Except to the extent provided above, one should therefore not expect to find extensive references to Belgian literature or Belgian law and Belgian case law.

Besides, if I refer to an important extent to US and UK theoretical as well as empirical contributions to support my thesis, it is not because of an arguable US or UK bias but because I believe in the strength of the arguments therein developed and the relevance of the data therein examined. In that respect, I trust to have made the necessary inquiries to avoid a transposition of the results of these contributions in a Continental European context where such transposition would not be warranted because of the specificities of that context.

As a last note on the comparative law approach adopted in the dissertation, it should be noted that I did not have access to literature not written in Dutch, French or English.

The dissertation uses an interdisciplinary approach in so far as it relies on economic studies and other empirical evidence to support the arguments and the policy or regulatory suggestions.

In particular, it takes into account advances in behavioural finance, the area of behavioural psychology and the sub-set of behavioural economics[43] which is growing at the time of writing and which studies how psychology affects financial decision-making and financial markets. As disclosure affects issuers who have to bear the burden of it, as well as investors and their advisors, who are believed to take investment decisions or give investment advice on its basis, it is interesting to know with precision how these actors react toward information mandated from them or disclosed to them. Behavioural

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Financial Markets - Final Report (June 2008)., at 26; Federation of European Securities Exchanges, online database, 2007; EUROPEAN COMMISSION, European Financial Integration Report (Commission Staff Working Document) (2007)., at 19-20; see also World Bank, World Development Indicators (2008).

[43] For a definition of behavioural economics, see GARY BELSKY, et al., Why Smart People Make Big Money Mistakes And How To Correct Them: Lessons From The New Science Of Behavioral Economics (Simon & Schuster Adult Publishing Group. 2000). ("[t]his area of enquiry is sometimes referred to as 'behavioral finance', but we call it 'behavioral economics'. Behavioral economics combines the twin disciplines of psychology and economics to explain why and how people make seemingly irrational or illogical decisions when they spend, invest, save, and borrow money."). See also DANIEL KAHNEMAN, et al., *Prospect Theory: An Analysis of Decision under Risk*, 47 Econometrica 263, (1979)., on which (experimental psychology) article behavioural economists are building to uncover economic effects of systematic human biases and heuristics.

finance main focus is to demonstrate how investing driven by cognitive limitations explains observed anomalies in asset pricing and impacts asset pricing.[44]

The idea that the stock markets are influenced by psychological factors has a long history, going back at least to John Keynes and its comparison of stock markets to beauty contests.[45] US academics have recently begun to consider the implications of cognitive biases and heuristics for securities regulation.[46] Also worth to be noted are the UK FSA's recent efforts to examine the influence of neuro-psychological situations on individuals' decision-making that affect their financial capability.[47]

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[44] See, *inter alia*, the works of Robert J. Shiller, Werner F.M. De Bondt, Richard H. Thaler, Nick Barberis, David A. Hirshleifer. For overviews of literature, see, *inter alia*, DONALD C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Virginia Law Review 1025, (2009)., at 16 et seq.; RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003)., at 15 et seq.; STEPHEN J. CHOI, *Behavioral Economics and the Regulation of Public Offerings*, 10 Lewis & Clark Law Review 85, (2006).; STEPHEN J. CHOI, et al., *Behavioral Economics and the SEC*, 56 Stan L. Rev. 1, (2003).; DONALD C. LANGEVOORT, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Northwestern University Law Review 135, (2002).; ROBERT PRENTICE, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 Duke L.J. 1397, (2002).; EMILIOS AVGOULEAS, *Reforming Investor Protection Regulation: The Impact of Cognitive Biases*, *in* Essays in the Law and Economics of Regulation, in Honour of Anthony Ogus, (Michael Faure, et al. eds., 2008).; LYNN A. STOUT, *The Mechanisms of Market Inefficiency - An Introduction to the New Finance*, 28 Journal of Corporation Law 635, (2003). See also DAVID DE MEZA, et al., Financial Capability: A Behavioural Economics Perspective (2008). (review of the behavioural finance literature prepared for the UK FSA).

[45] See JOHN MAYNARD KEYNES, The General Theory of Employment Interest and Money (Macmillan Cambridge University Press. 1936). On Keynes's influence on noise theory (for the concept of noise theory, see Part II:Chapter II:III.B.1 in Chapter Market Efficiency), see ROBERT PIRON, *Correspondence: Keynes as Noise Trader*, 5 J. Econ. Persp. 215, (1991)., at 215.

[46] See STEPHEN J. CHOI, et al., *Behavioral Economics and the SEC*, 56 Stan L. Rev. 1, (2003). (arguing for a series of presumptions against interventions by such behaviourally-flawed regulators as the SEC); LAWRENCE A. CUNNINGHAM, *Behavioral Finance and Investor Governance*, 59 Wash. & Lee L. Rev. 767, (2002). (explaining the policy implications for corporate governance of behavioural finance); LESLIE HODDER, et al., *SEC Market Risk Disclosures: Implications for Judgment and Decision Making*, 15 Accounting Horizons 49, (2001). (drawing on insights from cognitive psychology to examine the implications of the SEC's Financial Reporting Release No. 48 about derivative and market risk disclosures); DONALD C. LANGEVOORT, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Northwestern University Law Review 135, (2002). (discussing implications of four cognitive biases of investors for three areas of securities regulation); ROBERT PRENTICE, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 Duke L.J. 1397, (2002)., at 1410-1510 (discussing behavioural reasons to question recently proposed securities deregulation); PETER H. HUANG, *Regulating Irrational Exuberance and Anxiety in Securities Markets*, *in* The Law and Economics of Irrational Behavior (Francesco Parisi, et al. eds., 2003).; PETER H. HUANG, *How Do Securities Laws Influence Affect, Happiness, & Trust?*, 3 Journal of Business and Technology Law 433, (2008).

[47] See FSA, Consumer Research Paper 69, 2008.

VI. Impact of the 2007-2008 Financial Crisis

How did the 2007-2008 financial crisis impact my researches?[48]

I started to write the dissertation before the 2007-2008 financial crisis. The financial turmoil impacted my researches without however changing my core arguments, all to the contrary. I do not mean to downplay the extent of the uncertainty raised by the financial turbulences. My timeframe here, however, is much longer than the current market uncertainty. My goal is to highlight what I argue to be secular trends, driven by (economic) forces that will survive current perturbations. For instance, I do not consider that the few financial crises of the last decades are evidence of the general inefficiency of securities markets, nor that the governmental stakes in corporate issuers reveal a long-term tendency toward increased ownership concentration in the E.U and in the U.S.

I think the 2007-2008 financial crisis highlights the defects of a narrow view of the shareholder model adopted by management, i.e., a view which is too much focussed on short-termism. A main challenge is thus the good old theme of corporate governance. Capitalism implies that shareholders should have an eye on management. But this can be made possible only if there are, *inter alia*, sound corporate governance practices which are properly implemented by companies and duly enforced. In that respect, a common concern of the current crisis seems to be a lack of faithful disclosure and failures in disclosure processes. This might require more information to be disclosed. But, more importantly, what seems to be needed is transparency beyond disclosure. Disclosure could not prevent Enron or any other corporate governance scandal to happen.[49] Nor was it able to prevent any financial crisis, like the current one. In other words, more disclosure is not the remedy to all evils, even less so when one takes into consideration the dangers of information over-load. But more quality disclosure could be part of the solution.

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[48] Note that, at the time of writing, the financial crisis is still unfolding. I however refer to it as the "2007-2008 financial crisis" as the main past financial turbulences which are related to credit institutions' failures seem to have occurred during 2007 and 2008.

[49] *Accord*, *inter alia*, REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004).

Equally important in my opinion is the role of shareholders investing in equity markets. The 2007-2008 financial crisis gave an opportunity to stress that aspect. Equity markets are a risky business. It is a rather non controversial issue. However, one thing is to say it, another one is to face all the consequences of this statement. Among them is the fact that investors should know what they do when investing in equity markets or seek professional advice or financial intermediation. Among them as well is the fact that some shareholders at least, depending on their own characteristics, should carry out their responsibilities as share owners with a long-term view, which I believe is the only view that can work in corporate interest. Giving shareholders more rights to monitor will not bring about changes in corporate behaviour if these shareholders do not properly exercise them (or delegate someone to exercise them).

VII. Important Side-Remarks

A. Foreword

Before getting to the core of the dissertation, I discuss two important issues which are subject to debate. I explain my position with respect to each of them as these views will be implicit in the remainder of the dissertation.

Firstly, I take position on the interests that the corporate issuer should ultimately protect. Having an opinion about the choice of corporate objectives is very important as effectiveness analysis, one of the purposes of the dissertation, critically depends upon goal specification.

Secondly, I explain why I start from the premise that issuer-disclosure should indeed be mandated by the regulator, as is the case in the U.S. and in the E.U.

B. Shareholders' Value Maximisation with a Long-Term View

Before explaining my own view in the debate in further details, I need to set the scene by recalling the terms of the discussion.[50]

[50] The reader should note that the following is a very synthetic discussion of a subject which is dealt differently under each jurisdiction's laws, case law and legal literature. For US authors, see, *inter*

The "shareholder primacy" concept posits that shareholders should be attributed more control and financial rights than other corporate stakeholders, like employees and creditors.[51] According to conventional wisdom, shareholder primacy flows from the fact that shareholders are the residual claimants in the company, i.e., they have the right to receive the surplus after all other claims have been paid. It is premised on the assumption that other stakeholders are well protected by law or contract while shareholders are relatively less protected by law or contract.[52] Contrary to a labour contract for instance, the contract between a shareholder and the company he invested in is largely an implicit contract that is based on promises from management. For example, shareholders expect management to maximise shareholder value but cannot force the company to pay dividends or to repay their investment by a share buyback (unless they are controlling shareholders). Therefore, (minority) shareholders, among all stakeholders involved in the corporation, need protection the most.[53]

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alia, JILL E. FISCH, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy* 31 Iowa J. Corp. L. 637, (2006). (analysing the equation of shareholder wealth with firm value); and also ADOLF BERLE, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049, (1921)., at 1074 versus MERRICK DODD, *For Whom are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145, (1932)., at 1156 (for the origins of the debate relating to the equation of shareholder wealth with firm value). For authors in Member States, see, for instance, for Belgian authors, *inter alia*, ALAIN FRANÇOIS, Het vennootschapsbelang in het Belgische vennootschapsrecht (Intersentia Rechstwetenschappen. 1999).; YVES DE CORDT, L'intérêt social comme vecteur de la responsabilité sociétale (Academia-Bruylant. 2008). A different subject concerns the equation between, on the one hand, the corporate interest of a specific company and, on the other hand, the corporate interest of the group to which it belongs or specific companies of that group. On that latter subject, see, for Belgian authors, *inter alia*, JOHAN PEETERS, Het vennootschapsbelang en de verhouding ervan met het groepsbelang. Een studie naar Belgisch en Frans recht (Kluwer. 2002).; see for German authors (and the concept of *Konzernrecht*), KLAUS HOPT, *Le droit des groupes de sociétés* Rev. soc. 373, (1987).; see for the French leading case law, French Criminal Supreme Court, 4 February 1985 (case Rozenblum), *Rev. soc.*, 1985, at 648.

[51] The debate over "shareholder primacy" is considered to have two aspects: the first going to the objective of the company and shareholder value maximisation as the answer; and the second going to the allocation of power within the company and is more commonly referred to as "shareholder empowerment". This section deals with the first aspect. The second one is discussed in other sections of the dissertation.

[52] See, *inter alia*, OLIVER WILLIAMSON, *Employee ownership and internal governance: a perspective*, 6 Journal of Economic Behavior and Organization, (1985).; OLIVER WILLIAMSON, *Corporate governance*, 93 Yale Law Journal 1197, (1984).

[53] For the conception of the corporation as a "nexus of contracts", where the company is an equilibrium among various stakeholders (shareholders, creditors, workers, bondholders, the government and managers), see MICHAEL C. JENSEN, et al., *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J.Fin. Econ. 305, (1976).

Shareholder primacy arguably manifests itself in law in the doctrine that directors owe fiduciary duties of care and loyalty to their shareholders, i.e., they should manage the firm in the interests of shareholders, as opposed to other corporate stakeholders.

It arguably manifests itself in economics in the doctrine that maximising shareholder value is the primary objective of the company as it is the most efficient in a competitive environment with a well-functioning market for corporate control.[54] Once all other claims have been paid to other stakeholders, maximising the surplus to shareholders means maximising total firm value, assuming that other stakeholder values remain unchanged. Consequently, maximising firm value is the equivalent of maximising shareholder value.[55] Shareholder value is thus a good proxy for firm value. Even if shareholder wealth does not reflect aggregate firm value, if regulatory changes are likely to have a similar effect on all corporate constituencies - that is, if shareholder wealth is closely correlated with firm value - any error resulting from the use of shareholder wealth is likely to be small.

The view that shareholder value maximisation is the purpose of the corporate firm arguably finds much support.

It is the one promoted by influential (law and economics) academics across the Atlantic for its efficiency.[56]

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[54] The theme that efficiency considerations shape corporate structures has a long history. See HAROLD DEMSETZ, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & Econ. 375, (1983). Conventional economic theory holds that in a competitive economy in which anti-social behaviours are properly regulated, like pollution, management decisions that are best for existing shareholders are also the ones that allocate the economy's scarce resources most efficiently. See WILLIAM J. BAUMOL, Economic Theory and Operations Analysis (fourth edition) (Prentice Hall. 1977)., at 395-400; MILTON FRIEDMAN, Capitalism and Freedom (The University of Chicago Press. 1962).; Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. Times, Sept. 13, 1970, at 32; PAUL A. SAMUELSON, et al., Economics (2004 edition) (McGraw-Hill. 1948)., at 305-360; GERARD DEBREU, Theory of Value: An Axiomatic Analysis of Economic Equilibrium (Yale University Press. 1959).

[55] For a definition of shareholder value and its measures, see Part II:Chapter II:IV.B.4.c in Chapter Market Efficiency.

[56] See, in the E.U., HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKE-OVER BIDS, Report of the High Level Group of Company Law Experts on Issues Related to Take-Over Bids (2002)., at 19; see also JAAP W. WINTER, et al., Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002)., at 59 ; ALESSIO M. PACCES, Why Investor Protection is Not All that Matters in Corporate Law and Economics (2008).; Theo Vermaelen, How to recapitalise banks: a personal view, available on Insead web-site (promoting private capital to rescue banks instead of government control as the latter leads to a stakeholders' primacy view which ultimately leads bank stocks in a death spiral. Suggesting tax provisions inspired by the Belgian experience in the early 1980's); THEO VERMAELEN, *Maximising Shareholder Value: An Ethical Responsibility?*, *in* Mainstreaming Corporate Responsibility: Text and Cases, (Gilbert Lenssen, et al. eds.,

Besides, international organisations seem to have adopted it. The International Monetary Fund and the World Bank's financial assistance in response to the 1997-1998 East Asian financial crisis was conditioned not just on macro-economic criteria, but also on corporate governance, corporate, bankruptcy and securities laws' reform to move to more shareholder-oriented system.[57]

In addition, it seems that major jurisdictions, including the European Union, have enacted business law and judicial reforms that are shareholder-oriented. For instance, the European directive on take-overs (hereafter the Take-Over Directive)[58] reflects the importance of the creation of a market for corporate control in the European Commission's opinion. An active market for corporate control is viewed as an important corporate governance tool for monitoring poor management.[59] Although currently available results seem disappointing due to protective implementation by Member States in national laws,[60] the Take-Over Directive could have increased the probability for a company of Continental Europe to be the subject of a take-over by a UK or US company, thereby bringing direct exposure to a shareholder-oriented corporate governance system.[61] The disappointing results of the Take-Over Directive are a cause for concern for the European Commission, which said that it would evaluate

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2009). See in the U.S., *inter alia*, JOHN H. MATHESON & BRENT A. OLSON, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 Minn. L. Rev. 1313, (1992)., at 1326 (stating that "the fundamental goal of corporate law is so theoretically and historically obvious that it need not be explicated: the goal is to maximise corporate - and thus shareholder – welfare"); Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations 2.01(a) (1994) (stating that "a corporation ... should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."); HENRI HANSMANN, The Ownership of Enterprise (The Belknap Press of Harvard University Press. 1966).; HENRY HANSMANN, et al., *The End Of History For Corporate Law*, 89 Geo. L. J. 439, (2001).; JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 5 (considering, on the basis of Professor Coase's "Theory of the Firm" (the firm as a nexus of contracts), that shareholder wealth maximisation "is and should be both a norm and a default rule, but *only* a norm and a default rule", i.e., "shareholders should be, and are, basically free to invest either in companies that maximise profits or in those that do not").

[57] See, *inter alia*, Magdi R. Iskander and Nadereh Chamlou (2000) *Corporate governance: A framework for implementation*, The World Bank, Washington DC; Timothy Lane et. al., IMF-Supported Programs in Indonesia, Korea, and Thailand 72-73 (Int'l Monetary Fund Occasional Paper No. 178).

[58] See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ, 30 April 2004, L 142/12.

[59] See Part II:Chapter II:IV.B.2.c.iib in Chapter Market Efficiency.

[60] See EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008).

[61] It should be added that the mandatory bid rule of the Take-Over Directive induces, as a matter of principle, dispersed ownership as shareholders will want to own less than the mandatory bid threshold to avoid to be required to make a mandatory bid.

and consider revision of the directive for 2011.[62] Another example is provided by the International Financial Reporting Standards (hereafter IFRS) which, since 2005, must be complied with by all European listed companies when drafting their consolidated financial accounts.[63] These new standards are commonly said to be shareholder-oriented and derived from the US inspired model of accounting principles.[64] Further illustrations are provided by the provisions relating to stronger public and private enforcement, stricter control on market manipulation and insider trading, improved disclosure, or limitations on unequal voting structures in national company law.

Lastly, it can be seen that global competition has put a strain on the corporate governance model of concentrated ownership structures which does not fully endorse a shareholder-oriented view.[65] For instance, where companies from concentrated systems raise equity from external capital markets or have been privatised into those markets, institutional investors who invest in such company expect to be able to enforce a shareholder orientation and to prompt management to rethink long-term commitments with non-shareholder constituencies. Another example is the fact that globalisation made it more and more common for Continental European companies to raise capital through the UK or the US stock exchange, exposing those companies to the shareholder-oriented regulations of those exchanges.[66] Hence, market and regulatory

[62] The Commission reconfirmed its view in EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008). (the aim is to "promote integration of European capital markets by creating favourable conditions for the emergence of a European market for corporate control").

[63] See Directive 2001/65/EC of the European Parliament and of the Council amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions, OJ, 27 September 2001, L 283. See also Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ L 243, 11 September 2002, at 1–4 (hereafter the IFRS Regulation).

[64] Some academics have expressed doubts in connection with the import of IFRS shareholder-oriented model in Continental Europe (see, *inter alia*, CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008)., suggesting that they might not be as effective as expected in a concentrated ownership structure).

[65] See Marco Becht, Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure – European Corporate Governance Network – Executive Report, 1997; GÉRARD HERTIG, et al., *Company and Takeover Law Reforms in Europe: Misguided Harmonisation Efforts or Regulatory Competition?, in* After Enron - Improving Corporate Law and Modernising Securities Regulation in Europe and the US, (John Armour, et al. eds., 2006).; ALAN DIGNAM, et al., *Corporate Governance and the Importance of Macroeconomic Context*, 28 Oxford Journal of Legal Studies 201, (2008).

[66] See LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 12 (stressing that

competition, consolidation of stock exchanges, the growth of foreign institutional investors who seek a common set of rules to govern their investments, shareholder activism facilitated by voting organisations,[67] but also information technology which made knowledge of foreign law accessible instantly and at low cost, transplantation,[68] international trade[69] and international governance practices,[70] facilitated convergence to the shareholder-oriented model. This should not come as a surprise to comparative law academics.[71]

This being said, contrary to the U.S., most European countries have not developed a generally formulated fiduciary duty, imposing on directors overall duties of care and loyalty toward not only the company but also shareholders.[72] Some Member States, i.e., the countries which follow the so-called Rhineland model, believe that if a behaviour of a controlling shareholder or of directors involves decisions that benefit other stakeholders at the expense of shareholders, then it should be welcomed.[73] The main representative of this model is Germany which favours a balance between shareholders and employees' interests. This model is also followed, although to a lesser and more

companies with international growth ambitions subject themselves to the rules of the stock exchanges which are market-oriented).

[67] See Part II:Chapter III:II.E.3.b.iii in Chapter Corporate Governance.

[68] Most legal systems in the world are said to have received elements of their legal infrastructure and their substantive law from "parent" systems through colonisation, conquest, adoption or other forms of diffusion. See on that subject, the work of Professor Katharina Pistor. Borrowing between systems has always gone on and most systems are, in practice, hybrids, with elements of both common and civil law styles (see generally the most recent works of Professor Siems).

[69] See Professors Rajan and Zingales (suggesting that rent-seeking by insider groups is linked to with the reluctance of countries to allow the free flow (entry and exit) of capital). See also Professor Roe (holding that shocks such as major economic depressions and wars have shaped attitudes to trade openness and corporate governance reform).

[70] See the principles for Corporate Governance of the Organisation for Economic Cooperation and Development (hereafter OECD), which, although they are non-binding, could serve as reference base for minimal global convergence for listed companies. They are also shareholder-oriented.

[71] It is accepted that a "basic rule of comparative law" is that "different legal systems give the same or very similar solutions, even as to detail, to the same problems of life, despite the great differences in their historical development, conceptual structure, and style of operation"; in particular, "we find that as a general rule developed nations answer the needs of legal business in the same or in a very similar way" (KONRAD ZWEIGERT, et al., Introduction to Comparative Law (Oxford University Press. 1996).). There is a "common core of efficient principles hidden in the different technicalities of the legal systems" (UGO MATTEI, Comparative Law and Economics (University of Michigan. 1997).).

[72] For a view in the US literature that management is not the agent of shareholders but are fiduciaries largely insulated from shareholders' control who owe fiduciary duties not just to shareholders but to the entire company, see LYNN A. STOUT, *The Mythical Benefits of Shareholder Control*, 93 Va. L. Rev. 789, (2007).

[73] Comp. with the Japanese "community firm" or keiretsu. See JOHN BUCHANAN, et al., The Limits of Shareholder Value? Hedge Fund Activism in Japanese Listed Companies (2009).

ambiguous extent, by some other jurisdictions under consideration in this dissertation, and in particular by Belgium, France and the Netherlands.[74]

And more importantly, across the Atlantic, the shareholder-oriented model, and the related shareholder value maximisation concept, are put into question.[75]

In the debate relating to shareholder primacy and shareholder value maximisation, the questions raised are three-fold: (1) is it true that shareholders are the exclusive residual claimants in the firm and therefore do shareholders deserve more protection than other corporate constituencies; (2) is it possible to maximise the value of the firm to the residual claimants without affecting the value of other stakeholder interests; (3) does maximising firm value lead to economic efficiency?

The stakeholders' view has gained increased momentum.[76]

It is argued that shareholders' interests are not always the same. Within the shareholders' class, investors vary considerably among dimensions such as the time frame over which they invest, the extent to which they trade versus passively holding the shares, their degree of diversification, the extent to which they hold non-equity interests in the issuer, any option or other hedging positions that they hold, and so forth. Academic commentary recognises that, consequently, shareholders may prefer different

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[74] See EDDY WYMEERSCH, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, *in* Comparative Corporate Governance. The state of the art and emerging research, (Klaus J. Hopt, et al. eds., 1998)., at 1079 et seq.; KLAUS GUGLER, et al., *Corporate Governance and Globalization* 20 Oxford Review of Economic Policy 129, (2004)., at 136; MARTIN GELTER, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 Harvard International Law Journal, (2009).

[75] See, *inter alia*, JEFFREY N. GORDON, *Deutche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1 Colum. Bus. L. Rev. 185, (1998)., at 197 ("[s]een from an economic perspective, the goal of a system of corporate governance is to maximise the economic value of the firm, as measured by the total of economic returns for all possible residual claimants. For instance, the goal is to maximise the sum of the returns for shareholders, debt claimants, and workers. The ultimate defense of the assignment in the Anglo-American system of exclusive governance rights to the stockholders rests on the empirically contestable fact that this is how to maximise the size of the economic pie."). See also the authors who blamed the Enron disaster on pre-occupation with shareholder value maximisation, and, *inter alia*, SIMON DEAKIN, et al., *After Enron: an Age of Enlightment?*, 10,3 Organisation, (2003).; WILLIAM W. BRATTON, *Enron and the Dark Side of Shareholder Value*, 76 Tulane Law Review, (2002).; SUMANTHRA GOSHAL, *Bad management Theories are Destroying Good Management Practices*, 4,1 Academy of Management Learning and Education 75, (2005).

[76] See BRADLEY R. AGLE, et al., *Dialogue: Toward Superior Stakeholder Theory*, 18 Business Ethics Quarterly 153, (2008). See also article 50(2)(g) of the Treaty on the Functioning of the European Union (previous article 44(2) of the Treaty establishing the European Community (hereafter TEC)) (holding that companies must be run in the interests of their members "and others").

corporate decisions. Other observers further argue that the idea that corporate and securities laws can be interpreted to protect only one identified interest is an illusion.[77] Hence, according to them, there are reasons to doubt the consistency and usefulness of the notion of shareholder value maximisation as it ignores the conflicts which may exist amongst the various groups of shareholders.[78]

Besides, the central idea of the listed company that assigns voting rights to shareholders because they bear residual risk is being challenged. Advances in risk management and availability of many new financial instruments to firms and investors beyond stocks, bonds and bank loans, that allow a firm to transfer risk, permit shareholders to decouple economic ownership from voting rights.[79] This decoupling takes place in the secondary markets, through stock lending, equity swaps, derivatives, and other trading strategies, where investors can synthetically unbundle voting and ownership without action by the company. It is thus argued that increasingly complete capital markets could alter a principal characteristic of equity itself.

Consequently, people do not necessarily consider shareholder value as efficiency criterion.[80] They start making reference to societal wealth maximisation which includes value to a variety of non-shareholder groups, including, directors (executive or non-executive), employees, creditors, customers and suppliers.

Whether to take into account other constituencies with whom the firm has business relationships, and how, are even more important issues in the context of the unfolding financial crisis. Some complain that management was too much focussed on short-term perspectives and the evolution of stock price. In their analysis, they seem to

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[77] See FRANCESCO DENOZZA, *Nonfinancial Disclosure between "Shareholder Value" and "Socially Responsible Investing", in* Investor Protection in Europe - Corporate Law Making, the MiFID and Beyond, (Francesco Ferrarini, et al. eds., 2006). and the references therein cited at note 3 and accompanying text.

[78] Note that I do not make a distinction between an investor, once he took an investment decision, and a shareholder, based on an arguable difference in holding and involvement strategy.

[79] See HENRY T. HU, et al., *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811, (2006)., at 823, 828-35; MARCEL KAHAN, et al., *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review (2007)., at 1070-77; FRANK PARTNOY, *Financial Innovation in Corporate Law*, 31 J. Corp. L. 799, (2006)., at 809-11.

[80] To dissipate any doubt, efficiency in this respect is to be understood as Pareto efficiency and surplus maximising efficiency. See, *inter alia*, MICHAEL C. JENSEN, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 12 Business Ethics Quarterly 235, (2002).

consider that the short-term views of management were constrained by the emphasis on shareholder value maximisation in conventional thinking and regulatory provisions.

It should also be noted that from a company law point of view, it has been argued that the distinction between a shareholder primacy model and stakeholder primacy model should not be over-estimated. Primacy of one corporate constituency over the other is, in general in most major jurisdictions across the world, a matter of contract law: although it might be somewhat framed by existing regulations, it depends most of the time on particular circumstances, with a view to determine the most efficient corporate governance arrangement. And comparative company law shows the existence of important similarities across jurisdictions and in individual contracts.[81] This issue is further discussed below.[82]

I believe that increasing shareholder value has a positive effect on overall social wealth as it maximises the company's contribution to society.[83] In essence, I share a position that could be labelled a "shareholders' value maximisation position with a long-term view".[84] It takes all constituencies into account to reflect their respective

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[81] See MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008)., at 178 et seq.; GUIDO A. FERRARINI, *Shareholder Value and the Modernisation of European Corporate Law*, *in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003).; REINIER H. KRAAKMAN, et al., The Anatomy of Corporate Law: a Comparative and Functional Approach (Oxford University Press. 2004).

[82] See Part II:Chapter III:II.B in Chapter Corporate Governance.

[83] *Accord* MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at 19; ROBERT C. CLARK, Corporate Law (Little, Brown. 1986). (arguing that there is overlap between firm interests and societal interests).; JOHN ARMOUR, et al., The Essential Elements of Corporate Law (2009)., at 26.

[84] *Accord* Michael C. Jensen, From Conflict to Cooperation for Promotion of the Common Good, in BRADLEY R. AGLE, et al., *Dialogue: Toward Superior Stakeholder Theory*, 18 Business Ethics Quarterly 153, (2008). (referring to "maximising the total long run value of the firm", and to "total long term market value of the firm" and "long run total value of all financial claims on the corporation" as the ideal behaviour of corporations, and to "enlightened value maximisation" and "enlightened stakeholder theory"); MICHAEL C. JENSEN, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 12 Business Ethics Quarterly 235, (2002)., at 245; CYNTHIA A. WILLIAMS, et al., An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct (2004).; LAWRENCE E. MITCHELL, The Legitimate Rights of Public Shareholders (2009). (suggesting building financial incentives into market decision-making for long-term holding as well as limitations on shareholder rights to help to relieve short-term pressures from management). Comp. with International Federation of Accountants, International Good Practice Guidance: Evaluating and Improving Governance in Organizations, February 2009 (promoting a long-term stakeholder view); LEO E. STRINE, JR., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, Journal of Corporation Law, (2007). (setting forth the idea that the company is an organisation with a distinct set of interests above and beyond those of all the stakeholder groups combined).

concerns, be they social, corporate governance-related or environmental concerns, but only to the extent they contribute to the company's long-term value.[85] One should not forget that shareholders may also be creditors, customers and employees, leading management to care about the effects of corporate conduct on non-shareholder constituencies. As long as there is a business case for it that can be reflected in the spreadsheet, it should be considered economically justified to pay attention to all interests groups that can affect the firm.[86] From that angle, I believe that corporate social responsibility programmes do not necessarily conflict with a shareholder-oriented model. They do so where there is no business case for them and where they actually destroy shareholder value. But otherwise they can serve not only as a marketing tool to maintain corporate reputation but more importantly as a way to positively impact corporate value. The increasing focus on corporate social responsibility and the related critique on the pure liberal market model could support global convergence to a shareholders' value maximisation position with a long-term view.[87] Management should not be focussed on short-term value maximisation and current stock price to the extent not dictated by long-term value enhancement. Indeed, shareholder value depends on successful management of the company's relationships with other stakeholders. The UK concept of "enlighted shareholder value" seems to accurately reflect my position on the duty of loyalty.[88] Compliance with it could be checked by increased disclosure obligations from directors.[89]

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[85] *Accord* JILL SOLOMON, Corporate Governance and Accountability (John Wiley & Sons 2nd ed. 2007)., at 28 et seq. (referring to "instrumental ethics").

[86] *Accord* R. Edward Freeman, Ending the so-called "Friedman-Freeman" Debate in BRADLEY R. AGLE, et al., *Dialogue: Toward Superior Stakeholder Theory*, 18 Business Ethics Quarterly 153, (2008).; MICHAEL C. JENSEN, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 12 Business Ethics Quarterly 235, (2002)., at 242 ("[s]pend an additional dollar on any constituency to the extent that the long-term value added to the firm from such expenditure is a dollar or more").

[87] See LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002).; see as well, JOHAN A. OTTEN, Origins of executive pay & corporate governance reform codes: essays on an institutional approach to corporate governance (Universiteit Utrecht. 2007)., at chapter 5 (describing the comparative corporate governance debate and assimilating the current status of varying conceptions of what constitutes "good corporate governance" as "a perspective of local repairs in light of a global ideal" of economic efficiency).

[88] "Enlightened shareholder value" implies "[a]n obligation on directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose" including "a proper balanced view of the short and long term, the need to sustain effective ongoing relationships with employees, customers, suppliers and others; and the need to maintain the company's reputation and to consider the impact of its operations on the community and the

The next question is how does my position actually serve the purposes of this dissertation?

I should stress from the outset that the concern relating to the best proxy of firm value in the context of empirical studies is separate from the concern that management should pay attention to all corporate constituencies' needs to allow for sustainable corporate growth.

Some authors pointed to the fact that the measures of shareholder value typically employed by empirical academics not only omit the interests of other stakeholders, but may be distorted by market deficiencies and inefficiencies, risk and "noise".[90] Professor Hansmann argued that the move to a shareholder-oriented model for the business firm in the last two decades was strongly related to the particular political and economic international context, which was characterised by strong capital markets.[91] He continued by saying that in times of crisis, in the absence of perfect market efficiency, short-term performance and value indicators, like profitability and stock price, may not accurately reflect the long-term value of operational decisions. He concluded that shareholder value maximisation as traditionally measured is less useful in times of financial crisis, both as a decisional rule and as a tool of empirical analysis.[92]

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environment" (Company Law Review Steering Group, 2000: 12). See also Company Law Review Steering Group, 2001: 41 and section 172 of the Companies Act 2006.

[89] To avoid the risk of so-called "accountability gap" with respect to the duty of directors to promote shareholder wealth maximisation with a long-term view, see s 417 of the Companies Act 2006 (Contents of directors' report: business review) which provides for reinforced disclosure obligations through the business review which is part of the directors' annual report. See for a commentary, JOHN LOWRY, *The Duty of Loyalty of Company Directors: Bridging the Accountability Gap through Efficient Disclosure*, The Cambridge Law Journal 607, (2009).

[90] See Part II:Chapter II:III.B.1 in Chapter Market Efficiency.

[91] See HENRY HANSMANN, *How Close is the End of History?*, 31 The Journal of Corporation Law 745, (2006)., at 748-49.

[92] See also AJIT SINGH, et al., *Shareholder Value Maximisation, Stock Market and New Technology: Should the US Corporate Model be the Universal Standard?*, 19 International Review of Applied Economics 419, (2005). (considering that a firm should be concerned with product market competition, increasing market share and corporate growth, leaving stock markets alone; referring to John Kay, "Challenging the Claims for the Role of Capital Markets", *CES ifo* Forum, Munich Economic Summit 2-3 May 2003, Summer 2003, Vol.4, No.2, at 17-20).

Some others argue that share price is not a good proxy of firm value, and also contend that stakeholder value cannot be measured.[93]

Other academics have identified broader conceptions of firm value that could be incorporated into empirical research.[94] This research is however at its infancy.

I believe that, to the extent share price does reflect long-term and sustainable perspectives, to the benefits of social wealth and economic efficiency, share price is a good proxy of firm value for the purposes of empirical researches which assess the effectiveness of disclosure requirements. This being said, the time period covered by the studies should be long enough to have a stock price which actually reflects the expected cash flows in the long term and is not subject to the "vagaries of the movements in a firm's value from day to day"[95] or the consequences of a financial bubble or crisis.

C. The Theoretical Case for Mandating Disclosure

Whether disclosure should be set out in mandatory provisions or left to the discretion of issuers has always been at the centre of a heated debate.[96] However, "as a matter of positive law, the debate has been settled for decades, with mandatory disclosure winning the day".[97] I set out below the arguments of legal and economic academics in favour of mandatory issuer-disclosure requirements.[98] These arguments are said to

[93] See MICHAEL C. JENSEN, *The Agency Cost of Overvalued Equity and the Current State of Corporate Finance*, 10 Eur. Fin. Mgmt. 549, (2004). (arguing that when stock price exceeds the firm's fundamental value, managers will be pressured to make value-destroying decisions - manipulating reported accounting figures or engaging in high risk negative net present value projects - in an effort to maintain the inflated price. Such actions appear justified in terms of the shareholder primacy norm. As Jensen puts it, how can managers argue to their board (or their shareholders) that "they must manage the price of their stock down?"). See also THEO VERMAELEN, *Maximising Shareholder Value: An Ethical Responsibility?, in* Mainstreaming Corporate Responsibility: Text and Cases, (Gilbert Lenssen, et al. eds., 2009). referring to MICHAEL C. JENSEN, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 12 Business Ethics Quarterly 235, (2002). (asserting that stakeholder value cannot be measured as one can only maximise over one dimension at a time).

[94] See JILL E. FISCH, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy* 31 Iowa J. Corp. L. 637, (2006). and the references therein cited at 669 et seq.

[95] MICHAEL C. JENSEN, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 12 Business Ethics Quarterly 235, (2002)., at 246.

[96] See for references to authors against mandatory disclosure and pleading for regulatory competition, note 421 and accompanying text.

[97] TROY A. PAREDES, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L. Quarterly 417, (2003)., at 2. But see the more nuanced view developed in OMRI BEN-SHAHAR, et al., The Failure of Mandated Disclosure (2010). (suggesting that, although mandatory disclosure seems to fail in most cases, there is no better alternative).

[98] See for good literature reviews in the U.S., MERRITT B. FOX, *The Issuer Choice Debate*, 2 Theoretical Inquiries in Law, (2001).; MERRITT B. FOX, *Retaining Mandatory Securities Disclosure:*

apply equally in a concentrated ownership structure as in a dispersed ownership structure.[99]

Market failures which are incidences of imperfect information in the relationship between issuers and investors provide a central argument for mandating disclosure:

Market failures include the problem of "uncertainty about the quality of the products and services" or "*qualitative uncertainty*".[100] It refers to the inability of investors to distinguish good quality products from bad quality products (the so-called "lemons") because of informational problems and shows the limits of reputation and signalling theory as disciplining devices.[101]

Market failures also include *moral hazard* and *adverse selection*. Whereas adverse selection suggests that good firms exit the market in the absence of a mandatory disclosure regime because they have to sell at a discount to their true value as they cannot signal themselves out as well performing firms,[102] the moral hazard problem

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Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335, (1999).; BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001).; JOEL SELIGMAN, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 The Journal of Corporation Law, (1983). See for a more nuanced view, PAUL M. HEALY, et al., *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, Journal of Accounting and Economics 405, (2001).; CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008).; FRANK H. EASTERBROOK, et al., *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, (1984).; DAVID LLEWELLYN, The Economic Rationale for Financial Regulation (1999).

[99] See ALLEN FERRELL, The Case for Mandatory Disclosure in Securities Regulation Around the World (2004). (arguing that mandatory financial disclosure for controlled companies increases competition in capital and product markets. Competition for capital will be enhanced because some firms will find their access to external finance improved as a result of being able to credibly commit to higher disclosure levels. That, in turn, can be expected to also promote competition in the product markets).

[100] See ANDROMACHI GEORGOSOULI, *The Debate over the Economic Rationale for Investor Protection Regulation: a Critical Appraisal*, 15 JFRC 236, (2007). and the references therein stated at 238.

[101] See GEORGE A. AKERLOF, *"The Market for Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 The Quarterly Journal of Economics 488, (1970)., at 488.

[102] Adverse selection has indeed been defined as an aspect of information asymmetry whereby those offering securities for sale practise self-selection, implying that securities of different "quality" sell for the same price. See STEWART C. MYERS, et al., *Corporate Financing and Investment Decisions When Firms Have InformationThat Investors Do Not Have*, 13 Journal of Financial Economics (1984). and STEWART C. MYERS, *Capital Structure Puzzle*, 39 Journal of Finance 575, (1984).

suggests that good firms are induced to follow the bad behaviour of other firms.[103] These problems lead to disastrous consequences for competition and market performance.

Another oft-cited rationale for mandatory disclosure which flows from a market failure relates to the likely under-production of information if left voluntary.[104] Authors have explained under-production by the fact that the *social costs of an issuer's disclosure are lower than its private costs and the social benefits of its disclosure are greater than its private benefits*.[105]

As best explained by Professor Fox, for each individual issuer, a disclosure involves two different kinds of costs, "operational" costs and "inter-firm" costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the information. Inter-firm costs (also referred to as "competitive costs" or "third parties effects") arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers and major customers.[106] Operational costs are costs both to the individual firm and to society as a whole. Inter-firm costs are costs only to the individual firm. They are no social costs because the inter-firm disadvantages to the issuer from the disclosure are counter-balanced by the advantages it confers on the other firms. Thus, at all levels of disclosure, an issuer's private marginal cost of disclosure will exceed its social marginal cost by an amount equal to these inter-firm costs. There is consequently a market failure and a market solution is unlikely to produce a socially desirable level of disclosure. Competition and private contracting cannot address this market failure.

On the benefits' side, information disclosed by one issuer can be useful in analysing other issuers. These benefits will not be captured in the price of the issuer

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[103] Moral hazard implies that the agent will attempt to benefit from the principal's inferior information set. See WILLIAM H. BEAVER, Financial Reporting: An Accounting Revolution (2nd ed.) (Prentice Hall International Editions. 1989).

[104] See JEFFREY N. GORDON, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465, (2007)., at 1556.

[105] See, *inter alia*, MERRITT B. FOX, *Required Disclosure and Corporate Governance*, 62 Law and Contemporary Problems 113, (1999).

[106] See also CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008)., at 12 et seq. for references to researches.

making the disclosure and therefore the private benefit to the issuer and its shareholders from disclosure will be less than the social benefit.

Because an issuer's disclosure involves both social costs and social benefits, each issuer has some socially optimal level of disclosure. Because the private costs of an issuer's disclosure exceed the social costs and the private benefits fall short of the social benefits, even management which completely identifies with existing shareholders – management which seeks to maximise share value so that costs of disclosure to the shareholders are equivalent to costs to them – would therefore choose a disclosure level below the social optimum. Mandatory disclosure can be viewed, to a large extent, as an effort to correct this shortfall. In this connection, it should be noted that if all issuers are required to disclose at their socially optimal level, the effects of the inter-firm costs that give rise to the divergence between private and social cost would likely be a wash for each firm. Each firm would lose as a result of its own disclosure, but gain from the disclosures of its competitors, major suppliers and major purchasers.

Next to this main argument relating to inter-firm externalities produced by information, other arguments lead to the same conclusion that, in an unregulated market, there is likely to be underproduction of information by issuers and therefore continuing information asymmetry between issuers and investors:

For instance, the fear to raise *liability concerns* if a certain piece of information is disclosed or the lack of will to unravel and disclose bad news also make the case for mandating disclosure.[107]

Moreover, without mandatory disclosure, analysts, for instance, as important actors for market efficiency, would refrain from digging out relevant information as they are not able to capture the benefits of their efforts, unless the very first ones to trade on the new information they found. The problem related to the *public good* nature of information[108] and the possibility of other actors of a *free ride* on the information found leads to under-investment by market actors in searching for information. And

[107] See SANFORD J. GROSSMAN, et al., *Disclosure Laws and Takeover Bids,* 35 Journal of Finance, (1980).

[108] The public good nature of information, i.e., the fact that it becomes public once disseminated, that use of information by one person does not lower its value to others, and that suppliers of information cannot easily control free-riding on information, or restrict its dissemination to those who will directly or indirectly pay for it, means that suppliers of information are not given adequate incentives to supply it.

Professor Luigi Zingales to conclude that "General Motor disclosure helps investors evaluate Ford, but GM will never internalise this benefit".[109] As a solution, mandatory disclosure reduces transaction costs of searching for the valuable information by mandating disclosure from the issuer, as the least-cost provider.

Mandatory disclosure is also useful in the sense that it leads to *standardisation* of information provided.[110] Standardisation eases the comparison process for market participants and the process of capital allocation toward the more competent firms. Standardisation could not be provided without mandating disclosure as each investor only gets a small benefit from the more standardised disclosure: the greater benefit in terms of comparability accrues to all market participants, leading to sub-optimal level of standardisation. Standardisation also allows for precision in what ought to be disclosed. This makes me jump to another justification: in the case of alleged liability, a mandatory rule implies a more rigorous definition of what had to be included in disclosure and eases the enforcement process. It also imposes the same timing of and the same access to disclosure to all market participants. This contributes to the credibility of the financial system by avoiding the privileged treatment of some, e.g., analysts or journalists, with the related risk they would repay the privilege by providing, for instance, favourable future earnings forecasts or favourable press articles for the firm.

Lastly, mandatory disclosure creates *positive externalities* for all actors in financial markets. It enhances welfare through investment decision closer to the optimal from the investor's point of view as investors take less risks: mandatory disclosure reduces information asymmetries and agency problems.[111] And it decreases cost of capital from the issuer's point of view, as investors require lower returns on their investment and do not require a discount rate on the share price. It improves resource allocation/project choice in the economy from the society's point of view, as no waste in resource allocation will benefit the entire economy.[112]

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[109] LUIGI ZINGALES, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, (2009)., at 5.

[110] However, for the case for flexibility to accommodate specific cases, see Part II:Chapter III:II.D.2. in Chapter Corporate Governance.

[111] See generally, Chapter Corporate Governance.

[112] See generally, Chapter Market Efficiency.

Part II:

Objectives of the EU Issuer-Disclosure Regime

Chapter I: Investor Protection

I. Introduction

International organisations,[113] regulators,[114] supervisory authorities,[115] and many legal academics[116] across the Atlantic consider that issuer-disclosure should primarily protect investors and enhance their confidence in the market place. Investor protection and investor confidence are perceived as important, if not the primary, objectives of issuer-disclosure.

The EU Treaty on the Functioning of the European Union does not provide for a specific basis for investor protection law-making.[117] Indeed its purpose is the creation of an internal market in which obstacles to the free movement of goods, persons, services and capital are abolished. From a historical perspective, removal of regulatory hurdles hindering cross-border activity has initially been at the heart of European securities

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[113] See, for an early text, OECD, *Minimum Disclosure Rules Applicable to All Publicly Offered Securities* (1976), at 67; see also IOSCO, Objectives and Principles of Securities Regulation (February 2008). at §4.1, 4.2.1 and Principle 10 (Issuers).

[114] See, in the E.U., the recitals to the Prospectus Directive and the Transparency Directive. See in the U.S., *inter alia*, Section 409 SOx; Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722 (final rule Dec. 1, 2005); Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, 70 Fed. Reg. 42,234 (final rule Aug. 22, 2005); Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, 65 Fed. Reg. 51,716 (final rule Oct. 23, 2000).

[115] See, in the E.U., CESR charter and CESR annual reports. See also the web-sites of all national authorities competent for the supervision of financial markets. For a recent re-affirmation of investor protection as priority, see French AMF, Financial Regulation Newsletter, Issue 14, 2009). See, in the U.S., the US SEC's mission as stated on its web-site and in its annual reports.

[116] See, *inter alia*, in the E.U., LUIGI GUISO, et al., *Trusting the Stock Market*, 63 Journal of Finance 2557, (2008).; MICHEL TISON, *De bescherming van de belegger in het kapitaalmarktrecht: de hobbelige weg naar een Europees Ius Commune*, *in* Liber Amicorum André Bruyneel, (Bruylant ed., 2008). In the U.S., see RALPH K. WINTER, *On 'Protecting the Ordinary Investor'*, Washington Law Review 881, (1988).; JOSEPH F. MORRISSEY, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 Cath. U.L. Rev. 561, (2007).; LYNN A. STOUT, The Investor Confidence Game (2002)., at 3; DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003).; ROBERT PRENTICE, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 Duke L.J. 1397, (2002)., at 1397; EMILIOS AVGOULEAS, What Future for Disclosure as a Regulatory Technique? Lessons from the Global Financial Crisis and Beyond (2009).

[117] See for a discussion, NIAMH MOLONEY, EC Securities Regulation (Oxford University Press. 2002)., at 577-606. See the additional comments I make under Part II:Chapter I:V.C below relating to a move away from consumerism.

regulation.[118] This means that, further to article 114 of the EU Treaty on the Functioning of the European Union,[119] investor protection laws can only be adopted with a view to achieving the over-riding goal of market integration.[120] This macro-economic function of investor confidence and investor protection in the European Union is expected to lead to more European cross-border investments in order to achieve the over-arching goals of economic growth and job creation set out in Lisbon.[121]

Throughout the FSAP, investor protection is treated as a matter of public interest and as essential, from a macro-economic point of view, for the proper functioning of the market.[122] Investor confidence is regarded as critical for sustaining the continued successful development of integrated European financial markets. Investors are believed to be less likely to invest if they are not confident in markets' and financial institutions' integrity, in the information that they are being provided and, more generally, in the regulation that is said to protect them.[123]

As the need for barrier-dismantling laws required by companies gradually diminished over time, culminating with, *inter alia*, the passport concept under the Prospectus Directive, the attention of European policy-makers increasingly turned to investor protection issues.[124] This is illustrated by the place of choice attributed to

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[118] See European Commission, Financial Services: Building a Framework for Action, Communication from the Commission, COM(98) 625 final, 28 October 1998, at 2.

[119] Article 114 is the former article 95 TEC. See also article 169 of the EU Treaty on the Functioning of the European Union (former article 153 TEC).

[120] See, *inter alia,* Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets, Nov. 2000, at 12 and 22; European Commission, Financial Services: Building a Framework for Action, Communication from the Commission, COM(98) 625 final, 28 October 1998, at 1a.

[121] See recitals (4) and (5) of the Prospectus Directive; recitals (1), (3), (7), (41) but also recitals (23), (24), (25) and (36) of the Transparency Directive; recital (1) of the MAD. See also NIAMH MOLONEY, EC Securities Regulation (Oxford University Press. 2002)., at 54; NIAMH MOLONEY, *Confidence and Competence: the Conundrum of EC Capital Markets Law*, 4 J.Corp.L.Stud. 1, (2004)., at 27.

[122] Article 114.3 of the EU Treaty on the Functioning of the European Union and the FSAP use the term "consumer protection". Given the more focused scope of the dissertation, I use the term "investor protection".

[123] See Charlie McCreevy, Opening Remarks, Open Hearing on Retail Investment Products, Speech/08/393, 15 July 2008.

[124] In the remainder of the dissertation, and consistent with the investor protection model developed under the FSAP, I consider investor confidence to be the consequence of "investor protection" and "investor protection" to be meant by the European instances as paramount objective of the Prospectus Directive and the Transparency Directive. See NIAMH MOLONEY, EC Securities Regulation (Oxford

investor protection as policy objective of the EU issuer-disclosure regime in the Prospectus Directive, the Transparency Directive and the MAD.[125]

But who is the "investor" the European Commission seeks to protect through the EU issuer-disclosure regime?

The *characteristics of the recipient* of the EU issuer-disclosure regime are not specified anywhere in the Prospectus Directive, the Transparency Directive and the MAD.[126] Is it the unsophisticated retail investor or the sophisticated (professional) investor or someone else on the continuum of investors?

It is very difficult to identify a coherent philosophy of investor protection in the EU issuer-disclosure regime. If it is conceivable that policy choices were required at the time of the drafting of the regime concerning the extent to which investor protection is to be pursued, it must be stressed that the regime is full of contradictions.[127]

On the one hand, the requirement of a summary prospectus is illustrative of an unsophisticated retail investor concern of the European Commission.[128]

On the other hand, there are many areas where the provisions on their face seem to oppose the interests of unsophisticated retail investor protection.

University Press. 2002)., at 137 ("[i]nvestor protection is a means to achieve the wider investor-confidence which is in turn a function of market integration.").

[125] See recitals (16) and (21) as well as recitals (18), (33) and (41) of the Prospectus Directive. See also recital (41) and recitals (1) and (36) of the Transparency Directive. See also recital (12) and also recitals (2) and (13) of the MAD.

[126] See however, recital (25) of the Transparency Directive (using the term "retail investors"). Note that the issuer-disclosure regulatory apparatus sometimes refers to "small investors": see Opinion of the Committee on Legal Affairs and the Internal Market, for the Committee on Economic and Monetary Affairs on the proposal for a directive amending Directive 2001/34/EC, (COM(2003) 138 – C5-0151/2003 – 2003/0045(COD)); recital 41 of the Prospectus Directive and recital 36 of the Transparency Directive). Note that "retail investors", referred to as "retail clients", are defined for the first time for the purposes of MiFID.

[127] For a similar critic in the US context, see JOSEPH F. MORRISSEY, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 Cath. U.L. Rev. 561, (2007).

[128] See article 5.2 of the Prospectus Directive. See also EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009)., at 7 (when speaking about the summary prospectus).

It seems that the EU issuer-disclosure regime is more concerned at times with providing easy access for issuers to capital markets. However, doing things in the name of improving access to capital markets is not always in line with unsophisticated retail investor protection. Consider for instance the exemption to the requirement to publish a prospectus for offers below a certain amount whereas unsophisticated retail investors targeted by these small issues are arguably the ones who mostly need protection.[129] Or the time allowed to potential investors to read the prospectus which could make unsophisticated retail investors incapable of participating in the offer as it requires the prospectus to be made public at the latest at the beginning of the offer/admission to trading.[130] Or the language regime which could conflict with the idea of unsophisticated investor protection as French investors, for example, may be confronted with prospectuses and periodic reports that are not drafted in French, while the summary prospectus is required to be written in French.[131] If unsophisticated investors need to have the prospectus or periodic reports translated[132] and are possibly referred to a foreign legal system, this might critically impede legal actions from unsophisticated investors. A last illustration could be that none of the periodic reports, nor the price sensitive information disclosure duties are subject to clarity or accessibility requirements under the Transparency Directive or the Market Abuse Directive.

Worth to be noted as well is the disconnection between the level of protection given to the prospectus, which is rarely read, and that given to advertisements, on which retail investors are more likely to rely.[133]

Moreover, the Prospectus Directive and the Transparency Directive do not consider the fast changing European markets. In particular, they do not require more extensive disclosure for retail structured securities, even though they might display similar functionalities to units offered by collective investment schemes which are

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[129] See article 3.2(e) of the Prospectus Directive.

[130] See article 14.1 of the Prospectus Directive. I believe as well that this constitutes a recognition of the importance of institutional investors who were already involved (and provided with the necessary information) in the oft-used bookbuilding mechanism for price setting purposes.

[131] See PETER MATTIL, et al., *The language of the prospectus: Europeanisation and investor protection*, 1 JIBFL 27, (2008).

[132] Note that depending on the national rules applicable, investors might have to bear the costs of translation.

[133] See article 15 of the Prospectus Directive (regulation of advertisements). *Accord* NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 120.

regulated under the more stringent UCITS regime.[134] Nor do they require additional disclosure in connection with less mature markets, i.e., the new entrants, which are therefore accessible to anyone, at no special condition.

The above makes me suggest that although the EU issuer-disclosure regime has an undisputable unsophisticated retail investor protection dimension, it cannot be said, without nuance, that it considers unsophisticated retail investors as its primary or central focus.

From a comparative point of view, the U.S. and international fora seem to be concerned with unsophisticated retail investors. Throughout the US SEC's history and culture, the focus has been on "average investors", defined as ones lacking enough investing experience and sophistication to need the protection of the securities laws.[135] The International Organisation of Securities Commissions (hereafter IOSCO) seems to refer to a retail investor concept.[136]

This being said the conventional perception of issuer-disclosure (partly) designed to protect unsophisticated retail investors is subject to a growing debate in policy circles and among academics, especially in an international context of cross-border transactions. The extent to which cross-border transactions should be regulated with an eye toward protections designed for unsophisticated retail investors is put into question.

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[134] However, on the works of the European Commission relating to packaged retail investment products (the so-called PRIPs), see, *inter alia*, EUROPEAN COMMISSION, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council Packaged Retail Investment Products Impact Assessment (2009). and the relevant pages on the European Commission web-site.

[135] See, *inter alia*, S. Rep. No. 73-47, at 1 (1933) (legislative history of US Securities Act); H.R. REP. NO. 73-1383, pt. 2 (1934) (legislative history of US Securities Exchange Act). See generally, Joel Seligman, The Transformation of Wall Street: a History of the Securities and Exchange Commission and Modern Corporate Finance (3d ed. 2003). At the risk of substantial over-simplification of an overwhelming complicated subject, the US SEC determined in the early 1980's that in terms of original placements by issuers, sufficient wealth *or* sophistication on the part of the investors was enough to justify lack of registration of offering documents. That wealth measure ("accredited investor" status), though perhaps substantial then, has now been eroded by inflation so that most upper middle-class investors now readily qualify. For a good discussion, see MARK SARGENT, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 Wash. U.L.Q. 225, (1990).

[136] See International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers, September 1998, at II-4 (referring to "investor of average intelligence and imaginative faculty").

Effectiveness and efficiency of issuer-disclosure designed for the protection of unsophisticated retail investors are at the core of the discussions.

I share the views of the sceptics, as developed in this chapter.

More specifically, my argument is two-pronged in the European context:

On the one hand, I fully recognise the *importance of the participation of retail investors for the growth of European equity markets*. As retail investors are usually not sophisticated investors, *minimum protection is necessary* if we want them to participate in equity markets. I do not share the view of authors who argue that "investors are sophisticated actors who know what legal protections they enjoy and so are fully capable of protecting themselves from securities fraud by not investing".[137] To the contrary, I contend that unsophisticated retail investor protection is a worthy goal of securities regulation.

On the other hand, the retail investor protection objective of the EU issuer-disclosure regime, even if it is of secondary relevance only, clouds the regulatory picture. More specifically, together with numerous observers, I q*uestion issuer-disclosure as a tool to achieve unsophisticated retail investor protection*. I do not believe that retail investors have the necessary will and the required competence to read and make use of the information that is disclosed to them. Moreover, under current situation, information disclosed is often unreadable and full of disclaimers from responsible persons. Therefore, unsophisticated retail investor protection cannot effectively be achieved through issuer-disclosure. And consequently, it is neither a cost-efficient objective of issuer-disclosure. In this context, I take a rather critical view of the law and finance school which, *inter alia*, links legal protections, financial market development and national economic growth, and of any claim of a "positive transformative effect" of the EU issuer-disclosure regime.

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[137] See LYNN A. STOUT, The Investor Confidence Game (2002)., at 11 (referring to Professor Roberta Romano and contending that it became "something of an intellectual gaffe for a serious securities scholar to suggest that investors might actually need some compulsory investor protection") or FRANK H. EASTERBROOK, et al., *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, (1984)., at 692 (stating that many theoreticians view the argument that investor protection is necessary to unsophisticated investors "as unsophisticated as the investors it is supposed to protect").

I draw some policy implications from my position, including alternative measures to protect unsophisticated retail investors who participate in securities markets.

The rest of this chapter is organised as follows. Section II focusses on how retail investors positively contribute to financial markets. Section III shortly reviews the reasons to protect retail investors. Section IV argues that issuer-disclosure cannot effectively protect retail investors and consequently that it cannot cost-efficiently contribute to investor protection. Section V concerns the policy implications of this chapter, some of which are further developed in Part III. Section VI concludes.

II. Reasons to Promote Retail Investor Participation in European Financial Markets, Including its Equity Markets

A. Economic Reasons

Retail investors form *15%* of the public that *directly* invests in listed shares in Europe.[138]

In addition, it is widely recognised that retail investors are important contributors to economic development through their *indirect* participation in financial markets.[139]

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[138] See FEDERATION OF EUROPEAN SECURITIES EXCHANGES, Share Ownership Structure in Europe (2007). (data mainly from 2005); LUIGI GUISO, et al., *Household Stockholding in Europe: Where Do We Stand, and Where Do We Go?*, 36 Economic Policy 123, (2003). (for France, Germany, Italy, the U.K. and the Netherlands (data from 2000)); LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 38 et seq. (period between 1990 and 1999 for the major jurisdictions of the European Union, the U.S. and Japan). For further details on this participation and a comparison with the U.S., see Part III:Chapter I:II.A.2 in Chapter Issuer-Disclosure Addressees and Consequences.

[139] See JAMES A. FANTO, *Regulatory Implications of Individual Management of Pension Funds: Comparative Investor Education*, 64 Brooklyn L.R. 1093, (1998)., at 1093 (arguing that small investors are as "critical to the survival of capitalism as are the elites and, without their support and participation, institutional investors and capital markets would not exist"). See also GREGORY LA BLANC, et al., *In Praise of Investor Irrationality*, *in* The Law and Economics of Irrational Behavior, (Francesco Parisi, et al. eds., 2005). (arguing that irrationality of investors might be essential to market efficiency and that reforms designed to save investors from the costs of their cognitive errors would reduce market liquidity and deprive the market of valuable private pricing information that they hold; also arguing that the alternative system - institutional financing - could produce even less accurate prices than a fluid securities market fraught with individually erroneous decisions).

A study estimated that an effective pan-European retail market would boost European GDP by some 0.5-0.7%.[140] Some consider that "[r]etail securities markets […] have become an urgent necessity", given the political reasons explained below.[141]

Beyond the obvious advantage of providing an *increased supply of investment capital* to entrepreneurs who need external funding,[142] which would in turn stimulate economic growth, retail investors' participation in equity markets is believed to increase market efficiency as follows.[143]

Retail investors' trades on equity markets contribute to the *liquidity* of those markets, which in turn is an element of market efficiency.[144]

Retail investors' activity on equity markets also contributes to solve the "efficient market paradox". As shall be further detailed in Chapter Market Efficiency, if the only trades were those based on relevant information and if all traders had access to (and could act on) the same information, no one, other than for liquidity reasons, would have reason to trade.[145] Thus, "noise trading", i.e., trading on the basis of irrational expectations, who are activated by fads, fashions, and irrational psychological predispositions,[146] makes markets more efficient as informed traders attempt to exploit inefficiencies in markets caused by noise trading.[147] Noise trading indirectly aids in *price accuracy*, another element of market efficiency, as noise traders make it worthwhile for informed traders to acquire and trade on information that ultimately will make share prices more reflective of fundamental value.[148] One author even found that

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[140] See Friedrich Heinemann and Mathias Jopp, The Benefits of a Working European Retail Market for Financial Services, Report to the European Financial Services Roundtable, 2002, at 12.

[141] LACHLAN BURN, *KISS, but tell all: short-form disclosure for retail investors*, 5 Capital Markets Law Journal 141, (2010). at 143.

[142] See 2nd FSAP Report (May 2000), at 3 ("[p]rivate sector savings in Europe amount to some 20% of GDP – a valuable asset, if efficiently used, to stimulate growth and job-creation").

[143] For market efficiency and related concepts referred to below, see Chapter Market Efficiency.

[144] See also ALICIA DAVIS EVANS, Do Individual Investors Affect Share Price Accuracy? Some Preliminary Evidence (2008).; RON KANIEL, et al., *Individual Investor Trading and Stock Returns*, 63 Journal of Finance 273, (2008). (for a discussion of ways in which individuals provide liquidity for institutional investors).

[145] See Part II:Chapter II:III.D in Chapter Market Efficiency.

[146] See Part II:Chapter II:III.B.1 in Chapter Market Efficiency.

[147] See FISCHER BLACK, *Noise*, 16 Journal of Finance 529, (1986). (suggesting that noise trading makes markets more liquid as informed traders attempt to exploit inefficiencies in markets caused by noise trading).

[148] *Accord*, GREGORY LA BLANC, et al., *In Praise of Investor Irrationality*, *in* The Law and Economics of Irrational Behavior, (Francesco Parisi, et al. eds., 2005).

increased levels of retail trading are associated with lower R^2s.[149] If a lower R^2 is consistent with a more accurate price, it means that restricting the access of large numbers of individual investors to equity markets could harm market functioning.[150]

B. Political Reasons

Retail participation in financial markets, including equity markets, if properly regulated,[151] provides a nice substitute at a time when governments withdraw from social welfare, education and pension provision. Financial markets, including equity markets, have become important politically from this perspective.

III. The Need for Retail Investor Protection

The European Commission has never been explicit about the assumptions underlying its policy choice to enhance unsophisticated retail investor protection through the EU issuer-disclosure regime.

Most retail investors are not sophisticated: they lack the appropriate financial literacy to invest in, *inter alia*, equity markets, i.e., the competence to assess the risks related to their investments.

Moreover, as developed below, they are subject to limited cognitive capabilities and suffer from behavioural bias.[152] Their irrationality could lead to disastrous decisions for the value of their portfolio.

Lastly, their weaknesses could be exploited by management or the controlling shareholder who could reap personal gains which are otherwise attributable to them.[153]

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[149] For a definition and commentary on R^2, see Part II:Chapter II:IV.B.4.c in Chapter Market Efficiency.

[150] *Accord* ALICIA DAVIS EVANS, Do Individual Investors Affect Share Price Accuracy? Some Preliminary Evidence (2008).

[151] See my suggestions in that respect, Part II:Chapter I:V below.

[152] See Part II:Chapter I:IV.B.2 below.

[153] See Part II:Chapter III:II.D.1 below.

In a context where retail investor participation in financial markets, including equity markets, is promoted as alternative to public pensions, these reasons make the case for unsophisticated retail investor protection through appropriate regulation.[154]

IV. The EU Issuer-Disclosure Regime is Not an Effective Solution

A. Preliminary Remark

If there is a need to protect retail investors, does the EU issuer-disclosure regime effectively achieve this objective?

The European Commission has never provided evidence that the EU issuer-disclosure regime contributes to increase retail investor protection.

On the one hand, there seems to be empirical difficulties inherent in the exercise of measuring the effectiveness of investor protection through issuer-disclosure.[155]

The European Commission appears to be taking the investor confidence argument as an article of faith. However, investor confidence is at best an elusive and nebulous goal. What proxy of investor confidence to use: stock price, liquidity, volume, or something else? What specifically impacts investor confidence? Is it protective regulation? If yes, which provisions exactly?[156] Or is it macro-economic conditions?[157] Or is it enforcement?[158]

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[154] In the US context, see LUIGI ZINGALES, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, (2009). (commenting that in such context, "the efficiency of individual investment choices and the costs they bear is not just an issue of fairness, but a primary public finance consideration. Without wise investments, the vast majority of Americans will not have enough to support themselves in retirement.").

[155] See FRANK H. EASTERBROOK, et al., *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, (1984)., at 693 (concluding that "after fifty years, the proponents of regulation have *no* scientifically-acceptable evidence of a favourable cost-benefit ratio for any disclosure rule that rests on the benefits of reducing fraud or increasing confidence"); see also STEPHEN J. CHOI, et al., *Behavioral Economics and the SEC*, 56 Stan L. Rev. 1, (2003)., at 35; NIAMH MOLONEY, *Building a Retail Investment Culture through Law: The 2004 Markets in Financial Instruments Directive*, 6 European Business Organisation Law Review 341, (2005)., at 371-72; OLIVER HART, *Norms and the Theory of the Firm*, 149 U. Pa. L. Rev. 1701, (2001)., at 1703; LYNN A. STOUT, The Investor Confidence Game (2002)., at 410-15.

[156] See the suggestions of the authors of the law and finance school in that respect, in Part II:Chapter I:IV.B.3.a below.

On the other hand, the leitmotiv of investor confidence/investor protection as ever-strengthening undercurrent in European securities regulation does not fit well if one considers the requirements for evidence-based legislation and the costs-benefits analysis requirements of European bodies. One has to balance the benefits of mandatory issuer-disclosure, i.e., reduction of market failures,[159] against compliance costs and indirect costs of regulatory intervention. Benefits will arguably increase firms' valuation by their reduction of firms' cost of raising external finance, whereas costs are likely to negatively impact such firms' valuation. The empirical question of interest is at what point the costs exceed the benefits of further or more stringent issuer-disclosure to protect investors. Notably, the European Commission argued that, while it accepted the need for evidence-based policy making, analytical metrics were not sufficiently developed to allow regulators to quantify with precision the costs and benefits of proposals, particularly with respect to intangibles such as investor confidence.[160]

Leaving aside difficulties of measuring the effectiveness of issuer-disclosure to promote investor protection, I submit that the EU issuer-disclosure regime does not protect unsophisticated retail investors.

B. The Infrequency of Rational Investment Decisions

1. The myth

Under neoclassical economic theory[161] as well as under the economic analysis of the law approach (otherwise referred to as the "law and economics school"),[162] rational

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[157] One of the few empirical studies on the function of investor confidence to the well functioning of the financial markets is JEFFREY J. LAWRENCE, The Economics of Market Confidence: (Ac)Costing Securities Market Regulations (2002). However, at note 99, the author undermines the results of his research by saying that the share price is no good proxy of confidence but that volume and liquidity are better proxies.

[158] See RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 Journal of Finance 1, (2006).; UTPAL BHATTACHARYA, et al., *The World Price of Insider Trading*, 57 The Journal of Finance 75, (2002).

[159] See Part I:VII.C above in the General Introduction.

[160] See 10th FSAP Report, Financial Services. Turning the Corner (June 2004), at 15.

[161] See MILTON FRIEDMAN, *The Methodology of Positive Economics*, *in* Essays in Positive Economics, (Milton Friedman ed., 1953)., at 3-43.

players weigh all available information. The use by the European Commission of the disclosure remedy for unsophisticated retail investor protection rests on the premise that all investors are rational or at least on the assumption that investors who fall short of the rational actor model enough to require paternalistic intervention will necessarily process the information rationally once it is delivered to them, i.e., with a view to increase their own welfare. Investors are never misled by emotion and they never make foolish mistakes. This model permeates as well that investors value securities accurately on the basis of available information and they are part of an efficient market in which prices reflect fundamental value.[163]

As rational players, it is further assumed that, first, investors take the time to read the documents provided to them. Second, investors have the capability to accurately process the information provided to them. Third, investors make investment decisions and exercise their voting rights and monitoring rights on the basis of this information.

It is also assumed that every shareholder is conscious that its ownership of equity carries important responsibilities, particularly due to the voting rights that can influence the way in which a business is conducted. In other words, every shareholder is believed to be a committed shareholder, focussing on the performance of the company it invested in with a long-term view, who exercises its voting and monitoring rights where required.

The emphasis in securities regulation is therefore logically on making accurate information available as the investor is presumed to be willing and able to use it wisely.

[162] See, *inter alia*, the works of Ronald Coase or Richard Posner (arguing that the law can make us all better off by reducing transaction costs).

[163] On these two last concepts, see, *inter alia*, Part II:Chapter II:II in Chapter Market Efficiency.

2. The reality

However, as far as unsophisticated retail investors are concerned, it is rather uncontroversial that the rational and committed actor assumption is a flight from reality.[164]

The myth of the rational unsophisticated retail investor is best given expression in the writings of Professor Homer Kripke, as early as in the 1970s.[165]

Behavioural finance literature is full of evidence of so-called heuristics, i.e., coping strategies used in a stressful world with too much information and too many choices, and biases, i.e., systematic departures from rationality.[166]

With respect to information made available to them, the irrational attitude of unsophisticated retail investors is reflected as follows:

As shown by surveys, unsophisticated retail investors usually do not read, or at least do not read carefully, the information made available to them.[167]

This makes sense from their perspective because the costs of reading would exceed its benefits:

On the one hand, going through the few dozen if not hundred pages long documentation requires time and courage;[168] on the other hand, behavioural analysis of human decisions suggests that unsophisticated retail investors are less likely to rely on information made available to them to make investment decisions.

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[164] Note that the "trusting investor model", suggested by Professor Lynn Stout (see LYNN A. STOUT, The Investor Confidence Game (2002).), is also open to question as a trusting investor, once deceived, should not return to stock markets; yet they do.

[165] See HOMER KRIPKE, *The Myth of the Informed Layman*, Bus. Law. 631, (1973).; HOMER KRIPKE, *New Approaches to Disclosure in Registered Security Offerings - A Panel Discussion*, 28 Bus. Law. 505, (1973).; HOMER KRIPKE, *A Search for a Meaningful Securities Disclosure Policy*, 31 Bus. Law. 293, (1975).

[166] See Part I:V in General Introduction. But see however Part II:Chapter II:III.B.2 in Chapter Market Efficiency (explaining the limits to behavioural finance).

[167] See IFF Research Limited, Investment Disclosure Research – Research Report prepared for the FSA, March 2006; French AMF, Pour une meilleure régulation, November 2006; TNF Sofres Survey: Investigation of investment information and management processes and analysis of disclosure documents for retail investors; BRUCE A. MANN, *Prospectuses Unreadable or Just Unread? - A Proposal to Reexamine Policies Against Permitting Projections*, 40 Geo. Wash. L. Rev. 222, (1971).

[168] As way of example, the prospectus related to the secondary public offering of ABInbev in November 2008 contained 734 pages. The average length of prospectuses for international offerings is considered to be 300 pages.

The summary prospectus[169] could be seen as an implied recognition by the European Commission that unsophisticated retail investors do not read full-fledged prospectuses.[170]

Besides, in the vast majority of cases, unsophisticated retail investors turn to a professional advisor before making an investment decision or invest in some sort of collective investment scheme, drastically reducing the necessity to read information made available.[171]

In addition, even if they do read the information, it is very unlikely that unsophisticated retail investors properly understand the data made available to them.[172]

This is due to their limited financial literacy, i.e., their "technical" ability to be aware of financial risks and opportunities and to make informed decisions.[173] In that respect, MiFID can be seen as reflecting the weaknesses in investor understanding by focussing on the investor-financial adviser relationship.[174]

Concern about whether disclosures are understandable, and consequently protective, is nothing new. William O. Douglas, who later became chairman of the US SEC and a US Supreme Court Justice, was among the first to raise this concern as early as in 1934.[175] Professor Louis Loss echoed these concerns.[176] Even the US SEC

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[169] See article 5.2 of the Prospectus Directive.

[170] To support this statement, see European Commission, Background Document, Review of Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, at 11; see also recital (21) of the Prospectus Directive (and the limitation to 2,500 words).

[171] See Part III:Chapter I:II.A.2 in Chapter Issuer-Disclosure Addressees and Consequences.

[172] For a review of recent surveys, see Communication from the Commission – Financial Education, COM(2007) 808, available on the European Commission web-site.

[173] See note 168 above and accompanying text (referring to the research report to the UK FSA). See also C. EDWARD FLETCHER, III, *Sophisticated Investors Under the Federal Securities Laws*, Duke L.J. 1081, (1988). (exploring the issue of investor sophistication in securities regulation generally); ANNAMARIA LUSARDI, et al., *Financial literacy and retirement preparedness: evidence and implications for financial education* 42 Business Economics 35, (2007).

[174] See however that MiFID also relies to some extent on disclosure. See Part III:Chapter I:III.C.2 in Chapter Issuer-Disclosure Addressees and Consequences.

[175] See WILLIAM O. DOUGLAS, *Protecting the Investor*, 23 Yale Rev. (N.S.) 521, (1934). (being sceptical that disclosure would adequately protect investors, and instead advocating more substantive regulation).

[176] See the first edition of 1983 of LOUIS LOSS, et al., Fundamentals of Securities Regulation (fifth edition) (2009).

recognised it.[177] However, even with the plain English requirement in US securities regulation[178] or the requirement to present information "in an easily analysable and comprehensible form" in the Prospectus Directive,[179] offering documents are still long and complex, full of jargon and opaque to unsophisticated retail investors. It is still difficult for unsophisticated retail investors to understand the products or competitive position of an issuer in its sector. Even more so that the operations of enterprises have hidden complexity for any reader without knowledge of the industry. The difficulties unsophisticated retail investors face in understanding the financial statements of issuers become crucial since the heart of modern disclosure is accounting.

Moreover, in the exceptional circumstances that they do understand information disclosed to them, unsophisticated retail investors rarely rely on this information to make their decision.

As best explained by behavioural works, human beings all have a bounded rationality and limited cognitive capabilities. The case is arguably worse for unsophisticated retail investors who are even more likely to have limited capability to manage information submitted to them.[180]

More precisely, bounded rationality affects how people make decisions and their mental strategies to manage the processing of large amounts of information under conditions of ambiguity and uncertainty.[181] Behavioural works have shown that disclosure is likely to be ineffective because it may be easily misinterpreted or because

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[177] See SEC, Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts: The Wheat Report 62-63 (1969) (concluding that prospectuses are often too long or complex and that investors cannot easily understand them).

[178] See Rule 421 of the US Securities Act. See also Rules 461 and 481of the same act and A Plain English Handbook – How to create clear SEC disclosure documents?, August 1998, available on the US SEC web-site.

[179] See article 5.1 and recital (20) of the Prospectus Directive.

[180] See for a discussion of the argument that more sophisticated actors are also irrational, Part III:Chapter I:II.C.3 in Chapter Issuer-Disclosure Addressees and Consequences.

[181] See HERBERT A. SIMON, *A Behavioral Model of Rational Choice*, 69 Q.J. Econ. 99, (1955).; HERBERT A. SIMON, Models of Bounded Rationality: Economic Analysis and Public Policy (1982).; STEPHEN M. BAINBRIDGE, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 19, (2002).; RUSSELL B. KOROBKIN, et al., *Law and Behavioural Science: Removing the Rationality Assumption from Law and Economics*, 88 Calif. L. Rev. 1051, (2000).; RICHARD NISBETT, et al., Human Inference: Strategies and Shortcomings of Social Judgment (1980).; ZIVI KUNDA, *The Case for Motivated Reasoning*, 108 Psychol. Bull. 480, (1990).

the little experience of investors may lead them to rely on the fallacy of available information.

The list of biases that affect unsophisticated retail investors has grown with time, and includes "*overconfidence*, the tendency of individuals to overestimate their skills; the *endowment effect*, the tendency of individuals to insist on a higher price to sell something they already own than to buy the same item if they do not already own it; *loss aversion*, the tendency for people to be risk averse for profit opportunities, but willing to gamble to avoid a loss; *anchoring*, the tendency for people to make decisions based on an initial estimate that is later adjusted, but not sufficiently to eliminate the influence of the initial estimate; *framing*, the tendency of people to make different choices based on how the decision is framed such as whether it is framed in terms of the likelihood of a good outcome or in terms of the reciprocal likelihood of a bad outcome; and *hindsight*, the tendency of people to read the present into assessments of the past".[182]

Concerning cognitive capabilities, these are scarce resources that have to be allocated. Because of limited cognitive capabilities, people cannot handle all the information made available to them and cannot evaluate all their choices perfectly. As a result, people decide how much time and effort to spend on a task and rationally exclude certain information and options, because to consider everything would make the decision-making process unmanageable and overwhelming or would simply take too much time.

It should also be noted that unsophisticated retail investors do not have the right incentives to exercise the engagement contemplated by a legally mandated increase of information requirements. As they are aware that their vote is unlikely to be decisive, they often refrain from undergoing the expenses associated with exercising their vote in an informed manner. Similarly, outside a case of outright theft or self-dealing, they do not want to engage in an expensive legal battle given the uncertain benefits under current national law liability regimes which do not necessarily favour shareholders'

[182] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003)., at 15.

suits.[183] This "rational apathy"[184] makes economic sense given the free rider problem associated with the public good nature of information.[185]

3. Consequences

a. The alleged "positive transformative effect" of the EU issuer-disclosure regime and the "law matters" doctrine

The outlook of unsophisticated retail investors' behaviour given above casts doubts on the power of the EU issuer-disclosure regime to change the decision-making process of unsophisticated retail investors and to contribute to increased unsophisticated retail investor participation in European equity markets.

However, the European Commission seems to have a *retail investor agenda*. Broadly stated, this retail investor agenda concerns access to the retail market to stimulate growth and job creation.[186] There is arguably a European intention to initiate a "retail policy shift",[187] including the creation of a "retail equity culture".[188] In particular, the European Commission believes in a "positive transformative effect" of

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[183] See for a discussion relating to the state of play of shareholders' rights in connection with law suits, Part II:Chapter III:II.E.3.d.iii in Chapter Corporate Governance.

[184] See ROBERT C. CLARK, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776, (1979)., at 779; FRANK H. EASTERBROOK, et al., The Economic Structure of Corporate Law (Harvard University Press. 1991)., at 66-67.

[185] Information is said to be a public good as the benefits from enduring the expenses to dig out a relevant piece of information cannot be captured by the shareholder who bears the costs while at the same time every shareholder can free ride on the expenses by the one shareholder who made the effort. See BERNARD S. BLACK, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, (1990). See the regulatory consequence I draw from the rational apathy of unsophisticated (small) retail investors in Chapter Issuer-Disclosure Addressees and Consequences.

[186] See EUROPEAN COMMISSION, Communication on Implementing the Framework for Financial Markets: Action Plan (11 May 1999)., at 9 – 26; Lisbon Council Conclusions, 23-24 March 2000, §21; Second FSAP Report, 31 May 2000, COM(2000) 336, at 3; Communication from the Commission to the European Parliament and the Council – Upgrading the Investment Services Directive (93/22/EEC), 15 November 2000 (COM(2000) 729), at 5-6; Asset Management Expert Group Report on the FSAP (May 2004) at 24; Internal Market Commissioner Bolkestein, Reviving European Growth, speech to the European Parliament, 8 January 2004.

[187] See NIAMH MOLONEY, *Building a Retail Investment Culture through Law: The 2004 Markets in Financial Instruments Directive*, 6 European Business Organisation Law Review 341, (2005)., at 353.

[188] See Director General Schaub of the Internal Market Directorate General, Economic and Regulatory Background to the Commission Proposal for Revision of the ISD, speech to the Danish EU Presidency Conference on European Regulation of Investment Services (15 October 2002), at 3; COMMITTEE OF WISE MEN, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (15 February 2001)., *inter alia* at 80. See also EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 40.

the EU issuer-disclosure regime on the development of retail investor participation in European equity markets.

The European Commission's confidence in the transformative effects of the EU issuer-disclosure regime to promote retail investor participation in financial markets, including equity markets, reflects the assumption of much of the law and finance literature that "law matters" to financial markets' development. Broadly stated, this view, which especially developed in the 1990s, posits that a higher degree of investor protection through law, and particularly the laws which protect minority shareholders, encourages stock markets' development.[189] As strong financial markets are linked with economic development,[190] there is a powerful normative reason to get right the assessment of what contributes to the protection of investors, i.e., which particular laws, if one follows the main argument of the law and finance school. The law and finance academics identified issuer-disclosure as important investor protection tool to propel financial markets and hence economic growth.[191]

b. A discussion in the European context

The fact that weak securities markets and a weak legal system for the protection of (retail) investors go together is not disputed. The core idea of the law and finance school that there must be shareholders protection for corporate finance and economic development is not challenged. To this extent, the law and finance school is consistent with intuitive expectations and with long-established understandings of the relationship

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[189] The law and finance school was named after the seminal work of 1998 of Professors Lopez de Silanes, La Porta, Shleifer and Vishny, see RAFAEL LA PORTA, et al., *Law and Finance*, 106 Journal of Political Economy 1113, (1998). This work was revised in a subsequent paper, SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 Journal of Financial Economics 430, (2008). See other articles of the same authors and others in the same vein including, *inter alia*, THORSTEN BECK, et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. Comp. Econ. 653, (2003).; EDWARD L. GLAESER, et al., *Legal Origins*, 117 Q.J. Econ. 1193, (2002).; RAFAEL LA PORTA, et al., *Legal Determinants of External Finance* 52 The Journal of Finance 1131, (1997).; RAFAEL LA PORTA, et al., *Law and Finance*, 106 Journal of Political Economy 1113, (1998). ; SIMON JOHNSON, et al., *Tunnelling*, 90 Am. Econ. Rev. 22, (2000).; RAFAEL LA PORTA, et al., *Corporate Ownership Around the World*, 54 The Journal of Finance 471, (1999).; ANDREI SHLEIFER, et al., *The New Comparative Economics*, 31 Journal of Comparative Economics 595, (2003).; THORSTEN BECK, et al., *Legal Institutions and Financial Development*, *in* Handbook of New Institutional Economics, (Springer ed., 2005).

[190] See Part I:I above in General Introduction.

[191] See RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 Journal of Finance 1, (2006).

between law and the market-place.[192] Beyond this however things are more controversial.

The "law matters" doctrine has been heavily criticised on various grounds.[193] I only consider the criticisms that are most relevant in the context of the dissertation:

At a general level, the link between law and financial development is unclear. Does law drive financial development or does it follow after it to formalise the norms that market participants have already come to expect as a matter of established practice? In other words, does good investor protection laws produce strong securities markets or do strong securities markets give rise to the presence of interest groups that are in a position to press the regulator to enact laws to protect their interests?[194] The link between investor protection rules, through issuer-disclosure, and financial development has not been sufficiently proved by the law and finance doctrine. The direction of

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[192] See the works of Ronald H. Coase; see also the works of Karl Popper and Friedrich von Hayek; see also the "new institutional economics" which posit that institutions, understood as rules, practices and routines of varying degrees of formality and embeddedness, matter to economic performance (*inter alia*, DOUGLASS C. NORTH, Institutions, Institutional Change, and Economic Performance (Cambridge University Press. 1990).).

[193] The empirical basis, the use of econometrics and the coding method used by the law and finance school are heavily criticised. See generally, the contributions of the Centre Business Research at the University of Cambridge (interdisciplinary project on law, finance and development), including the essays of Professors Armour, Siems, Singh and Deakin. See also, for a critic of the datasets used, HOLGER SPAMANN, 'Law and Finance' Revisited (2008).; SOFIE COOLS, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 Delaware Journal of Corporate Law 697, (2005).; UDO C. BRAENDLE, *Shareholder Protection in the USA and Germany - On the Fallacy of LLSV*, German Law Journal 257, (2006).; MICHAEL GRAFF, Legal Origin and Financial Development: New Evidence for Old Claims? The Creditor Rights Index Revisited (2008).; MICHAEL GRAFF, *Law and Finance: Common-law and Civil-law Countries Compared - An Empirical Critique*, 75 Economica 60, (2008).; MICHAEL GRAFF, *Myths and Truths: The "Law and Finance Theory" Revisited*, 57 Review of Economics, (2006). For econometric anomalies, see KENNETH DAM, The Law-Growth Nexus: the Rule of Law and Economic Development (Brookings Institution. 2006).; UDO C. BRAENDLE, *Shareholder Protection in the USA and Germany - On the Fallacy of LLSV*, German Law Journal 257, (2006). For a critic of the coding method, see JOHN ARMOUR, et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 Journal of Empirical Legal Studies 343, (2008).; HOLGER SPAMANN, 'Law and Finance' Revisited (2008). For other critics, RAGHURAM G. RAJAN, et al., *The Great Reversals: The Politics of Financial Development in the 20th Century*, 1 Journal of Financial Economics 5, (2003).; MARCO PAGANO, et al., *The Political Economy of Corporate Governance*, 95 American Economic Review 1005, (2005).; and the reference under Part II:Chapter III:II.B.2 in Chapter Corporate Governance.

[194] Comp. ANDY J.Y. YEH, et al., *Path Dependence or Convergence: The Evolution of Corporate Ownership Around the World*, 3 Review of Law and Economics 517, (2007). (observing that a causal link traverses from legal protection to corporate ownership concentration (but not vice-versa)) with JOHN C. COFFEE, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, Yale Law Journal 1, (2001). (arguing that economic development causes legal changes and not the reverse).

causality, i.e., whether it runs from laws seeking shareholder protection to economic development or the reverse, has not yet been clearly understood.[195]

Specifically in the European context, if one considers that there has been a growth of European retail market activity since the FSAP,[196] one cannot safely state that it is the EU issuer-disclosure regime that has stimulated the development of European securities markets for retail investors by requiring Member States to upgrade their disclosure requirements.[197] The European Commission itself realised that law has limited impact on the creation of a pan-European retail investors market.[198] Little is known as to what drives retail investor activity. It is not certain at all that increased securities' supply and choice consequent to European financial integration will stimulate pan-European retail activity and reduce the home country bias,[199] although there is some evidence of a European bias replacing a national bias.[200] But more importantly, limited cognitive capabilities and bounded rationality, cultural and local factors like language, varying levels of economic development and disposable income, are likely to continue to impede the development of pan-European retail activity,

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[195] *Accord* PRABIRJIT SARKAR, et al., Law, Finance and Development Further Analyses of Longitudinal Data, Cambridge Journal of Economics, Forthcoming, (2009).

[196] See for evidence contradicting a growth in retail investor participation in European financial markets, BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007 ("[Q]uoted stocks went from accounting for 12.6% of the long term investment of European households at year-end 1999 to 8.8% at the end of 2005."); FEDERATION OF EUROPEAN SECURITIES EXCHANGES, Share Ownership Structure in Europe (2007). (the share of household in share ownership in 1999 was 16.3%, as compared to a 14.2% in 2005); Fin-Use Forum, Financial Services, Consumers and Small Businesses. A User Perspective (October 2004), at 4.

[197] *Accord* NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 41 and at 88; EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004).

[198] See the speech of then Internal Market Commissioner Bolkestein, Learning the Lessons of the Financial Services Action Plan, speech to Edinburgh Finance and Investment Seminar, 29 January 2004 (admitting that the extent to which regulation drives integration is difficult to judge given the impact of the euro, technology and cyclical economic factors); 10th FSAP Report, at 14 (noting that it is difficult to assess whether legislation is improving cross-border opportunities for investors and investment firms, expressing a loss of faith in the ability of law to deliver retail market activity); CENTRE FOR STRATEGY & EVALUATION SERVICES LLP, Framework Contract for Projects relating to Evaluation and Impact Assessment Activities of Directorate General for Internal Market and Services - Study on the Impact of the Prospectus Regime on EU Financial Markets - Final Report (June 2008)., at 52 ("[…] from the perspective of retail investors, the Prospectus Directive has had a fairly limited impact. While the regulations have harmonised the information available to investors to some extent, they have not provided greater legal protection or facilitated access to a wider pool of capital at the retail level. To the extent that investor protection is one of the Directive's most important objectives, these results should be set against any cost increases incurred by issuers under the new regime.").

[199] On the concept of "home bias" and related statistics, see Part III:Chapter I:III.B.3.b.ii and note 870 and accompanying text.

[200] See EC Financial Integration Report 2007, at 9.

without issuer-disclosure regulation, or any other European regulation, being able to do anything about it. This concern is particularly true with respect to direct investments. The picture changes for collective investments.[201] This leads to posit that one of the most serious failures of the FSAP is the construction of a disclosure regime not informed by studies on investor behaviour.[202] This is important as investor protection regulation is costly and could be used as cover for political and national interests.[203]

If it was proved that there had been a stronger European retail equity market lately and that issuer-disclosure had something to do with it, in any case, it is most likely that issuer-disclosure is only one of various factors. In other words, it is more likely that it would be an interplay of different factors that drove European financial markets' development, and not exclusively the FSAP.[204] More specifically, the growth of European securities markets could be linked to political and economic decisions not directly concerned with investor protection, such as the introduction of the euro and an increased influence of international institutional investors as well as advances in technology, and to social factors, such as the growth of European ageing population, that lay outside the direct control of policy-makers.[205] Some authors even draw attention to the impact of comparative law, the sociology of law, legal history,[206] the history of failed and successful legal transplants,[207] a country's predominant religion,[208] cultural

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[201] See Part III:Chapter I:III.D in Chapter Issuer-Disclosure Addressees and Consequences.

[202] See however the groundbreaking improvement of the European Commission in that respect in connection with Key Investor Information under UCITS IV where the European Commission tested its proposal on retail investors. See Part III:Chapter I:III.D.2 in Chapter Issuer-Disclosure Addressees and Consequences.

[203] *Accord* EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 58 and at 126; NIAMH MOLONEY, *Building a Retail Investment Culture through Law: The 2004 Markets in Financial Instruments Directive*, 6 European Business Organisation Law Review 341, (2005)., at 410. See in the US context, STEPHEN J. CHOI, et al., *Behavioral Economics and the SEC*, 56 Stan L. Rev. 1, (2003)., at 36; LARRY E. RIBSTEIN, *Bubble Laws*, 40 Houston L.R., (2003)., at 79; JONATHAN R. MACEY, *Corporate Law and Corporate Governance: a Contractual Perspective*, 18 J. of Corp.L., (1998)., at 185.

[204] See European Commission, Financial Integration Monitor 2004 (SEC 52004) 559) 3; European Central Bank, Report on Financial Integration (2007), at 31.

[205] *Accord*, EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 24, 36 et seq.

[206] See MARK J. ROE, Strong Managers, Weak Owners: the Political Roots of American Corporate Finance (Princeton University Press. 1994).

[207] See DARON ACEMOGLU, et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 Amer. Econ. Rev. 1369, (2001).; DANIEL BERKOWITZ, et al., *Economic Development, Legality, and the Transplant Effect*, 476 European Economic Journal 165, (2003).

characteristics,[209] climatic conditions,[210] geography,[211] openness to trade,[212] open, decentralised, and stable political economy,[213] and enforcement,[214] in explaining economic growth. Professors Katarina Pistor and Curtis Milhaupt recently suggested a new perspective on how law supports economic development by focussing on several factors including (1) the organisation of the legal system, (2) the functions that law plays in support of market activity, and (3) the political economy for law production and enforcement.[215]

The above suggests that if investor protection laws matter for financial development, the law and finance school cannot be used to support that a disclosure regime specifically targeted at unsophisticated retail investors effectively meets its objective of unsophisticated retail investor protection.[216]

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[208] See RENE M. STULZ, et al., *Culture, Openness and Finance*, 70 Journal of Financial Economics 313, (2003).

[209] See AMIR LICHT, et al., Culture, Law, and Finance: Cultural Dimensions of Corporate Governance (2001).

[210] See DARON ACEMOGLU, et al., *Reversal of Fortunes: Geography and Institutions in the Making of the Modern World Income Distribution*, 117 Quarterly Journal of Economics 1133, (2002).

[211] See generally, JARED DIAMOND, Jared Diamond, Guns, Germs and Steel: The Fates of Human Societies (1997). (the dominant theme of this analysis is that tropical countries faced severe health problems that limited economic development and limited the effort made to direct capital to them).

[212] See RAGHURAM G. RAJAN, et al., *The Great Reversals: The Politics of Financial Development in the 20th Century*, 1 Journal of Financial Economics 5, (2003). See also STIJN CLAESSENS, et al., Financial Development, Property Rights and Growth (2002).

[213] See JOHN C. COFFEE, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, Yale Law Journal 1, (2001).; MARK J. ROE, Political Determinants of Corporate Governance - Political Context, Corporate Impact (Oxford University Press. 2003).; ENRICO C. PEROTTI, et al., *The Political Economy of Corporate Control and Labor Rents*, 114 J. Pol. Econ. 145, (2006).

[214] See UTPAL BHATTACHARYA, et al., *The World Price of Insider Trading*, 57 The Journal of Finance 75, (2002).

[215] See CURTIS J. MILHAUPT, et al., Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World (University of Chicago Press. 2008).

[216] See DOMINIC CHAI, et al., Product Market Competition, Corporate Governance and Legal Origin (2009). (for the view that it is intense international competition in world product markets that is the main constraint on the ability of managers in large companies to run the company for their own interests rather than in shareholders' interests).

V. Regulatory Implications: an Introduction

A. Promotion of Investor Confidence Through Other Means

1. The importance of investor confidence

Investor confidence seems to be paramount for investors to participate in securities markets.[217] The 2007-2008 financial crisis provides the latest (dramatic) illustrations of this importance.[218] The link between investor protection (which leads to investor trust), investor confidence and financial stability is stressed by many commentators. Some academics even refer to a "trusting investor" model that should replace the "rational expectations investor" outlined above.[219]

In that context, some authors consider that economic growth and macro-economic stability are more important for investor confidence than strong securities regulation.[220]

Other commentators consider that issuer-disclosure is the cure against the evils that would jeopardise investor trust. Issuer's credibility *vis-à-vis* investors and analysts is won in years but is lost overnight. This credibility is believed to be positively related to the level and quality of issuer-disclosure.[221] This would explain why each financial turmoil or scandal is followed by more (or better) disclosure as immediate regulatory response.[222]

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[217] See LUIGI GUISO, et al., *Trusting the Stock Market*, 63 Journal of Finance 2557, (2008). (assessing linkages between investor confidence and stock market participation and concluding that the evidence pointed to the presence of a strong link. Further finding that differences in confidence levels across individuals and countries help explain why some invest in stocks while others do not).

[218] See, for instance, the confidence barometer provided by ING in January 2009, where it stated that the level of confidence of equity retail investors reached an historical low. See also the misselling episodes at the beginning of the current financial crisis in the Netherlands and in the U.K. which have almost resulted in the failure of the offending banks. Other banks were less lucky and filed for bankruptcy.

[219] See LYNN A. STOUT, The Investor Confidence Game (2002).

[220] See JEFFREY J. LAWRENCE, The Economics of Market Confidence: (Ac)Costing Securities Market Regulations (2002).

[221] See YAEL V. HOCHBERG, et al., *A Lobbying Approach to Evaluating the Sarbanes-Oxley Act of 2002*, Journal of Accounting Research, (2009). (showing that the passage of SOx was followed by an increase in the general trust toward the US stock market).

[222] For past illustrations, see in the European Union, *inter alia*, the European company law action plan that was passed in May 2003 following concerns about corporate governance raised by corporate collapses. In the U.S., see, *inter alia*, the US Securities Act and the US Securities Exchange Act which were passed after the 1929 crash. See also the US SOx which was passed in the aftermath of the burst of the high-tech bubble. With respect to the current financial crisis, see the policy response of the European

In that debate, I ultimately think that stable results, long-term vision/short-term results, dividend stability, under-promise/over-deliver, do what you say, obey by one's own corporate governance principles, are as important as disclosure and its truthfulness to build confidence.

2. The means to promote unsophisticated retail investor trust

If I share the concern that investor trust is important for the growth of securities markets, however, given the views I have developed in this chapter, I do not believe that issuer-disclosure should be used to specifically promote unsophisticated retail investor trust. Issuer-disclosure is not effective to protect unsophisticated retail investors.

I consider that the relationship between unsophisticated retail investors and their financial intermediaries/advisers should be the central focus of the regulator with a view to protect unsophisticated retail investors.[223] In addition, some ancillary measures, like due enforcement, cost-efficient financial education, and the promotion of the involvement in the law-making process, should be drafted with that specific purpose in mind.[224] Together, these would serve as effective and cost-efficient alternatives to issuer-disclosure for the promotion of unsophisticated retail investor protection.

Moreover, I assert that unsophisticated retail investors will be protected effectively and cost-efficiently through the achievement of more efficient markets and better corporate governance on the basis of an appropriate issuer-disclosure regime. In other words, enhancing market efficiency and corporate governance, through an appropriate EU issuer-disclosure regime, will incidentally serve an investor protection function by reducing uncertainty and increasing confidence in issuer-disclosure.[225] The

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Commission with respect to credit rating agencies, directors' remunerations or alternative investment fund managers on the European Commission web-site. Comp. with the U.S. and the initiatives with respect to credit rating agencies and management remuneration.

[223] On the importance of the relationship between investors and investment firms subject to MiFID, see also Part III:Chapter I:III.C in Chapter Issuer-Disclosure Addressees and Consequences.

[224] See Part III:Chapter I:III.E in Chapter Issuer-Disclosure Addressees and Consequences.

[225] This stresses the fact that the objectives of the EU issuer-disclosure regime are not watertight. See also Part II:Chapter II:V in Chapter Market Efficiency (mentioning the link between market efficiency and agency problems).

reduction of the difference between share price and fundamental value of a stock as well as the increased alignment of controlling parties' interests to (other) shareholders' interests will improve the "fairness" of securities markets. This perception of "fairness" of securities markets influences the trust of investors in the functioning of these markets and ultimately impacts liquidity and the functioning of securities markets which in turn promote economic growth.

Consequently, investor protection should be considered as an objective of issuer-disclosure *only* to the extent it is subordinated to the other two objectives, i.e., market efficiency and corporate governance.[226]

In short, I believe that the minimum level of confidence that is necessary for a good functioning of securities markets can only be achieved as a result of a minimum set of disclosure requirements. This minimum set of disclosure requirements is the set required by market efficiency and corporate governance, as further developed in the chapters below.[227]

B. Promotion of Indirect Investments by Unsophisticated Retail Investors – The Addressees of Issuer-Disclosure

On the one hand, I fully share the European policy stimulating investments in the European Union and unlocking the pool of retail capital to channel it to the markets.[228]

Therefore, I do not suggest to prohibit unsophisticated retail investors' participation in financial markets, even in equity markets which are arguably more risky

[226] *Accord* F.G.H. KRISTEN, Misbruik voor voorwetenschap naar Europees recht, Een onderzoek naar de grondslag et de werking van het Europese verbod van misbruik van voorwetenschap, met aandacht voor de doorwerking van EG-richtlijnen in het strafrecht (2004) University of Tilburg)., at 144; KRISTIAN J. HEISER, *Harmonising Capital Market Law and Company Law. Can Capital Market Law Approaches be Harmonised with Essential Principles of Company Law?*, 11 EBLR 60, (2000)., at 68.

[227] Comp. with LUIGI GUISO, et al., *Trusting the Stock Market*, 63 Journal of Finance 2557, (2008)., at 6 ("since trust is the necessary act of faith we have to do when we are not properly informed or we do not understand what is going on, the need for trust is negatively correlated with information and education. More informed people rely less on trust (...).") and FRANK PARTNOY, *Why Markets Crash and What Law Can Do About It?* , 61 U. Pitt. L. Rev. 741, (2000). ("[t]o some extent the importance of trust is a sign that law is less likely to be relevant in financial markets than in other areas.").

[228] See the economic (*inter alia*, liquidity and price accuracy) and political (alternative to public pensions) reasons to promote retail participation in financial markets, in Part II:Chapter I:II above.

markets than, for instance, debt markets. I do not even suggest to deny *direct* access to financial markets to less sophisticated investors.

Restricting access to financial markets to more sophisticated investors by an outright prohibition of investments or a prohibition of direct investments by unsophisticated retail investors would require to draw an appropriate definition of the category of “unsophisticated retail investors”. This is presumably a very difficult exercise. A financial literacy test does not seem to be a cost-efficient solution. Indeed, it would require, *inter alia*, a continuous update to adapt to a fast-changing financial environment.

On the other hand, given the weaknesses of unsophisticated retail investors developed above,[229] these investors need protection.

In that respect, I contend that a more effective (and less costly) solution to protect unsophisticated retail investors than issuer-disclosure is to have regulation that *dissuades* them from *directly* investing in equity markets.

More precisely, I plead for issuer-disclosure not to be mainly addressed to unsophisticated retail investors. Indeed, as showed in this chapter, issuer-disclosure cannot effectively protect them. Besides, it is very unlikely that addressing issuer-disclosure to unsophisticated retail investors would be effective or, if it is, that it would be cost-efficient in promoting market efficiency and corporate governance.[230]

Instead, as further developed below, I suggest an EU issuer-disclosure regime explicitly addressed to more sophisticated actors, who are the only ones capable of improving market efficiency and corporate governance on the basis of the information disclosed to them.[231] This implies cost-efficient regulatory implications.[232]

I believe that once unsophisticated retail investors will be made aware of the suggested change of addressees with respect to issuer-disclosure and all related regulatory consequences, they will be more cautious before directly investing in

[229] See Part II:Chapter I:IV.B.2 above.
[230] See Chapter Market Efficiency and Chapter Corporate Governance.
[231] See Part III:Chapter I:II.A.1 in Chapter Issuer-Disclosure Addressees and Consequences.
[232] See Part III:Chapter I:III.B in Chapter Issuer-Disclosure Addressees and Consequences.

financial markets, i.e., investing without seeking the advice of a professional or without seeking professional intermediation.

C. Promotion of a Move Away from Consumerism in Securities Regulation

I believe it is time for the European Union to move away from consumerism in securities regulation, i.e., the assimilation of investors to consumers of financial products.[233]

"Securities regulation is not a consumer protection law".[234] Information asymmetry and contract incompleteness are inevitable on securities markets.[235] Because of the limited disclosure requirements on primary and secondary markets on the one hand and because of the limited cognitive capabilities and biases of investors on the other hand, investors will always be at a significant information disadvantage. "La démocratie de la finance de marché est inéquitable".[236] The concept of egalitarianism in financial markets, i.e., confidence of investors in the equality of access to information in the market-place, does not make sense although it is implicit in the EU issuer-disclosure regime.[237]

Some have pleaded for a specific competence in the Treaty on the Functioning of the European Union to regulate to increase investor protection.[238] I believe investor

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[233] See as illustrative example of increased consumerism in capital markets, *inter alia*, the home page of the web-site of the Belgian CBFA, where there is a corner dedicated to "financial consumers".

[234] ZOHAR GOSHEN, et al., *The Essential Role of Securities Regulation*, 55 Duke L. J. 711, (2006)., at 3.

[235] See on incomplete contracts, Part II:Chapter III:I.A in Chapter Corporate Governance. For a recent illustration of persisting information asymmetry on securities markets, see "flash orders", i.e., a sub-set of high-frequency trading that exploits regulatory loopholes to give favoured traders notice of orders a fraction of a second before they are transmitted to everyone else.

[236] PIERRE-NOËL GIRAUD, *Forcément inéquitables – Injustes, les crises financières sont aussi imprévisibles qu'inéquitables*, Le Monde 2008., at 26 ("[d]emocracy of market finance is inequitable" (free translation), meaning that even though most financial market products are available to investors, there will always be better informed investors because of information asymmetry and contract incompleteness).

[237] *Accord* NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008).

[238] See NIAMH MOLONEY, EC Securities Regulation (Oxford University Press. 2002)., at 605 (2002 edition) (referring to the TEC).

protection should not enjoy particular prominence in the Treaty n the Functioning of the European Union by way of a specific competence.

Yet, further to article 114(3) of the Treaty on the Functioning of the European Union, the European Commission must take as a base a high level of protection in its proposals relating to the establishment and the functioning of the internal market which concern consumer protection. And article 169 of the Treaty on the Functioning of the European Union gives the Union competence to promote consumer interests and ensure a high level of consumer protection via article 114 and via measures to support, supplement and to monitor the policy pursued by the Member States.

I plead for pulling securities regulation out of consumer protection principles of the Treaty on the Functioning of the European Union and to adopt a less paternalistic approach.

D. Promotion of Diversification as a More Efficient Method to Protect against Risk

1. Issuer-disclosure protects against risk

For some time, US commentators of the US Securities Act and the US Securities Exchange Act believed that the primary purpose of securities laws was to promote fairness, i.e., prices not greater than their actual value.[239] However, fairness is unrelated to issuer-disclosure as, in an efficient market, prices reflect in an unbiased way both disclosure and the absence of disclosure.

By “unbiased”, one must understand that the price equals on average the share’s fundamental value, i.e., it is as likely to be below the share’s actual value as above. The persons whose action in the market sets the stock price assess what the fundamental value of the share will be, on the basis of available information relating to the issuing company and the lack thereof.

This has been illustrated by empirical literature drawing from event studies showing unbiased reactions to announcements of issuer-disclosure. Market’s evaluation

[239] See, *inter alia*, JOHN A.C. HETHERINGTON, *Insider Trading and the Logic of the Law*, Wisc. L. Rev. 720, (1967).; HOMER KRIPKE, *Manne’s Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, (1985).; ROY A. SCHOTLAND, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 Va L. Rev. 1425, (1967).

of the significance of the event, such as a stock split for instance, for the fundamental value of the shares, while it may sometimes be too high and sometimes too low, is unbiased: the average change is near 0. Academics also assume that there is no reason to believe that the market will not also be unbiased in its reactions to an issuer's absence of comment about certain events.[240]

In other words, as the amount of issuer-disclosure does not affect the proposition that the issuer's share price will be unbiased, issuer-disclosure is not related to the "fairness" of the price of the share.

This being said and as further explained in Chapter Market Efficiency, the level and quality of issuer-disclosure affects the accuracy of share price. A share price, although unbiased, can still have a low expected accuracy. In that case, there is a significant likelihood that it will heavily deviate one way or the other from its fundamental value. With less issuer-disclosure, market participants will have greater uncertainty about its future and, as a consequence, the issuer's shares will have lower expected price accuracy.

This means that with less issuer-disclosure, there will be a greater risk associated with the issuer's shares because there will be a greater likelihood that the fundamental value of the share will deviate substantially, one way or the other, from what the investor pays for it. This increased risk means that any investor holding shares of the issuer will have a more risky portfolio than would have been the case if there had been more issuer-disclosure.

Hence, issuer-disclosure, by impacting price accuracy, minimises risk associated with investments.

2. But diversification is a more cost-efficient means to protect against risk

Yet, since issuer-disclosure only relates to revelation of firm-specific information, as opposed to information relating to all issuers in the market, the risk is unsystematic. Unsystematic risk can be diversified away, resulting in investors only losing a little

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[240] For an extensive discussion on this and a consideration of the process by which securities are priced, see MERRITT B. FOX, *Rethinking Disclosure Liability in the Modern Era* 75 Wash. U. L. Rev. 903, (1997)., at 2533-39.

money from any single fraud. Hence, some argue that it is irrational for an investor who can do so not to diversify.[241]

Consequently, I believe that it will be more cost-efficient to engage in a publicly-sponsored educational campaign promoting the merits of diversification than to mandate a costly issuer-disclosure regime that at best could only protect those who choose not to diversify. In other words, the risk-reduction function of issuer-disclosure can be achieved more efficiently, i.e., at lesser costs, by encouraging investors to diversify.[242] This alternative policy might be at least as effective as issuer-disclosure at increasing investor expected utility. Through diversification, an investor can eliminate the risk that goes with investing in a single stock without any sacrifice of expected return.[243] For further discussion, I refer to the excellent contribution of Professor Fox in that respect from which this part heavily draws.[244]

One could argue that diversification did not prove helpful in the 2007-2008 financial crisis, despite the use of sophisticated mathematical modelling of correlations between asset classes. However, diversification is a matter of judgement, not statistics and "a model will tell you only what you have already told the model. It can never replace an understanding of market psychology and the factors that make for successful business".[245] Some argue that diversification could not work well in a credit bubble "because virtually all asset categories are driven up by leverage".[246] In essence, under the 2007-2008 financial crisis, one faced a mismanaged diversification which does not put into question the virtues of diversification as such. Or one faced a market risk (or,

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[241] See RICHARD A. BOOTH, *The End of Securities Fraud Class Action?*, 29 Regulation 46, (2006)., at 49.

[242] See for studies highlighting the little diversification of investors, BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007; Alessandra Franzosi; Emanuele Grasso; Enrico Pellizzoni, "Retail Investors and Stock Market. Second Report on Shareholding in Italy*"*. *Bit Notes*, Borsa Italiana, nr. 12, November 2004.

[243] *Accord* HOWELL E. JACKSON, To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns, 28 Journal of Corporation Law 101, (2003). (pointing to the importance of diversification).

[244] See MERRITT B. FOX, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Michigan Law Review, (1997)., at 2510-12. See also BARBARA ANN BANOFF, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 135 Va. L. Rev., (1984).

[245] John Plender, Error-Laden Machine, Financial Times, 3 March 2009, at 8.

[246] Id.

more specifically, a credit risk), which cannot be diversified away (but by derivative swaps).

VI. Conclusions

Retail investors are important to capital markets and to economic stability more generally. From an economic point of view, retail investors increase liquidity as well as indirectly price accuracy, which in turn contribute to the strength of equity markets. From a political point of view, the European Union needs to find alternative sources of funding for the pensions of its ageing population and therefore needs to promote retail access to financial markets, including equity markets.

It follows that there should not be a prohibition imposed on retail investors to invest in equity markets, be they more or less sophisticated.

While equity markets will remain a risky business and while regulation cannot seek to isolate investors from sustaining losses, the least we can expect from regulation is that it creates the conditions for investors to be confident in investing in equity markets. In this context, it seems paramount to provide minimum protection for the ones who, to the benefit of economic growth and thereto related social welfare, dare to invest their savings in entrepreneurial projects of companies in search of public funding.

In this context, I argued that there are good reasons to believe that the role of issuer-disclosure as a mechanism for the protection of unsophisticated retail investors is limited. I contended that there are other more effective and cost-efficient means to protect them.

Issuer-disclosure is believed to protect investors by reducing information asymmetries between investors and issuers.

However, asymmetries will always subsist, no matter the degree of disclosure required. An issuer will always be able to hide the information it would like to keep hidden. And unsophisticated retail investors are more likely to be victims of information asymmetries than more sophisticated ones, given their limited financial literacy and their little knowledge of the financial world.

Moreover, assumptions of investor rationality leading them to rational decision-making on the basis of the information provided to them do not always match up to empirical reality. And the case is even stronger with respect to unsophisticated retail investors.

Therefore, unsophisticated retail investor protection cannot be effectively achieved through issuer-disclosure.

The inability of unsophisticated retail investors to understand and use information rationally serves to limit not only the usefulness of mandatory disclosure requirements for unsophisticated retail investors but also the justifications for the imposition of additional costs on firms and investors, not to mention opportunity costs of the regulator, and costs of supervisory agencies. In other words, the European policy-maker should bear in mind that if it enacts regulations against a background of uncertainty about how law can help the identified objective to be achieved, it could impact negatively rather than positively. Regulatory intervention with the wrong objective in mind may prove counter-productive in the sense that it would entail additional unnecessary costs not matched by corresponding benefits, to the detriment of market development.

From the issuer's perspective, extra compliance costs with more stringent requirements imposed by the unsophisticated retail investor focus are an obvious *additional burden*, which is indirectly borne by those investors in terms of reduced returns. Besides, multiplying regulatory requirements with a view to protect unsophisticated retail investors could entail the risk that regulatory action hinders *financial innovation*. In that respect, it should be reminded that, if competition between promoters and distributors of financial products is fair and takes place on a level playing field and if distribution channels are professional, then financial innovation may play a positive role for the economy.

From the investors' perspective, where disclosure is tailored to unsophisticated retail investors, it could operate "so as to feed *over-confidence*" and this "could lead to excessive trading activity and unprofitable investment of time and resources".[247] With unsophisticated retail investors in mind, there is also a risk of increased disclosure

[247] *Accord* EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 178, and especially note 156.

requirements leading to *information over-load*,[248] which could have as negative consequence, *inter alia*, that bad information could be more easily buried under the mass of information provided or concealed without those who could understand and act upon the information noticing, leading to less accurate decision strategies. It is important to note that the risk of information over-load is even more acute today as the *risk of liability for failure to disclose has increased* since corporate scandals of the early 2000's. Current international practice gives reasons to believe that issuer-disclosure is often used by issuers (and those responsible of drafting the disclosure documents) to provide them with the appropriate defence tools against potential liability.[249] Issuers often add as much information as possible to shield against any liability issue. The EU issuer-disclosure regime is thus often used against those who the European Commission thought to protect.[250]

As issuer-disclosure would only provide marginal benefits to unsophisticated retail investors, if any at all, costs of information specifically drafted to their attention would very likely exceed benefits. Consequently, unsophisticated retail investor protection is unlikely to be efficiently achieved through issuer-disclosure.

In short, I believe that the retail investor protection goal of the EU issuer-disclosure regime should only be considered as the consequence of a political choice, resulting from the over-arching aim of market integration, at the time of the drafting of the relevant directives.

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[248] On information over-load generally, see TROY A. PAREDES, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L. Quarterly 417, (2003).

[249] See the numerous disclaimers contained in disclosure. See EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 11 ("[…] the character of a prospectus might have already changed: instead of being a source of information for the investor it might have become a liability shield protecting the offeror, the issuer, the banks and other intermediaries involved in the offer, as well as the competent authority responsible for approving the prospectus."); Anna T. Pinedo and James R. Tanenbaum, Afraid of Revolution – Liability concerns have impoverished the use of free-writing prospectuses under US offering reforms, IFLR, October 2007, at 24 (observing that generally market participants have been reluctant to use free-writing prospectuses to convey information that is not "routine" or "pricing information", given their concerns about liability).

[250] To fight this tendency, ESME suggests the following: "[…] the Commission and competent authorities should adhere to and enforce the principle laid down in Article 5 that information in a prospectus should be presented in an easily analyzable and comprehensible form." "[…] those authorities should limit their scrutiny to the completeness of the prospectus, which includes the consistency of the information given and its comprehensibility […]" (see EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 11).

I have tried to argue that, even where issuer-disclosure could effectively improve unsophisticated retail investor protection, there are other ways to achieve the same result at less social costs, i.e., more efficiently.

I have stressed that, interestingly, the European Commission services seem to recognise the limited impact of disclosure for unsophisticated retail investor protection, although they do not draw (yet) any policy implications from this observation.

I have pleaded for an issuer-disclosure regime primarily aimed at improving market efficiency and corporate governance. As further detailed below, I believe that market efficiency and corporate governance can be improved effectively and cost-efficiently through issuer-disclosure.[251]

I have contended that unsophisticated retail investors will be indirectly protected by the improvement of market efficiency and corporate governance.

I develop in Part III the few complementary measures that will contribute to genuinely safeguard unsophisticated retail investors' access to equity markets.

[251] See Chapter Market Efficiency and Chapter Corporate Governance.

Chapter II: Market Efficiency

I. Introduction

The European Commission has never explained the relevance of pursuing improvement of market efficiency, nor the impact of the EU issuer-disclosure regime in that respect. However, in the recitals of both the Prospectus Directive and the Transparency Directive, the European Commission makes it clear that market efficiency is the objective of disclosure together with investor protection.[252]

The European Commission has never alluded to the ECMH, the founding theory of market efficiency,[253] or provided empirical evidence with respect to the efficiency of European markets.[254]

However, the ECMH is implicit in some provisions of the Prospectus Directive and the Transparency Directive. An arguably clear illustration of the ECMH is the possibility for issuers to incorporate information by reference.[255] Another possible

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[252] See recital (10) of the Prospectus Directive and recital (1) of the Transparency Directive. See also IOSCO, Objectives and Principles of Securities Regulation (February 2008)., at 4.2.2.

[253] The ECMH has its origins in the work of Louis Bachelier (see Louis Bachelier, Théorie de la spéculation, Gauthier Villars, 1900 reprinted as The Theory of Speculation, Princeton University Press, 2006). On the history of the ECMH, see MICHAEL C. JENSEN, et al., The Modern Theory of Corporate Finance (2d edition) (McGraw-Hill Education ed. 1984). or STEPHEN F. LEROY, *Efficient Capital Markets and Martingales*, 27 J. Econ. Literature, (1989). For early works on the ECMH, see, *inter alia*, BENOÎT MANDELBROT, *Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models*, 39 J.Bus. 242, (1966).; Paul A. Samuelson, Proof that Properly Anticipated Prices Fluctuate Randomly, 6 Indus. Mgmt. Rev. 41 (1965), reprinted in 3 The Collected Scientific Papers of Paul A. Samuelson 782-790 (R. Merton ed. 1972); EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970).

[254] See for theoretical backing of market efficiency by European instances, other than the European Commission, Presidency Conclusions, Lisbon European Council, 23-24 March 2000, at §20 ("[e]fficient and transparent financial markets foster growth and employment by better allocation of capital and reducing costs. They therefore play an essential role in fuelling new ideas, in supporting entrepreneurial culture and promoting access to the use of new technologies"); European Central Bank, Opinion of the European Central Bank of 16 November 2001 on a proposal for a directive on the prospectus to be published when securities are offered to the public or admitted to trading (CON/2001/36), OJ, 6 December 2001, C344/4), §4 (the Prospectus Directive should "ultimately […] enhance the capability of issuers to raise capital on an EU-wide basis by reducing the costs of financing and improving the efficiency of allocation of resources across the euro area"). See for a European academic, NIAMH MOLONEY, EC Securities Regulation (Oxford University Press. 2002)., at 123 (referring to "allocational efficiency" as justification advanced in favour of mandatory issuer disclosure, next to investor protection (and thereby the promotion of investor confidence) and the prevention of fraud).

[255] See article 11 of the Prospectus Directive. See for further explanation of incorporation by reference, Part III:Chapter II:II.B.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets. But see references to Jeffrey Gordon and Donald Langevoort in notes 259 and 260 in

illustration is the possibility to file a registration document, valid for 12 month and to be updated at the time of any new issue, instead of a full-fledged prospectus each time an issuer, who intends to make repeated public offerings, taps the public market.[256]

The U.S. offers a quite similar picture. In US securities regulation, the faith in the ECMH seems to be unquestioned. Despite the fact that many reforms are clearly predicated on the ECMH, it is seldom named and no evidence is cited in the US SEC releases to support the efficiency of the markets, other than a general feeling that it must be true.

The influence of the ECMH in US federal mandatory disclosure regime is arguably illustrated by, *inter alia*, the "integrated disclosure system", dating back to the 1980's,[257] shelf-registration under Rule 415 of the US Securities Exchange Act,[258] the fraud-on-the-market theory of reliance under Rule 10b-5 of the US Securities Exchange

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the US context (discussing why incorporation by reference and shelf-registration (and fraud-on-the-market cases) do not need to rely on the ECMH for their legitimacy).

[256] See article 9.4 of the Prospectus Directive. See also for further explanation of the European-flavoured shelf-registration, Part III:Chapter II:II.B.2.d in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[257] For the concept of "integrated disclosure system" and all related concepts used in this footnote, see Part III:Chapter II:II.B.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets. The US SEC has indicated that Form S-3 was created "in reliance on the efficient market theory." (Adoption of Integrated Disclosure System, Securities Act Release No. 33- 6383, 47 Fed. Reg. 11,380, 11,382 (1982)). In the proposing release, there was a more elaborate statement that it is the "Commission's belief that the market operates efficiently for [S-3] companies, i.e., that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for by the marketplace." (Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6331, 46 Fed. Reg. 41,902, 41,904 (1981)). But see DONALD C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REv. 876, (1992)., at 876 (discussing why integrated disclosure does not need to rely on the ECMH for its legitimacy); see also JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at 814 (arguing that if the US SEC regulation providing for incorporation by reference really relied on the ECMH, then there would be no need to incorporate by reference. Finding other purposes for incorporation by reference like liability issues (underwriters' liability because periodic reports would be included in offering prospectus subject to underwriters' review)).

[258] See SEC Securities Act Release No. 6235, 45 Fed. Reg. 63, 693, 63, 698 (1980) reprinted in Fed Sec. L. Rep. (CCH), Spec. Rep. No. 875, second extra ed., at 28 (Sept. 10, 1980). For an explanation of the concept of "shelf-registration", see Part III:Chapter II:II.B.2.d in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets. But see JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985). (for an argument that shelf-registration is not premised on the ECMH); STEPHEN F. LEROY, *Efficient Capital Markets and Martingales*, 27 J. Econ. Literature, (1989)., at 1593, 1613 (pointing out the "tautologous nature of Fama's characterization of capital market efficiency"); DONALD C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REv. 876, (1992)., at 881 et seq. (discussing why Rule 415 does not need to rely on the ECMH for its legitimacy).

Act,[259] and the 2005 US Securities Offerings Reforms.[260] Judge Frank Easterbrook even wrote in 1989, without qualification, in an opinion that "[t]he Securities and Exchange Commission believes that markets *correctly* value the securities of well-followed firms, so that new sales may rely on information that has been digested and expressed in the security's price."[261]

Many US legal academics also endorse the ECMH, although most commentators integrate the critiques of the perfectly efficient market theory, the role of "noise" in stock market behaviour and the advances of "behavioural finance".[262]

It can thus safely be said that the ECMH, as theory behind the idea of efficiency of securities markets, has strongly influenced not only legal theory but also prevailing doctrines and regulations of issuer-disclosure across the Atlantic.[263]

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[259] See *Basic Inc. v. Levinson*, 485 U.S. 224, 245-47 (1988) (stating that the plaintiff need not have read the prospectus to have "relied" on, and been injured by, the misstatement or omission contained therein). For discussion of the so-called "fraud-on-the-market" cases, see BERNARD BLACK, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L.Rev. 435, (1984).; DANIEL R. FISCHEL, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.Law., (1982). But see DONALD C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REv. 876, (1992)., at 889 et seq. (discussing why market efficiency is not necessary nor sufficient to the ultimate decision in faud-on-the-market cases).

[260] See Securities Act Release No. 33-8591, *70 Fed. Reg. at 44, 725*. The 2005 US Securities Offerings Reforms introduced even easier access to the capital markets via shelf-registration for a new category of large issuers ("well-known seasoned issuers"), allowing automatic effectiveness of shelf-registrations filed by such issuers without any US SEC review. Updates to a registration statement are necessary every three years only and issuers pay as needed for take-downs. The reforms also eliminated most of the restrictions on communications during the three phases of an offering of securities under the US Securities Act: (i) the pre-filing period, (ii) the waiting period, and (iii) the post-effective period.

[261] Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 510 (7th Cir. 1989) (emphasis added).

[262] See Part II:Chapter II:III below for further details relating to the critiques of the initial version of the definition of market efficiency. And see, *inter alia*, RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984).; WILLIAM K.S. WANG, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, (1986).; DONALD C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REv. 876, (1992).; JOHN C. COFFEE, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review, (1984).; STEVEN A. ROSS, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signalling Theory*, *in* Issues in Financial Regulation, (Franklin Edwards ed., 1979).; ROBERTA ROMANO, *Empowering Investors: A Market Approach to Securities Regulation*, 107 The Yale Law Journal 2359, (1998)., at note 17; Merritt B. Fox in general; JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at 802.

[263] See however PAUL MAHONEY, *Mandatory Disclosure as a Solution to Agency Problems*, 62 The University of Chicago Law Review 1047, (1995). (for a view that the goal of disclosure should be limited to helping investors uncover breaches of contractual or fiduciary obligations, and not focused on anything else like market efficiency for instance).

I argue in this chapter that issuer-disclosure effectively promotes market efficiency.

The case is not necessarily easy as reality of securities markets seems to give arguments to market efficiency opponents.

To back up my opinion, I first need to define what exactly is meant by "market efficiency". I take a critical view of the initial version of market efficiency (Section II) and suggest a more realistic approach which is consistent with market phenomena (Section III).

I then highlight the reasons why it is important to promote market efficiency in equity markets (Section IV). I examine the positive impact of the two components of market efficiency on the economy, i.e., the positive role of price accuracy and liquidity on allocative efficiency and on cost of capital. This is very important with a view to have orderly equity markets, i.e., markets that function well, for the benefit of investors and the economy as a whole.

At the same time, I analyse the function of issuer-disclosure in promoting price accuracy and liquidity.

Section V concludes.

II. The Conventional View of Market Efficiency: the Perfect Market Efficiency

As from the 1950's, financial economists focussed on developing theories that might explain the existing large body of empirical results. They believed that science involves empirically testing hypotheses and looked for an animating financial theory to formulate these hypotheses.

In the period from the late 1950s to the early 1970s, the ECMH was developed next to the theory relating to how capital assets are priced, i.e., the Capital Asset Pricing Model (hereafter the CAPM)[264] and whether a firm's choice to issue debt or equity affects firm value (the Miller-Modigliani Irrelevance Propositions).[265]

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[264] The CAPM holds that rational investors value stocks according to their expected return and non-diversifiable risk. For founding works, see WILLIAM F. SHARPE, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. Fin. 425, (1964).; JOHN LINTNER, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets,* 47 Rev. Econ.

Among the various definitions of an efficient stock market,[266] the most conventional one was provided by Professor Eugene Fama: prices in an efficient stock market always immediately "fully reflect" "all available information" that is relevant to value the shares, so that arbitrage opportunities are minimal (i.e., any imperfection is trivial).[267]

The speed at which information is integrated into price and the degree of accuracy with which market prices reflect the fundamental value of the assets are crucial elements in this definition:[268]

In an efficient market as the one conceived by Professor Fama, prices immediately reflect available information. The trader who becomes aware of a piece of available information cannot make money by trading on it because "prices act as if everyone knows the information".[269] In other words, the share's price is the same as the price that would exist if everyone had immediately complete information at no costs. A number of studies in the 1960s confirmed Professor Fama's view by finding that mutual

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& Stat. 13, (1965). For a discussion of the CAPM, see RAZEEN SAPPIDEEN, *Securities Market Efficiency Reconsidered*, 9 University of Tasmania Law Review 132, (1988)., at 136 et seq. and 157 et seq. and JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at 776 et seq.

[265] For an explanation, see HERBERT J. HOVENKAMP, *Neoclassicism and the Separation of Ownership and Control*, 4 Virginia Law & Business Review (2009).

[266] Comp. WILLIAM H. BEAVER, *Market Efficiency*, 56 Acct.Rev., (1981).; MARK LATHAM, *Informational Efficiency and Information Subsets*, 41 J.Fin., (1986)., 39, 41, 50-51 (1986); with GEORGE FOSTER, *Capital Market Efficiency: Definitions, Testing Issues and Anomalies in Contemporary Accounting Thought*, *in* Essays in Honour of R J Chambers, (M. J. R. Gaffikin ed., 1984)., at 175-76.

[267] See Eugene F. Fama's doctoral dissertation, often credited with assembling the data and proofs that created the ECMH, that was published as EUGENE F. FAMA, *The Behavior of Stock-Market Prices*, 38 J.Bus., (1965). See also EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970)., at 383 and at 388 and EUGENE FAMA, *Efficient Capital Markets II*, 46 J. Fin. 1575, (1991). See also, RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984).

[268] It should be noted that the ambiguities inherent in the very first version of the ECMH have led initial commentators of the theory, including Professors Fama and Beaver, to propose restatements of the initial version of market efficiency. These restatements are incorporated in this section.

[269] WILLIAM H. BEAVER, *Market Efficiency*, 56 Acct.Rev., (1981)., at 35. Comp. Beaver's article and also MARK LATHAM, *Informational Efficiency and Information Subsets*, 41 J.Fin., (1986).; FRIEDRICH HAYEK, *The Use of Knowledge in Society*, 35 American Economic Review, (1945)., at 519-30 with JOHN MAYNARD KEYNES, The General Theory of Employment Interest and Money (Macmillan Cambridge University Press. 1936). (describing the stock market as a "beauty contest" in which investors seek to identify not the best investments (i.e., investment where price reflects fundamental value) but the investments that appear best to others (i.e., investment where price is the buyer's prediction of what valuation others would place on the firm's shares). Seeing stock prices as disconnected from economic reality).

funds, which are run by professional portfolio managers, underperformed market indexes.[270] These studies implied that traders cannot profit from trading on publicly available information in a way that allows them to consistently "beat the market". On the basis of these studies, it was affirmed that no one can identify shares which are under- or over-valued, except by chance or unless investors have unique access to relevant private information. It was believed that prices assimilate information faster than investors can adjust on the basis of the information. In other words, the ordinary investor is wasting his time trying to pick "winners" on the basis of information he collects from public sources. This view generated a certain scepticism about the economic value of professional advice.

In an efficient market as the one conceived by Professor Fama, prices accurately reflect available information. "[E]very security's price equals its investment value at all times".[271] There is no discrepancy between a market price and the intrinsic value of a stock.

In other words, in a perfectly efficient market as the one conceived by Professor Fama, prices are efficient in two ways: first, they immediately integrate new information provided to the market and second, they best predict the future value of the stock.

Professor Fama went on to distinguish three different versions of the ECMH depending on the particular set of "available information" to which it relates.[272] The "weak" form of the theory claims only that the history of securities prices, i.e., past

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[270] For a review, see RICHARD A. IPPOLITO, *On Studies of Mutual Fund Performance, 1962-1991*, 49 F. Anal. J., (1993). For a criticism of these studies, see LYNN A. STOUT, *The Mechanisms of Market Inefficiency - An Introduction to the New Finance*, 28 Journal of Corporation Law 635, (2003)., at 658.

[271] GORDON J. ALEXANDER, et al., Fundamentals of Investments (Prentice-Hall. 1989)., at 67. Comp. with JOHN MAYNARD KEYNES, The General Theory of Employment Interest and Money (Macmillan Cambridge University Press. 1936). and with "heterodox" academics like André Orléan (see, *inter alia*, Le pouvoir de la finance, Odile Jacob, Paris, 1999; ANDRÉ ORLÉAN, *Au-delà de la transparence de l'information, contrôler la liquidité*, Esprit 38, (2008). (who believes that markets do not produce just estimates of fundamental value but merely prices; who believes that markets' primary function is to create liquidity for investments; who does not believe, contrary to neo-classical finance academics, that financial markets are trustworthy; who believes that transparency will never put an end to financial bubbles, inherent to financial markets; who urges for segregation of actors and structures to avoid contagion of the excesses of a policy aimed at increasing liquidity)).

[272] See EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970). (noting at note 1 that the distinction between weak and strong form tests was first suggested by Harry Roberts).

prices, provides no useful information to the investor. The "semi-strong" theory makes the same assessment about publicly released information. The "strong" form of the theory hypothesises that even non-public information is reflected in price. Professor Fama concluded that "with but a few exceptions, the efficient markets models stand up well".[273]

During the 1970s and early 1980s, the perfectly efficient market hypothesis seemed to enjoy solid empirical support.[274] In 1978, economist Michael Jensen stated that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Markets Hypothesis".[275] Commenting on Professor Fama's 1970 article, Nobel Price William Sharpe stated: "simply put, the thesis is this: that in a well-functioning securities market, the prices […] of securities will reflect predictions based on all relevant and available information. This seems to be trivially self-evident to most professional economists – so much so, that testing seems almost silly".[276] Professor William Beaver made much the same point ten years later: "Why would one ever expect prices *not* to 'fully reflect' publicly available information? Won't market efficiency hold trivially?".[277]

This being said, the claim that, in an efficient market, prices always "fully reflect" "all available information" that is relevant to value the shares, is based on the following assumptions:

- all investors are equally rational (i.e., they always behave to maximise their own interests according to the widely accepted Bayesian principle which holds that new evidence results in continual revisions of assessments, depending on a

[273] EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970).388 (adding that "there is only limited evidence against the hypothesis in the strong form tests").

[274] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984). (offering a detailed and thorough summary of the literature on market efficiency and describing the ECMH as "*the* context in which serious discussion of the regulation of financial markets takes place" (emphasis in original)).

[275] MICHAEL C. JENSEN, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. Fin. Econ. 95, (1978)., at 95.

[276] WILLIAM SHARPE, *Discussion*, 25 J.Fin. 418, (1970)., at 418.

[277] WILLIAM H. BEAVER, *Market Efficiency*, 56 Acct.Rev., (1981)., at 24 (emphasis in the original).

fairly rigorous appraisal of the probative value of that evidence) and, to the extent they make mistakes, these are random and cancel each other out;

- all investors have homogeneous expectations, i.e., they "agree on the implications of current information for the current price and distributions of future prices of each security";[278]
- all investors have relatively immediate access to information which is available to all of them at no costs of acquiring, verifying and processing;
- there are no opportunities for arbitrage activities and, in the case there is nevertheless a difference between the fundamental value of the stock and its price, the arbitrage opportunities will be exploited until any significant disparity between fundamental value and market price is eliminated.[279]

III. The View of Market Efficiency Adopted by the Dissertation: the Relative Market Efficiency

A. Preliminary Remark

However, controversy about the initial version of market efficiency began in the late 1970's and continue today. It is supported by economic research. Whether markets are perfectly efficient in the sense claimed by the initial version of market efficiency started to be disputed by "post-modern finance" using different avenues of investigation, like the "noise trading theory",[280] the "heterogeneous expectations approach"[281] and "behavioural finance".[282] The accuracy of the tests that were thought to validate the efficiency model was put into question, and especially the underlying theory about how the market prices assets, i.e., the CAPM and its variants.

It is interesting to note that Professor Fama himself admitted in his work of 1970 that there is "already enough evidence to determine that the model [of the ECMH] is not

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[278] See EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 The Journal of Finance 383, (1970)., at 387.

[279] See RICHARD A. BREALY, et al., Principles of Corporate Finance (8th ed) (McGraw Hill Higher Education ed. 2006).; BURTON G. MALKIEL, A Random Walk Dow Wall Street (7th ed.) (1999)., at 242-43.

[280] See Part II:Chapter II:III.B.1 below.

[281] See Part II:Chapter II:III.C below.

[282] See Part I:V in General Introduction and Part II:Chapter II:III.B below.

strictly valid", conceding that the assumptions on which the ECMH is based, although sufficient for an efficient market, are not necessary.[283] Professor Jensen also wrote in 1978 that "widely scattered and as yet incohesive evidence is arising which seems to be inconsistent with the theory".[284]

More in particular, as from the late 1970's, empirical studies of financial theorists started to identify, in a more systematic fashion, market "anomalies", also referred to as "puzzles", that are impossible to reconcile with the notion that stock prices always reflect best estimates of risks and returns. This evidence against market efficiency includes evidence of pricing anomalies, such as strong market fluctuations.[285] It also includes evidence of demand inelasticity, excessive volatility, slow absorption of information by the market,[286] and consistently superior traders.[287]

The belief that perfect market efficiency fails to capture the reality of securities markets led prominent economist Robert Shiller to describe in 1987 efficient markets as "the most remarkable error in the history of economic theory".[288] Professor Andrei Shleifer also stated that"[w]hatever the reason why it took so long in practice, the cumulative impact of both [behavioural finance] theory and the evidence has been to undermine the hegemony of the E[C]MH".[289] Another well-known economist, Professor Fischer Black, also contended in 1986 that a reasonable definition of an efficient market

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[283] See EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970)., at 387-88 and at 410.

[284] MICHAEL C. JENSEN, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. Fin. Econ. 95, (1978).

[285] Puzzles include the event when the Dow Jones Index of industrial stocks lost 23% of its value in a single trading session on 19 October 1987; the burst of the high-tech bubble in the start of this century (in the spring of 2000, the Standard & Poors 500 Index of 500 US leading operating companies topped 1,500. By October 2002, the Standard & Poors 500 Index was hovering near 775. See Standard & Poors web-site); and the financial turmoil of 2007-2008 following the mortgage crisis (in September 2007, the Standard & Poors 500 Index was valued at 1,529.03; in August 2008, at 1,292.20; in November 2008, at 806.58). But the last mentioned financial crisis mainly concerns financial institutions. To name but a few illustrative examples, Lehman Brothers Holdings Inc. filed for chapter 11 US bankruptcy protection on 15 September 2008 (in August 2008, its shares were valued at USD63.6; on 5 September 2008, at USD16.2 and on 15 September 2008, at USD0.21); Fortis Bank became BNP Paribas Fortis and its share, valued at €22.52 in August 2007, was only worth €9.57 in September 2008 and €2.94 in September 2009.

[286] See Part II:Chapter II:III.E below.

[287] See Part II:Chapter II:III.D below.

[288] Barbara Donnelly, Efficient-Market Theorists are Puzzled by Recent Gyrations in Stock Markets, Wall St.J., 3 October 1987, at 7.

[289] ANDREI SHLEIFER, Inefficient Markets: An Introduction to Behavioural Finance (Clarendon Lectures in Economics ed., Oxford University Press. 2000).

is “one in which the price is within a factor of 2 of value, i.e., the price is more than half of value and less than twice value”,[290] a conception that does not inspire great confidence in the predictive value of efficient market theory.

I discuss below each assumption of the traditional definition of market efficiency. This examination shows that the idea of market efficiency is not necessarily tied to the initial assumptions and that the advances in behavioural finance have forced academics to reformulate market efficiency in a new light without dismissing the concepts that are at its core. In other words, “[w]hat makes the market efficiency claim non-trivial is that prices are said to be efficient despite the fact that perfect market assumptions do not hold.”[291]

B. Investors’ Irrationality

1. The presence of “noise” in securities markets and the insights of “behavioural finance”

The assumption of pervasive rationality in securities markets has been challenged for quite a while now.

Numerous studies found significant “noise” in securities markets behaviours, i.e., irrational decisions in capital markets generating demands that are driven by psychological considerations unrelated to the information about the value of the

[290] FISCHER BLACK, *Noise*, 16 Journal of Finance 529, (1986).
[291] RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

shares.[292] Noise traders are believed to move prices of stocks away from their fundamental value as trading is motivated by psychological heuristics and biases.[293]

"Behavioural finance" started to grow as separate field of research, relying on the psychological literature, and especially on empirical studies of human behaviour in experimental games, to identify predictable forms of "cognitive bias" that consistently lead people to make mistakes on securities markets.[294] The contributions of behavioural finance also examine whether the identified biases can help explain or predict empirically-observed market anomalies that cannot be explained or predicted by rational-actor-based traditional finance. Even if some studies are entertaining but do not offer serious explanations for market imperfections,[295] most of them are said to help explain market phenomena.[296]

As already suggested above, unsophisticated retail investors are more likely than more sophisticated actors to be noise traders.[297]

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[292] The signal that the action of "noise traders" sends is not informative but is like noise in a signal transmission line. In other words, noise traders trade on bogus information, or "noise". See FISCHER BLACK, *Noise*, 16 Journal of Finance 529, (1986). For a survey in the legal literature of the work of the noise theorists, together with an analysis of its legal implications, see DONALD C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REv. 876, (1992). See specifically the works of Professor Robert J. Shiller as well as those of Professors J. Bradford De Long, Andrei Shleifer, Lawrence H. Summers and Robert J. Waldmann. See also DOUGLAS W. DIAMOND, et al., *Information Aggregation in a Noisy Rational Expectations Economy*, 9 Journal of Financial Economics 221, (1981).

[293] See DAVID A. HIRSHLEIFER, et al., *Herd Behavior and Cascading in Capital Markets: A Review and Synthesis*, 1 European Financial Management 25, (2003). (arguing that the trades of irrational investors are not random and do not cancel one another out; showing that noise traders often act as a herd); ALOK KUMAR, *Hard to Value Stocks, Behavioral Biases and Informed Trading*, J. Fin. & Quant. Analysis, (2008).; LEONID KOGAN, et al., *The Price Impact and Survival of Irrational Traders*, 61 Journal of Finance 195, (2006). (arguing, on the basis of a partial equilibrium model, that irrational traders can potentially outgrow rational traders and thus survive).

[294] See references to behavioural economics and behavioural finance, under Part I:V in General Introduction.

[295] See, *inter alia*, Ilia D. Dichev and Troy D. Janes, Lunar Cycle Effects In Stock Returns (2002) (finding stock prices influenced by lunar cycle); Mark Jack Kamstra et al., Winter Blues: A Sad Stock Market Cycle (2002) (finding stock prices influenced by seasonal changes in length of day); Richard Teitelbaum, Investing Diary: A Psychiatric Theory on Irrational Exuberance, N.Y. Times, 5 March 2000, at C7 (offering "prozac effect" as explanation for the market upswing).

[296] But see for an example of an experimental study that supports the view that markets provide a useful corrective mechanism for many cognitive biases, except, to some degree, the "exact representativeness" heuristic, COLIN F. CAMERER, *Do Biases in Probability Judgment Matter in Markets? Experimental Evidence*, 77 Am. Econ. Rev. 981, (1987).

[297] See Part II:Chapter I:II.A in Chapter Investor Protection. See also BRAD M. BARBER, et al., Do Noise Traders Move Markets? (2006). (showing that individual investors can move prices in an irrational way).; ULRIKE MALMENDIER, et al., *Are Small Investors Naïve About Incentives?*, 85 J. Fin.

2. *The limits of behavioural finance*

Noise theorists and behavioural finance academics offer an appealing explanation for the fact that factors other than fundamentals are affecting stock prices, like investors' noise, or investors' limited cognitive capabilities and psychological biases.

This being said, the extent to which advances of noise theory and of the larger behavioural finance impact the market efficiency paradigm ought to be correctly appreciated.[298]

Too much credit should not be given to the findings of behavioural finance for the following reasons:

On the one hand, irrationality, although it does well exist, does not lead to *chronically* mispriced securities nor to a *serious* misallocation of resources.

Market collapses do well exist. However, over the last century and a half, there were no more than five major crashes: 1929, 1973, 1987, 2000-2002 and 2007-2008.[299]

Some highlight that there is no sustained, as opposed to episodic, impact of investors' irrationality on share price accuracy because of the inter-determinancy

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Econ. 457, (2007).; ZUR SHAPIRA, et al., *Patterns of Behavior of Professionally Managed and Independent Investors*, 25 J. Banking & Fin. 1573, (2001).

[298] See, for instance, GREGORY MITCHELL, *Why Law And Economics' Perfect Rationality Should Not Be Traded For Behavioral Law And Economics' Equal Incompetence*, 91 Geo. L. J. 67, (2002). (finding, on the basis of a review of the empirical evidence on individual and situational variability in rational behaviour, that the assumption of uniformly imperfect rationality found in behavioural law and economics is no more plausible than the assumption of uniformly perfect rationality found in law and economics). See the authors who argue that too much credit has been given to behavioural finance contributions, who note that behavioural finance has not unambiguously proven the impact of irrational psychological impulses and cognitive weaknesses of retail investors on stock price accuracy, and hence on the seriousness of any resulting problem with regard to efficient allocation of resources in the economy, and who suggest that retail investors are less irrational than assumed, including, *inter alia*, ANDREW JACKSON, The Aggregate Behaviour of Individual Investors (2003).; HYUK CHOE, et al., Do Domestic Investors Have More Valuable Information About Individual Stocks Than Foreign Investors? (2001).; JOSHUA D. COVAL, et al., Can Individual Investors Beat the Market? (2005).

[299] See however the academics who argue that there were more financial crisis in the last decades because of de-regulatory policy measures to promote competition and liquidity. They further consider that the period between 1945 and the early 1970s was a period of prosperity with no financial crisis and with regulatory measures to limit interconnexions between financial market actors (such as the Glass Steagal Act). They therefore suggest that the solution to the current crisis is less focus on liquidity and more regulation to separate market activities. See, *inter alia*, ANDRÉ ORLÉAN, *Au-delà de la transparence de l'information, contrôler la liquidité*, Esprit 38, (2008).

relating to the incidence and interaction of the variety of cognitive biases.[300] Others stress that the number of irrational investors may be too small to affect price and create a misallocation of capital.[301] There should be a critical mass for a specific bias to have a price effect. A bias should extend across most noise traders, i.e., individual behaviours should all follow the same bias when trading, to lead to a spike in individual trading. In other words, there needs to be a sufficient number of investors who adopt a specific investment strategy on the basis of the same bias for irrationality to impact prices.

Besides, if the number of irrational investors is large enough to affect price, there will be arbitrage opportunities.[302] Hence, the impact of irrational traders is likely to be short-lived as the opportunity of lucrative arbitrage could be exploited, at least to some extent.

For all these reasons, in my opinion, it can be safely concluded that markets are on average efficient, in the sense that they are not noisy as a whole but only episodically.[303]

On the other hand, the proponents of behavioural finance did not succeed, until now, to establish an alternative theory that would explain *better* than the ECMH the functioning of capital markets, how prices are set and what constitutes fundamental value of a stock.[304]

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[300] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

[301] See ALVARO SANDRONI, *Do Markets Favor Agents Able to Make Accurate Predictions*, 68 Econometrica 1303, (2000).

[302] See MILTON FRIEDMAN, *The Case for Flexible Exchange Rates*, *in* Essays in Positive Economics 1953). (holding that people and institutions who search for arbitrage opportunities quickly drive out of the market irrational traders); RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003). (emphasising the importance of arbitrage in connection with share price accuracy).

[303] *Accord*, RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003). See also JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken   (Princeton University Press. 2008)., at 267 ("[t]here is a wealth of evidence that capital markets are highly efficient, especially over time"); GREGORY LA BLANC, et al., *In Praise of Investor Irrationality*, *in* The Law and Economics of Irrational Behavior, (Francesco Parisi, et al. eds., 2005).

[304] *Accord* RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).; WILLIAM T. ALLEN, *Securities Markets as Social Products: The Pretty Efficient Capital Markets Hypothesis*, 28 J. Corp. L. 551, (2003)., at 558. See also TROY A. PAREDES, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L. Quarterly 417,   (2003)., at 484 ("[g]iven the apparent indeterminacy of investor psychology, the ECMH might be the most accurate model we have, at least for

While it allows devising *ad hoc* and *ex post* explanations for market phenomena, behavioural finance does not allow making predictions for the future.[305] Because behavioural finance theorists have identified a multitude of cognitive biases that can be expected to affect investor decision-making in different and often contradictory ways, it is impossible to use behavioural finance to predict anything other than that prices will depart randomly and unpredictably from best estimates of value in light of available information.[306] One cannot observe which among the variety of cognitive biases are operative in affecting stock price and the interaction among themselves. Therefore, one cannot assess whether a market price reflects any bias at all, meaning that the simple presence of cognitive biases has no necessary implications for prices.[307]

In conclusions, I believe that the empirical evidence of market inefficiencies, including the 2007-2008 financial turmoil, and the advances of behavioural finance do not make the market efficiency claim trivial.

Worth noting to reflect my view in the debate about the efficiency of capital markets is the reformulation of the ECMH in a new light by Professors Gilson and Kraakman. In their first article in 1984,[308] these prominent pro-market efficiency academics explained why the stock market is efficient. That work incorporated a number of Fama's errors. But with the insight of behavioural finance, the authors came back from what they originally said.[309] While they kept sharing the idea of an efficient market, they implicitly recognised that financial markets are not 100% efficient because

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the time being; and even when investor psychology is fully factored in, capital markets might turn out to be efficient enough to continue as a useful basis for policymaking").

[305] See ROBERT J. SHILLER, Market Volatility (MIT Press. 1989)., at 435 (noting that it is hard to model a partially rational person in a way that generates testable predictions). See however, DANIEL KAHNEMAN, et al., *The Psychology of Preferences*, 246 Sci.Am. 160, (1982). (developing a concept called "prospect theory" regarding decisions under uncertainty, which can be used as the basis for making behavioural claims). In that respect, I believe that, compared to the rationalist paradigm, theories of sub-optimal/irrational behaviour create greater ambiguity regarding the actions of large groups (such as investors in markets).

[306] *Accord* EUGENE F. FAMA, Market Efficiency, Long-Term Returns, and Behavioural Finance, 33 J. Fin. Econ. 3, (1998)., at 284.

[307] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

[308] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984).

[309] See RONALD J. GILSON, et al., *MOME in Hindsight*, 27 Regulation 64, (2004).; RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

of the presence of noise. Worth quoting also is Professor Henry Manne's response to the assertion that behavioural economics has destroyed the efficient market theory: "it sure had forced us to sharpen our descriptions and understanding of how some securities markets function, and most assuredly, [that] we have been forced to correct some of the misleading aspects of efficient market theory as it has come down to us".[310]

I do not believe that the paradigm of an efficient market is "crumbling".[311]

This being said, as behavioural finance obscures the appropriate regulatory path, "[i]n further research, it is important to bear in mind the demonstrated weaknesses of efficient markets theory and maintain an eclectic approach".[312] Behavioural finance should at a minimum make the regulator cautious with respect to regulatory reforms based on a strict view of the ECMH.[313]

Besides, academics and regulators should pay attention to the limits of arbitrage, including, of course, institutional limitations and those limits that are linked to investor irrationality, in order for arbitrage to be successful.[314]

C. Investors' Heterogeneous Expectations

Investors have heterogeneous expectations: contrary to what Professor Fama assumed,[315] they do not agree on the implications of information for the price and distributions of each stock. In other words, they value shares differently.[316]

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310 See HENRY MANNE, *Remarks on the Lewis & Clark Law School Business Law Forum: Behavioural Analysis of Corporate Law: Instruction or Distraction?*, 10 Lewis & Clark L. Rev. 169, (2006).

311 See for such view, LYNN A. STOUT, *The Mechanisms of Market Inefficiency - An Introduction to the New Finance*, 28 Journal of Corporation Law 635, (2003)., at 639.

312 ROBERT J. SHILLER, *From Efficient Markets Theory to Behavioral Finance*, 17 J. Econ. Perspectives 83, (2003)., at 102.

313 See in that respect the promising announcement of the European Commission that it might make use of the insights of behavioural economics when crafting, for instance, new consumer protection regulations (see European Commission, How Can Behavioural Economics Improve Policies Affecting Consumers (summarising the results of a conference on behavioural economics, the European Commission stated that "[i]t [the conference] has generated ideas for new research that could be carried out under the 7th Framework Programme")). See also the work commissioned by the UK FSA on behavioural finance literature: David de Meza, Bernd Irlen-Busch, Diane Reyniers, Financial Capability: A Behavioural Economics Perspective, July 2008.

314 For more details, see Part II:Chapter II:III.E below.

315 See EUGENE F. FAMA, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 The Journal of Finance 383, (1970)., at 387.

Accordingly, prices may diverge from fundamental value.

D. Information's Transaction Costs

Contrary to what Professor Fama assumed, information is not always readily available to all investors, and is definitely costly to gather, analyse and verify.[317]

The existence of transaction costs relating to the acquisition, processing and verification of information leads to the "efficient market paradox":[318]

On the one hand, market professionals require an acceptable return on their investment in acquiring, processing and verifying information relating to securities. In other words, they need to make a profit from their arbitrage activities, which are based on their market analysis from information they have.

On the other hand, perfectly efficient markets would render such a return impossible, as successful arbitrage activities are incompatible with efficient markets. There is thus a conflict between the fact that information collection is inevitably costly and the fact that this activity will be reduced or suspended if a positive return is not obtainable. As a result, perfectly efficient markets are not possible.

It is now widely recognised that it is possible to beat the market, or no one would have incentive to trade on information in a way that leads to the incorporation of that information into prices.[319]

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[316] For the original model of heterogeneous expectations, see EUGENE F. MILLER, *Risk Uncertainty, and Divergence of Opinion*, 32 J. Fin. 1151, (1977). and for academics who brought this work into legal literature, see LYNN A. STOUT, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Virginia Law Review 611, (1995).; LYNN A. STOUT, *The Mechanisms of Market Inefficiency - An Introduction to the New Finance*, 28 Journal of Corporation Law 635, (2003). (pointing the significance of investors' heterogeneous expectations and irrationalities and the limits of arbitrage to understand securities markets); WILLIAM W. BRATTON, et al., *The Case Against Shareholder Empowerment*, 158 University of Pennsylvania Law Review, (2010)., at 41 et seq.

[317] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984).

[318] See SANFORD J. GROSSMAN, et al., *On the Impossibility of Informationally Efficient Markets*, 70 The American Economic Review, 393, (1980)., note 43, at 405 ("because [acquiring private] information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation").

[319] For early studies, see references in RAZEEN SAPPIDEEN, *Securities Market Efficiency Reconsidered*, 9 University of Tasmania Law Review 132, (1988)., at 155 et seq. and RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984). See also JOSHUA D. COVAL, et al., Can Individual Investors Beat the Market? (2005). (finding that 20% of a large database covering 6 years systematically are able to substantially outperform market returns when adjusted for risks of their investments, without it being derived primarily from trading on inside information, and implying a violation of semi-strong form market efficiency. Questioning whether this result is skill or

The above leads to the suggestion that efficient markets have an "efficient degree of inefficiency", in the sense that enough profit opportunities exist to support a small professional class of arbitrageurs, among the first to trade on them, and to give them incentive to incur the costs associated with identifying and trading mispriced securities.[320] In other words, there will always be mispricing and the opportunity for profit given unexploited opportunities and uncertainty with respect to the future. Uncertainty explains that market's judgement will not always prove correct in the long-run because securities trading is forward-looking and is concerned with what the price will be at the next point of time. It is thus concerned with the future. However, the future is not only unknown but unknowable with perfect accuracy: past and present are informative but not conclusive of the future. Market price is only the starting point for arbitraging, which places securities markets on the road toward increased efficiency. This being said, the lower the transaction costs relating to information, the more efficient the market.

E. Limits of Arbitrage

Under the definition of market efficiency by modern finance academics, there is *a priori* no need for arbitrage activities as the price of the stock always, i.e., very promptly, reflects its fundamental value. There is *a priori* no room for any profitable trading strategy. In the case there is nevertheless a discrepancy between the price of a share and its fundamental value, the initial definition of the ECMH teaches that arbitrageurs immediately intervene to quickly move the price to reflect the fundamental value of the stock. Any gap between price and fundamental value is, under that acceptation, unlikely to persist for a long period.

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represents a statistical consequence of momentum investing (winners continue to outperform loser because others see the pattern and join in) over a particular period. Suggesting that a period of market exuberance could last 6 years). See also the profits made by value-investors who rely on the doctrine developed by Ben Graham, their spiritual father. See for instance the quite regular success in beating the market of Warren Buffet's investment firm, Berkshire Hathaway, or of George Soros, for which there seems to be little to suggest that it can be attributed to insider information. See also note 819 and accompanying text.

[320] See SANFORD J. GROSSMAN, et al., *On the Impossibility of Informationally Efficient Markets*, 70 The American Economic Review, 393, (1980). (referring to an "equilibrium degree of disequilibrium"). *Accord* RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003)., at 18 and JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985).

To support their theory, proponents of perfect market efficiency analysed how quickly prices respond to public announcements of information. In most cases, they found that prices seem to respond to new information almost immediately, with most of the change occurring within hours or even minutes of an announcement.[321]

These studies were performed in the years immediately following the development of the initial version of the ECMH and focussed on widely disseminated and easy-to-understand information, such as stock splits, dividend changes, corporate mergers, and the like.

In contrast, later studies focussed on information for which investors must invest substantial time, trouble, or money to get it or which is technical and difficult to understand. These studies suggest that many types of information although highly relevant to assessing the economic health of firms appear to be incorporated into stock prices far more slowly and far more incompletely than the conventional view of the ECMH would suggest.[322]

That evidence of slow absorption of some information by the market-place is used to refute claims of instantaneous transfer of information into prices.[323]

Academics tried to understand what accounts for delayed and incomplete absorption of information by the market.

Limits to the power of arbitrage activities of the smart money speculators, i.e., the "risk arbitrageurs", to increase market efficiency were identified to explain the sometimes relative speed of market reaction to new information. The limits of arbitrage include the following:[324]

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[321] See RICHARD A. BREALY, et al., Principles of Corporate Finance (8th ed) (McGraw Hill Higher Education ed. 2006)., at 358-60 (describing studies); RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984)., at 555-57 (same).

[322] See RICHARD A. BREALY, et al., Principles of Corporate Finance (8th ed) (McGraw Hill Higher Education ed. 2006)., at 351 et seq. (discussing studies).

[323] See LYNN A. STOUT, *The Mechanisms of Market Inefficiency - An Introduction to the New Finance*, 28 Journal of Corporation Law 635, (2003)., at 653 et seq.

[324] See the works of Andrei Shleifer or Richard Thaler generally. See also as potential limits to arbitrage, the doubts on the rational decision-making of professional investors expressed by behavioural academics, Part III:Chapter I:II.C.3 in Chapter Issuer-Disclosure Addressees and Consequences. See also RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*,

Arbitrage is always costly, as information is costly to acquire, process and verify.[325] Moreover, buying and selling securities is also costly: it involves commissions and fees and can also be restricted by legal or practical obstacles, such as the regulatory limitations on short-selling.[326]

Arbitrage cannot always perfectly move an inflated price as arbitrageurs have limited amounts of money to invest, leaving room for less informed traders who can be expected to continue to have an impact on price.

Moreover, pricing anomalies may persist because they are related to systemic risk that affect the whole market and that cannot disappear through diversification alone.[327]

Another limit to arbitrage in its role to increase market efficiency relates to the reluctance of arbitrageurs to invest large amounts of money in one single company and bear an otherwise diversifiable risk. They may fear that they will be left holding stock in the event that the rest of the market moves more slowly than what they had hoped for. Arbitrageurs, as any other investor, are risk-averse.

In addition, arbitrageurs may invest other people's money and therefore be subject to agency costs, which may cause them to take more conservative investment decisions in the face of noise trader risk and the resulting fact that their own investors may use bad outcomes as a proxy of bad judgment. The resulting decrease of arbitrage activity will be detrimental to correct market prices.[328]

Besides, in the face of irrational traders, arbitrageurs bear the risk that noise traders will continue to be irrational, therefore maintaining or even increasing the mispricing, which will in turn increase the required return of arbitrageurs while decreasing the level of arbitrage activity.[329]

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28 Journal of Corporate Law 715, (2003). (dismissing the existence of irrational professional traders as a limit to arbitrage).

[325] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984)., at 594.

[326] See, *inter alia*, the various short-selling restrictions worldwide further to the current financial crisis. See in that respect the ESME report on short-selling of March 2009.

[327] This is referred to as the "fundamental risk" of arbitrage, see RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

[328] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).(discussing the institutional limits to arbitrage and more precisely, the limit relating to the structure of arbitrageurs' incentive and the agency costs in the arbitrage relationship).

[329] This is referred to as the "noise trader risk" of arbitrage, see RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law

Next, arbitrageurs are out there to make money and may disregard the relationship between a stock's future price and its fundamental value to cease the opportunity to increase their own returns.[330] In other words, they may privately benefit more from trading that helps push prices in the wrong direction than from trading that pushes prices toward their fundamental value.[331]

It may also be impossible to arbitrage as the market may refuse or fail to appreciate the relevance of the information. Arbitrageurs must hope the market reacts slowly enough for them to be able to get in at a discount, but quickly and completely enough for them to be able to get out at a profit.[332]

Therefore, the supply of arbitrage activities is inherently limited. If empirical studies revealed that at least some traders do beat the market with some consistency, the job is not easy. Consequently, the arbitrage activities do not always exploit the arbitrage opportunities and mispricing is not always traded away. In other words, more rational arbitrageurs do not always fully counteract the actions of the irrational investors.

F. Conclusion: a Better Interpretation of Market Efficiency

It is now widely recognised that a distinction needs to be made between "fundamental efficiency" and "informational efficiency":[333]

715, (2003). See also J. BRADFORD DE LONG, et al., *Noise Trader Risk in Financial Markets*, 98 Journal of Political Economy 703, (1990)., at 703 ("[t]he unpredictability of noise traders' beliefs creates a risk in the price of the asset that deters rational arbitrageurs from aggressively betting against them.").

[330] This is referred to as the institutional limit of arbitrage and more precisely, a limit relating to the structure of arbitrageurs' incentive, see RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003).

[331] See SENDHIL MULLAINATHAN, et al., Behavioral Economics (2000).

[332] See for an article suggesting that the current financial crisis has revealed a profound weakness in the strategies of value-investors, Edward Chancellor, The Death of Value Investing, Institutional Investor, November 2008, at 92.

[333] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003). See also LYNN A. STOUT, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Virginia Law Review 611, (1995). (distinguishing informational from fundamental value efficiency)*; WILLIAM K.S. WANG, Some Arguments that the Stock Market Is Not Efficient, 19 U.C. DAVIS L. REV. 341, (1986).* (same); NICHOLAS BARBERIS, et al., *A Survey of Behavioral Finance, in* Handbook of the Economics of Finance, (G.M. Constantinides, et al. eds., 2002). (distinguishing between the claim that there are no arbitrage opportunities, and the claim that stock prices accurately reflect fundamental value, noting that a market may conform to the first claim without conforming to the latter).

Fundamental efficiency posits that share price reflects the share's fundamental value, i.e., future cash flows (dividends, liquidation and other distributions) paid out from then on to whoever holds the share over the lifetime of the issuing firm, discounted to present value.[334] Fundamental efficiency implies that stock price changes only in reaction to new fundamental information.

While markets are not necessarily fundamentally (or perfectly) efficient[335] as shown by theoretical models as well as overwhelming empirical evidence suggesting that share prices often depart from their fundamental value for prolonged periods, they can nevertheless be informationally efficient,[336] *at least with respect to widely held and heavily traded stocks and under normal market conditions*. They are informationally efficient where all publicly available information is rapidly circulated in the market and any new information is more or less immediately discounted by the market so that no gains are to be made from any publicly available information.[337] In other words, informational efficiency refers to the market's speed in adjusting prices to new publicly available information: the quicker the information is impounded into price, the more efficient is the market. In the U.S., since the famous US Supreme Court case Basic v Levinson, the US lower courts consider that markets can show informational efficiency.[338] In Cammer v Bloom, the court set out 5 criteria for efficient markets: (1) the percentage of securities that is weekly traded, (2) the extent to which the issuer is followed by analysts, (3) the presence of market makers or other form of arbitrage activities, (4) the possibility for the issuer to make use of "Form S-3 registration

[334] If some academics take stock price as the measure of present value of expected free cash flows (free cash flows being cash revenues *minus* cash expenses *minus* investments *minus* interest payments and repayments of debt *minus* cash taxes) from now until the end of the company, others use Tobin's q (calculated as the ratio of the book value of assets *minus* the book value of common equity and deferred taxes *plus* the market value of common equity to the book value of assets) or net profits.

[335] Fundamental efficiency refers to the "strong form" efficiency of Fama.

[336] Informational efficiency refers to the "semi-strong" form efficiency of Fama.

[337] See James Tobin, On the Efficiency of the financial system, *Lloyds Bank Review*, 1984; SANFORD J. GROSSMAN, et al., *On the Impossibility of Informationally Efficient Markets*, 70 The American Economic Review, 393, (1980). (describing a market as "informationally efficient" when "prices are such that all arbitrage profits are eliminated").

[338] See note 260 and accompanying text.

document", i.e., the shelf-registration system available for large issuers, and (5) the extent to which the price moves on the basis of new information.[339]

Outside the circumstances of a crash with respect to a share or to the market as a whole, market efficiency is thus to be interpreted as only suggesting that market price is the best possible, least biased measure of value at any given time on the basis of a specific set of information. Price reflects information and adapts to it rather than it being synonymous with information. Price reflects only a fraction, though a significant fraction, of the bundle of knowable information. While price is an indispensable element, it offers no more than a guide or signal for decision-making as there will always be a gap between a share's fundamental value and its price.[340]

As such, mere informational efficiency is not necessarily inconsistent with the view that stock prices can over- or under-react to information, for instance at times of crashes.[341] Informational efficiency allows for stock prices to temporarily deviate from fundamentals, as in crashes.

I believe that it can now safely be suggested that prices became more informed over time, thanks to mandatory disclosure and information intermediaries. This being said, it should be reminded that evidence that the market has become better informed

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[339] See Cammer v Bloom, 711 F. Supp. 1264, (D.N.J. 1989), at 1285-1287. See also Freeman v. Laventhol & Horwath, 915 F.2d 193 (6th Cir. 1990). Note however that, following the US federal Court of Appeals decision, First Circuit, re PolyMedia Corp. Securities Litigation, it became uncertain whether it was sufficient to satisfy these criteria for the market to be considered efficient. In re PolyMedica Corp. Securities Litigation, 432 F.3d 1, 26 (1st Cir. 2005). See also in re Xcelera.com Securities Litigation, 430 F.3d 503 (1st Cir. 2005). The Interim Report of The Committee on Capital Markets Regulation therefore pleads for certainty to be brought by the US SEC (Interim Report of The Committee on Capital Markets Regulation, 30 November 2006, at 80-81).

[340] See also WILLIAM T. ALLEN, *Securities Markets as Social Products: The Pretty Efficient Capital Markets Hypothesis*, 28 J. Corp. L. 551, (2003)., at 557-58 ("[p]rice can be observed; value is argument. Fundamental value is not a falsifiable number. It is an invitation to debate"). See as well, HOWELL E. JACKSON, *To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 Journal of Corporation Law 101, (2003). (pointing out to the importance of transaction costs and diversification in the decision-making process).

[341] See BARUCH LEV, et al., *Stock Price Crashes and 10b-5 Damages: A Legal, Economic and Policy Analysis*, 47 Stan L. Rev. 7, (1994). (arguing that in sharp stock price declines, a portion of the price drop is often unrelated to fundamentals but to extraneous factors. Accordingly, immediately following an important negative corporate announcement, and sometimes for several days thereafter, share price may not reflect a company's true value, as measured by fundamentals).

does not by itself imply that information asymmetries could one day be totally eliminated.[342]

Informational efficiency, referred to as "relative efficiency" in the terminology of Professors Gilson and Kraakman,[343] is the form of efficiency I try to promote in this dissertation by making regulatory suggestions to decrease information costs. Increasing informational efficiency will ultimately contribute to more fundamental efficiency, by foreclosing any exploitable trading opportunities, with more or less promptness, forcing prices to a new, fully informed equilibrium.[344]

IV. Impact of Market Efficiency on the Performance of the Economy and the Role of Issuer-Disclosure to Improve Market Efficiency

A. Preliminary Remark

Why is it worth to implement regulatory reforms, like the EU issuer-disclosure regime, with a view to enhance market efficiency?

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342 See for authors who hold that information asymmetries have ameliorated over time, by tracking the quantum of stock price variation explained by movements across the market as a whole, and showing a substantial diminution over time, along with a concomitant increase in firm-specific or idiosyncratic volatility and positing that good managers go to the stock price to get good instructions for business policy, claiming not only well-informed but also accurate stock prices, ARTYOM DURNEV, et al., *Does Greater Firm-Specific Return Variation Mean More or Less Informed Stock Pricing*, 41 J. Acct. Res. 797, (2003). (effecting an empirical connection between low R_2 and the informativeness of the stock price, and, by implication, its accuracy); ARTYOM DURNEV, et al., *Value-Enhancing Capital Budgeting and Firm-Specific Stock Return Variation*, LIX The Journal of Finance 65, (2004). (finding better quality investment decision-making at low R_2 firms, in turn suggesting that informative stock prices facilitate efficient investment); QI CHEN, et al., *Price Informativeness and Investment Sensitivity to Stock Price*, 20 Rev. Fin. Stud. 619, (2007). (showing a further correlation between stock price variation and the sensitivity of the firm's level of investment to its stock price). However, the studies' authors point to the weaknesses: the evidence as to price informativeness is only indirect, the implications are a matter of "theoretical conjecture," and other factors could be involved. See ARTYOM DURNEV, et al., *Value-Enhancing Capital Budgeting and Firm-Specific Stock Return Variation*, LIX The Journal of Finance 65, (2004)., at 69; QI CHEN, et al., *Price Informativeness and Investment Sensitivity to Stock Price*, 20 Rev. Fin. Stud. 619, (2007)., at 625. Idiosyncratic volatility, then, does not prove that the price has become better-informed and more accurate. It only makes a suggestion. For further explanation on this with reference to empirical works, see WILLIAM W. BRATTON, et al., *The Case Against Shareholder Empowerment*, 158 University of Pennsylvania Law Review, (2010)., at 40 et seq.

343 See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984)., at 560 ("relative efficiency is a measure of the speed with which new information is reflected in price").

344 For suggestions to decrease information costs, see Chapter Issuer-Disclosure Addressees and Consequences and Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

One could question the relevance of this question as most economists and legal academics tend to agree that the disclosure regime in capital markets is based on the semi-strong form of the ECMH.[345] Further to this consensus, this dissertation uses the term "efficient market" to refer to a capital market that displays features of a semi-strong efficient market.

However, a lack of further analysis could be criticised.

Indeed, the ECMH has been the centre of much debate on the basis of the advances of behavioural finance.[346] In addition, it became once again a "hot topic" in the context of the 2007-2008 financial crisis which seems to provide arguments to its opponents.

Furthermore, the analysis performed below is the pre-requisite for any assessment of market efficiency as efficient goal of the EU issuer-disclosure regime.[347] This latter examination is left for other researchers with the appropriate tools of costs-benefits analysis at their disposal, although some straightforward suggestions will be made in that respect in Part III.

In this section, I consider the effectiveness of issuer-disclosure to improve market efficiency.[348] I argue that issuer-disclosure contributes to improve market efficiency, by impacting its two main components, i.e., price accuracy and liquidity. In so doing, I explain why improving market efficiency is important. In that respect, I share the "relevance position" supported by prominent US legal academics and which considers

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[345] See DANIEL R. FISCHEL, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.Law., (1982)., at 911; Stephen A. Ross et al., Corporate Finance, reprinted in part in Foundations of Corporate Law 45, 51-58 (Roberta Romano ed., 1993); JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985).; JONATHAN R. MACEY, *State Anti-Takeover Legislation and the National Economy*, Wis. L. Rev. 467, (1988).; RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 Journal of Corporate Law 715, (2003)., at 9.

[346] See Part II:Chapter II:III.B above.

[347] Here, "efficiency" is to be understood in its economic sense which calls for a costs-benefits analysis.

[348] Survey papers that review disclosure regulation, information intermediaries, and the determinants and economic consequences of corporate disclosure include PAUL M. HEALY, et al., *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, Journal of Accounting and Economics 405, (2001). and the follow-up research of JOHN E. CORE, *A Review of the Empirical Disclosure Literature: Discussion*, 31 Journal of Accounting and Economics 441, (2001).; as well as CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008).

that price accuracy and liquidity create benefits for shareholders and for society as a whole.[349]

B. Price Accuracy

1. Foreword

More accurate share prices are prices that better reflect the share's fundamental value.

I discuss below the assertion that price accuracy enhancement positively impacts the allocation of investors' scarce resources among projects suggested by entrepreneurs, on primary and secondary markets.

I also examine the extent to which price accuracy enhancement contributes to a reduction of cost of capital for the benefit of both issuers, whose dividend policy therefore reflects a right price, and investors, whose investment is therefore less risky.

Lastly, I discuss the extent to which issuer-disclosure can effectively meet the objective of market efficiency. I reiterate the case for mandatory disclosure requirements as price accuracy depends on information availability. I make a distinction between the time of the IPO and any time thereafter and between smaller companies not well followed by analysts and whose shares are not actively traded and well-established firms.

2. Positive impact of price accuracy on resource allocation

a. Securities markets as important mechanisms for resource allocation

Securities markets are an important allocation mechanism for capital investment.[350]

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[349] See MERRITT B. FOX, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Michigan Law Review, (1997).; MERRITT B. FOX, et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, (2003). See also PAUL MAHONEY, *Mandatory Disclosure as a Solution to Agency Problems*, 62 The University of Chicago Law Review 1047, (1995).; MARCEL KAHAN, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 Duke L. J. 977, (1992).; JOHN C. COFFEE, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review, (1984).

[350] See WILLIAM T. ALLEN, *Securities Markets as Social Products: The Pretty Efficient Capital Markets Hypothesis*, 28 J. Corp. L. 551, (2003)., at 555-56 ("[o]ne does not need to believe in the

From this perspective, it is important to have shares correctly priced as they help capital markets perform their role in allocating capital in the economy.[351]

The positive impact of price accuracy on the allocation of investors' scarce resources among the numerous entrepreneurial projects proposed by the economy can be felt on primary and on secondary markets, as developed in the next two sub-sections.

b. Positive impact of price accuracy on resource allocation on primary markets

From an investors' perspective, if share prices are more accurate, investors will be in a better position to assess in which project they should invest their savings to get the level of returns they look for. They will be capable of making a more informed investment decision as information asymmetries will be reduced. Accurate share prices help point out which firms' proposed new investment projects promise the highest future returns and thereby help securities markets to allocate capital efficiently, i.e., cheaply,[352] to the most efficient issuers.[353]

Viewed from the issuer's perspective, it is also socially desirable to have more accurate share prices as they reduce issuer's misallocation risk. Mispricing increases the probability that valuable projects which are too low priced are not implemented because issuers would fear not to succeed to raise the capital they need. At the other extreme, with less accurate prices, issuers with less promising projects which are too high priced are tapping the public market, putting a risk on investors' confidence as there is an increased probability that the project will not turn out well. This reverts to the argument outlined in the preceding paragraph.

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exaggerated claims of the ECMH to nevertheless believe that, comparatively, securities markets are a highly useful way to allocate resources. Well-designed markets – that is markets with infrastructure that promote efficient pricing – are in many instances clearly superior to other techniques for allocating capital to users.").

[351] See MARCEL KAHAN, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 Duke L. J. 977, (1992)., at 1005 et seq. *Contra LYNN A. STOUT, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 Michigan Law Review 613, (1988).*, at 640 et seq. (arguing that efficient stock markets may be neither necessary nor sufficient for the proper allocation of capital among companies).

[352] See below Part II:Chapter II:IV.B.3.

[353] See EDMUND W. KITCH, *The Theory and Practice of Securities Disclosure*, 61 Brooklyn Law Review 763, (1995).

Empirical studies performed on the basis of the US securities regulation by US academics, although scarce, confirmed the conclusion that more accurate share prices improve the quality of choice among new proposed investment projects in the economy on primary markets. Thus, some empirical evidence suggests that the efficiency of the "real" economy - the actual production of goods and services - is enhanced when share prices become more accurate.[354]

c. Positive impact of price accuracy on resource allocation on secondary markets

i Direct impact

As already explained in the context of the primary markets, if a shareholder is confident that it can rely on share price as best estimate of fundamental value, it will be in a better position to assess the value of the company. It will be able to make a more informed decision to continue to invest, to refrain from investing more, to maintain its investment or to sell the stock. Price accuracy's effect on project choice by investors occurs directly in that sense.

From the issuer's perspective, i.e., the operation of existing projects on the market, more accurate share prices in the secondary market also improve capital allocation when the firm uses non-equity external sources of capital such as debt offerings or institutional borrowings.

On the supply side, with improved price accuracy, issuers may pretend to obtain better terms from intermediaries willing to extend financing for their project. Indeed, banks will be less likely to require a high rate of interests if they are confident that the company's shares are well valued. An increased accuracy of the stock of the borrower reduces the risk borne by the lender when lending funds to the borrowing company.

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[354] See for reviews of studies, MERRITT B. FOX, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335, (1999). (reviewing the affirmative evidence for the proposition that mandatory disclosure has increased the amount of meaningful information in the market and improved price accuracy); CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008). See also MERRITT B. FOX, et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, (2003). (finding that companies follow capital budgeting policies more aligned with market value maximisation where stock prices are more informed).

On the demand side, share price can affect management's willingness to use debt to finance a project because of the prospect that the company will subsequently counter-balance any new debt with new equity financing to obtain its optimal debt/equity ratio. In other words, if share price is inaccurately low, management may decide not to pursue relatively promising proposed investment projects. If it is inaccurately high, it may implement relatively unpromising proposed projects.[355]

ii Indirect impact

a Foreword

Among other US academics, Professor Fox has developed another argument to illustrate a more indirect effect of price accuracy on resource allocation on secondary markets.[356]

He argues that price accuracy's effect on project choice indirectly occurs as a result of its positive impact on the quality of two corporate governance mechanisms, i.e., the market for corporate control and equity-related compensation.[357] These corporate governance tools are believed to prompt a reduction of agency problems within a company.[358]

I discuss below the extent to which the reasoning followed by Professor Fox could be transposed to the European context given that Continental Europe is *mainly* characterised by concentrated ownership structures, as opposed to the US and UK

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[355] For an overview of these points and the responses of the adherents of financial structure irrelevance, see RICHARD A. BREALY, et al., Principles of Corporate Finance (8th ed) (McGraw Hill Higher Education ed. 2006).

[356] See MERRITT B. FOX, *Rethinking Disclosure Liability in the Modern Era* 75 Wash. U. L. Rev. 903, (1997).; MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at 25. See also MARCEL KAHAN, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 Duke L. J. 977, (1992).; and other references cited in JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at note 5.

[357] Although "market for corporate control" might be thought as including other subjects like mergers, asset or share acquisitions, going private transactions, squeeze-outs, sell outs and also the action of activist shareholders, like hedge funds, private equity funds, sovereign wealth funds and so on, and although take-over bids are only one technique for exercising corporate control, I shall use in this dissertation the concept of "market for corporate control" to refer to take-over bids. By "equity-based compensation", I refer to stock options plans, share incentive schemes, deferred share plans and any other share-based remuneration.

[358] For an explanation of agency problems, see Part II:Chapter III:I.A in Chapter Corporate Governance.

typical dispersed ownership structures.[359] The analysis necessarily includes an investigation as to whether market for corporate control and equity-based compensation are effective corporate governance tools *per se*. I conclude that there may be problems with the market for corporate control and equity-based compensation, which are not related to disclosure, nor necessarily to the specific ownership structures present in certain jurisdictions. These cast doubts on the relevance of these mechanisms as corporate governance tools *per se*.

b Market for corporate control

To the possible objection that hostile take-overs are relatively rarely used, although they have received a great deal of attention from academic researchers and although they are well publicised,[360] I would respond that it is the threat of a take-over that is considered to be important here.[361]

The market for corporate control is viewed by many US academics as an important device to mitigate agency costs that may arise out of the conflicting interests between management and shareholders.[362] As a reduction in agency costs is believed to positively impact allocation of resources and the economy as a whole, anti-take-over measures should be banned or seriously constrained from that perspective.[363]

In an efficient market, the market price of the firm's securities will point out the relative quality of management because evidence of management shirking,

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[359] For a description of the (Continental) European ownership patterns, see Part II:Chapter III:II.C in Chapter Corporate Governance.

[360] See however, JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 235 (pointing to the rising number of hostile take-over bids worldwide).

[361] See MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 13 and 39.

[362] See DAVID SCHARFSTEIN, *The Disciplinary Role of Takeovers*, 55 Rev. Econ. Stud. 185, (1988).; JEREMY C. STEIN, *Takeover Threats and Managerial Myopia*, 96 J. Polit. Econ. 61, (1988).; Henry G. Manne, Bring Back the Hostile Takeover, Wall St.J., 26 June 2003, at A16; HENRY MANNE, Corporate Governance – Getting Back to Market Basics (2008).; ANDREI SHLEIFER, et al., *Large Shareholders and Corporate Control*, 94 J.Pol.Econ. 461, (1986).; JOSEPH A. MCCAHERY, et al., Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (2009).; JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008).

[363] See XAVIER GIROUD, et al., Does Corporate Governance Matter in Competitive Industries? (2007). (linking anti-takeover laws with decreases in firm performance) and numerous references therein cited.

misappropriation or incompetence will be reflected in the price. With more accurate prices, management is consequently subject to the disciplining effect of the market as potential acquirers will be able to identify those companies where management has not maximised economic returns. If prices are accurate and management performs poorly, the likelihood of a (hostile) take-over bid/buy-out increases, putting pressure on management to improve its management in shareholders' interests.

The fact that more accurate prices, through increased disclosure, boost market for corporate control can be illustrated in two ways:

More accurate prices make the decision of the potential acquirer less risky. In deciding whether it is worth paying what it would need to pay to acquire a target that he considers mismanaged, a potential acquirer must make an assessment of what the target would be worth in his hands. This assessment is inherently risky and the acquirer's management is likely to be risk averse. Greater disclosure reduces the riskiness of this assessment and permits the potential acquirer to quickly make his decision.

In addition, when share price is inaccurately high, even a potential acquirer who believes for sure that it can definitely run the target better than can incumbent management may find the target not worth paying for. The increase in share price accuracy that results from greater disclosure reduces the chance that a socially worthwhile take-over will be thwarted.

Yet a well-functioning market for control requires control to be contestable.

It is generally assumed that this is not the case in Continental Europe.[364]

Indeed, Continental Europe is said to be mainly characterised by controlling shareholders or controlling minority shareholders[365] and the prevalence of anti-takeover devices like preference shares and pyramids. Where this is the case, companies are arguably immune to the disciplinary force of the market for corporate control as these controlling parties' consent to the take-over bid seems hard to obtain.

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[364] See LUCIAN A. BEBCHUK, et al., *The Elusive Quest for Global Governance Standards*, 157 University of Pennsylvania Law Review 1263, (2009).; LUCIAN A. BEBCHUK, et al., *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan L. Rev. 127, (1999).

[365] See Part II:Chapter III:II.C in Chapter Corporate Governance.

The Take-Over Bid Directive does not change the picture, at least in the current state of implementation by European Member States.[366] All to the contrary, some of the take-over regulations that have proven successful at protecting minority shareholders in the U.K., and have been incorporated into the Take-Over Directive, are said to operate in Continental systems as a deceptive guise that instead ensures protection for entrenched controlling shareholders.[367] According to the European report issued in 2007 on the implementation of the Take-Over Directive, "there is a risk that the board neutrality rule, as implemented in Member States will hold back the emergence of a European market for corporate control, rather than facilitate it. It is unlikely that the breakthrough rule, as implemented in Member States would bring any significant benefits in the short term. A large number of Member States have shown strong reluctance to lift takeover barriers. The new board neutrality regime may even result in the emergence of new obstacles on the market of corporate control. The number of Member States implementing the Directive in a seemingly protectionist way is unexpectedly large."[368]

This being said, a European market for corporate control did well exist before the peak of the 2007-2008 financial crisis which logically has changed the situation. Prominent examples of recent hostile take-over bids include Vodafone on Mannesmann (1999); Italenergia on Montedison (2001); ABN Amro on Banco Antonveneta (2005); E.on on Endesa (2006), Mittal on Arcelor (2006), Royal Bank of Scotland, Santander and Fortis on ABN Amro (2007) and Schaeffer on Continental (2008), to name just a few.[369]

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[366] See GÉRARD HERTIG, et al., *Company and Takeover Law Reforms in Europe: Misguided Harmonisation Efforts or Regulatory Competition?*, *in* After Enron - Improving Corporate Law and Modernising Securities Regulation in Europe and the US, (John Armour, et al. eds., 2006)., at 548.

[367] See MARCO VENTORUZZO, Takeover Regulation as a Wolf in Sheep's Clothing: Taking Armour & Skeel's Thesis to Continental Europe (2008).

[368] EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids (2007)., at 10.

[369] See MARINA MARTYNOVA, et al., *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand? (previous title: The History of M&A Activity Around the World: A Survey of Literature)*, Journal of Banking and Finance, (2008)., at 26-27. See also McKinsey February 2009 Newsletter, What's different about M&A in this downturn? ("[h]ostile activity, peaking in 2007, became increasingly prominent as a result of very strong market confidence and extraordinary financial conditions. Surprisingly, the pace of such deals was still high in 2008: in the first three quarters of 2008, they were still running at around USD50 billion a quarter, in line with the average 2000 to 2007 level, before declining to USD21 billion in the fourth quarter. They were typically large—for instance, German

Some say that if something can be learnt from past take-over waves, it could be the case that there will be a new wave of take-overs after the current financial crisis.[370]

Other authors point to the factors that are likely to fundamentally alter the European market for corporate control "into a much more fluid one focussed on financial performance and shareholder value".[371] They say that the current *decrease of cross-shareholdings, the reduced complexity in ownership and control structures as well as the gradual change toward more ownership dispersion* increase the free-float and the vulnerability to take-overs.[372] They mention the change of culture, which, on the one hand, facilitates take-overs from bidders' point of view by the increasing convergence of take-over regulation[373] and on the other hand, puts pressure on poor management and its use of anti-take-over defences, under the positive influence of, *inter alia*, institutional shareholders.[374] They believe that an increase of take-overs could be prompted by a greater acceptance of a model based on shareholder value.[375]

It should be noted that the European Commission appears to support the emergence of a market for corporate control.[376] In its Report on the Take-Over Directive, it stated that it will "analyse the reasons why Member States are so reluctant to endorse the fundamental rules of the Directive. In the light of this evaluation, the

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ball bearings manufacturer Schaeffler's USD35.6 billion bid to acquire car parts manufacturer Continental").

[370] MARINA MARTYNOVA, et al., *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand? (previous title: The History of M&A Activity Around the World: A Survey of Literature)*, Journal of Banking and Finance, (2008).27-28.

[371] INGO WALTER, *The Global Asset Management Industry: Competitive Structure and Performance*, 8 Financial Markets, Institutions, and Instruments 1, (1998)., at 60.

[372] See MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008)., at 285 et seq. (explaining why reciprocal holdings are in decline in Germany and France). On a possible move to more dispersion in European shareholdings, see Part II:Chapter III:II.C.3 in Chapter Corporate Governance.

[373] See MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008).187 (arguing that convergence in take-over regulation worldwide might be possible).

[374] See MIGUEL A. FERREIRA, et al., Shareholders at the Gate? Cross-Country Evidence on the Role of Institutional Investors in Mergers and Acquisitions (2007). (arguing that institutional investors facilitate the working of the international market for corporate control).

[375] See MARINA MARTYNOVA, et al., *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand? (previous title: The History of M&A Activity Around the World: A Survey of Literature)*, Journal of Banking and Finance, (2008)., at 28. See for further discussion relating to the prevalence of shareholder-oriented model, Part II:Chapter III:II.B in Chapter Corporate Governance.

[376] The aim of the European Commission's proposal for the Take-Over Directive was "to promote integration of European capital markets by creating favourable conditions for the emergence of a European market for corporate control" (see Report on the implementation of the Directive on Takeover Bids, SEC (2007) 268). See also HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKE-OVER BIDS, Report of the High Level Group of Company Law Experts on Issues Related to Take-Over Bids (2002).

revision of the Directive scheduled for 2011 may, if necessary, be brought forward."[377] The positive mind-set of the European Commission toward a market for corporate control in Europe is shared by some European academics.[378]

However, the European Commission recently declined to impose a mandatory one-share one-vote rule which arguably would have encouraged contestability of control within the E.U. In announcing the decision not to pursue proportionality between voting rights and cash flow rights, then-Commissioner Charlie McCreevy referred to a study which "found there is no economic evidence of a causal link between deviations from the so-called "proportionality principle" and the economic performance of companies".[379]

Whether the lack of imposition of proportionality by the European Commission is to be seen as a political compromise or a recognition of the fact that control contestability comes with benefits as well as with costs, and that therefore the socially optimal degree of contestability is subject to debate, remains open to question.

In any case, a *thorough costs-benefits analysis is required*, including an enquiry into take-over as disciplinary tool and its impact on firm valuation, in order to determine whether market for corporate control should be promoted.[380]

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[377] EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids (2007).

[378] See, *inter alia*, KLAUS J. HOPT, *Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron, in* After Enron - Improving Corporate Law and Modernising Securities Regulation in Europe and the US, (John Armour, et al. eds., 2003)., at 479.

[379] Speech by then-Commissioner McCreevy at the European Parliament's Legal Affairs Committee, 3 October 2007. The report of 18 May 2007 of ISS Europe, ECGI and Shearman & Sterling on the proportionality principle in the European Union is available on the web-site of the Internal Market.

[380] The evidence is inconclusive. See for a general overview of literature, MARCO BECHT, et al., *Corporate Law and Governance, in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 848 et seq. and MIKE C. BURKART, et al., Takeovers (2006). See also for an overview of literature finding a value-destroying effect of take-overs, MARINA MARTYNOVA, et al., *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand? (previous title: The History of M&A Activity Around the World: A Survey of Literature)*, Journal of Banking and Finance, (2008)., at 8, 20, 23 and 28 in particular. One study of the subsequent performance of firms adopting take-over defenses finds no performance decline. See SIMON JOHNSON, et al., *The Impact of Antitakeover Amendments on Corporate Financial Performance*, 32 Fin. Rev. 659, (1997). (surveying, in the U.S., a range of financial measures in respect of more than 600 anti-takeover amendments adopted between 1979 and 1985 and finding no adverse effect). Later performance improvement has even been detected. See LAURA C. FIELD, et al., *Takeover Defenses at IPO Firms*, 57 J. Fin. 1857, (2002). (comparing IPO firms with and without take-over defenses and finding that defenseless firms underperform for the first two years but no significant performance differences thereafter). *Contra* for an overview of literature and

Although it goes beyond the scope of this dissertation to take a definitive position on the *bien fondé* of a market for corporate control in the European context, the following points highlight the fact that there are many sceptics in this debate who base their opinion on empirical evidence:[381]

Even bids initially seen as successful encounter investor scepticism before long.[382] For most bids, investor opinion, some time after the bid, is sceptical about whether shareholder value has been created.[383] Take-overs may destroy or redistribute rather than create value.

Besides, evidence suggests that the take-over selection process in the market for corporate control works only to a limited extent on the basis of profitability and stock market valuation but operates to a much greater extent on the basis of size. A large but relatively unprofitable firm has a greater chance of survival than a small profitable company.[384]

Very importantly if one considers my view relating to the objective of the firm,[385] the take-over threat may lead management being too much concerned with short-term performance in order to make myopic stock markets happy. It may discourage firm-specific or long-term investments and it may cause under-investment, thereby

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empirical studies showing statistically significant positive abnormal returns on the investments of shareholders in companies that receive take-over bids, JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 118 et seq.

[381] See SIMON DEAKIN, et al., The Stock Market, the Market for Corporate Control and the Theory of the Firm: Legal and Economic Perspectives and Implications for Public Policy (2008). See also Richard Milne and John Reed, Porsche accelerates toward VW Control, Financial Times, 27 October 2008 (suggesting that Porsche's control of VW is not in VW's shareholders' interests).

[382] *Inter alia*, Fortis/ABN Amro; Lloyds/TSB; Scottish Power/Iberdrola; BAe/VSEL/GEC. Comp. "Marconi delivering on high growth for shareholders, having outperformed the market by 40%" (Financial Times, 26 November 1999) with "Marconi in need to rescue from banks, CEO and FD resigned" (Financial Times, September 2001).

[383] *Inter alia*, in connection with Granada-Forte take-over, "the returns for Granada have barely matched the group's cost of capital and […] its shareholders might have been better off if the deal had never been done", Financial Times, 29 May 2001 or "Glaxo-Wellcome is destroying shareholder value at the moment", Financial Times, 1 August 1997.

[384] See ALAN HUGHES, *Mergers and economic performance in the UK: A survey of empirical evidence 1950-1990, in* Merger and merger policy, (J. Fairburn, et al. eds., 1991).; GEOFFREY MEEKS, Disappointing marriage: A study of the gains from merger (Cambridge University Press. 1977).; GUNTHER TICHY, *What do we know about Success and Failure of Mergers?*, 1 Journal of Industry, Competition and Trade 347, (2001).; SCHERER, *A New Retropsepctive on Mergers*, 28 Review of industrial Organisation 327, (2006).; SIMON DEAKIN, et al., The Stock Market, the Market for Corporate Control and the Theory of the Firm: Legal and Economic Perspectives and Implications for Public Policy (2008).

[385] See Part I:VII.B in General Introduction.

constraining firm size. It may also distort insiders' behaviour rather than induce them to pursue profit-maximising strategies. For instance, insiders who are exposed to a substantial take-over threat may waste effort on measures to protect themselves.

In addition, high transaction costs are associated with take-overs. Thus, some degree of entrenchment, i.e., protection from take-overs, could be beneficial in that it would preserve or promote insiders' incentives to increase firm value.

And most importantly for the purposes of this dissertation, the take-over threat might be ineffective in disciplining management. There is little evidence that corporate governance improves after take-overs as in many of them the acquiring firm is motivated by empire-building considerations or by asset-stripping, without consideration for human capital and corporate governance.

Should market for corporate control be considered an effective corporate governance device to reduce agency costs within a firm in the specific context of Continental Europe, it would make sense to try to increase price accuracy (through disclosure) to promote such device as explained above. However, the case still needs to be made.

c Equity-based compensation

Equity-based remuneration, which links managerial compensation to shareholder wealth via share prices as performance indicator, is said to have a significant impact on whether a company can recruit and retain managers having the qualities required to run the company efficiently.[386]

Moreover, some US academics explain that equity-based remuneration is a powerful way to motivate managers, as rational maximisers of their own wealth, to pursue shareholders' wealth.[387] As further explained below,[388] most US (and, to a similar extent, UK) companies are characterised by the separation of ownership and control. This may give rise to conflicts of interests between the shareholders who own the company and the managers to whom shareholders have delegated the power to run

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[386] For empirical research finding that equity-based remuneration enhances loyalty, see SANJAI BHAGAT, *Director Ownership, Corporate Performance, and Management Turnover*, 54 Bus. Law. 885, (1999).

[387] See, *inter alia,* Richard A. Posner, Economic Analysis of Law, §1.1, at 3-4 (4th ed. 1992).

[388] See Part II:Chapter III:I.A in Chapter Corporate Governance.

the company, i.e., agency conflicts, where the shareholders act as principals and managers as agents. In that context, equity-based compensation is believed to have the potential to reduce corporate agency costs typical of fragmented ownership structures by encouraging value creation in the medium- to long-term.[389] It is thought that, with equity-based compensation, managers have greater incentives not to operate existing projects in ways that sacrifice profits to satisfy their personal aims. It is also believed that equity-based compensation provides an incentive to managers to avoid negative net present value projects which, if they would contribute to maintain or enlarge their empires by retaining cash flows, would on the other hand deprive shareholders of dividends which could be reinvested in more promising projects.[390]

In that context, more accurate prices could boost the use of equity-based compensation by rendering this type of remuneration less risky.[391] Price accuracy is believed to encourage managers to accept share-price-based compensation as there is reduced risk of having shares worth nothing because of market inefficiency reasons.

But the question is to what extent this reasoning applies in the European context which makes me incidentally ask whether equity-based compensation should be promoted as corporate governance tool.

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[389] See MICHAEL C. JENSEN, et al., Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them (2004). (for an in-depth review of US literature conducting quantitative studies trying to test whether executive directors compensation is significantly linked to corporate performance); DAVID A. BECHER, *Incentive Compensation for Bank Directors: The Impact of Deregulation*, 78 J.Bus. 1753, (2005).; BRIAN J. HALL, *What you need to know about stock options*, Harvard Business Review 121, (2000).; MERRITT B. FOX, *Insider Trading Deterrence versus Managerial Incentives: a Unified Theory of Section 16(b)*, 92 Mich. L. Rev., (1993)., at 2104 et seq. and references therein stated.

[390] See GERALD A. FELTHAM, et al., *Incentive Efficiency of Stock Versus Options*, 6 Rev. Acct. Stud. 77, (2001).; WEI SHEN, *Improving Board Effectiveness: the Need for Incentives*, 16 Brit.J.Mgmt., (2005).; JAMES HEARD, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. Cin. L. Rev. 749, (1995).; MICHAEL C. JENSEN, et al., *CEO Incentives – It's Not How Much You Pay, But How*, Harvard Business Review, (1990). See the Delaware Supreme Court supporting equity-based compensation (*Unitrin, Inc. v. American General Corp*., 651 A.2d 1361, 1380–81 (Del. 1995)) (holding that directors who hold substantial equity stakes in a target company may not be presumed to vote against their economic interests as shareholders).

[391] See CLIFFORD G. HOLDERNESS, et al., *Were the Good Old Days That Good? Changes in Managerial Stock Ownership Since the Great Depression*, 54 J.Fin. 435, (1999).

In the European jurisdictions under consideration,[392] equity-based compensation is recommended by corporate governance codes[393] and it sometimes enjoys favourable tax or accounting treatment.[394]

However, one could question its usefulness and effectiveness in concentrated ownership structures.[395]

As explained in more details below, most Continental European firms are characterised by concentrated ownership.[396] In those firms, incentives to control management and conflicts of interests change, compared to the most common US/UK situation of dispersed share ownership.

Blockholding/controlling shareholders seem to have enhanced incentives and resources to monitor managers more directly and effectively. There should be less need for an incentive pay contract to remedy any agency problem between management and shareholders.[397] Monitoring to ensure that shareholders' interests are well pursued should effectively occur *via* the large blockholders, the financial institutions which provide debt financing, and long-standing, interlocking relationships between

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[392] See Part I:V above in General Introduction.

[393] See Principle 7.11 of the Belgian Code on Corporate Governance; article 4.2.3 of the German Corporate Governance Code; article 7.C.1 of the Italian Corporate Governance Code; recommendation 5.2 of the Spanish draft Unified Code – Recommendations on the Good Governance of Listed Companies; article II.2 of the Dutch Corporate Governance Code – Principles of good corporate governance and best practice provisions; article 15.3 of the French Corporate Governance of Listed Corporations; Part B of the UK's Combined Code on Corporate Governance.

[394] See, *inter alia*, in Germany until 31 March 2009, Section 19a of the German income tax code (*Einkommensteuergesetz* (EstG)) which provided that equity-related compensation of up to an amount of €135 per year was tax exempt, the remainder was treated as normal income. There were no specific accounting/legal privileges, but equity-based remuneration programmes could be structured in a way to yield certain advantages regarding the amount of expenses to be incurred by the company. Since 1st of April 2009, there are new regulations which provide for a possibility to establish tax efficient employee participation programmes (*Mitarbeiterkapitalbeteiligungsgesetz*).

[395] For an overview of the literature, see the works of Professors Moloney and Ferrarini on the subject and, *inter alia*, GUIDO A. FERRARINI, et al., *Executive Remuneration in the EU: The Context for Reform*, 21 Oxford Review Economic Policy 304, (2005);GUIDO A. FERRARINI, et al., Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis (2009). See also MARCO BECHT, et al., *Corporate Law and Governance, in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 862; 901 and 914.

[396] See Part II:Chapter III:II.C in Chapter Corporate Governance.

[397] See also BRIAN R. CHEFFINS, *Will Executive Pay Globalise Along American Lines*, 11 Corporate Governance 8, (2003). (arguing that it could also be the case that the lesser attractiveness of equity-based compensation to management in Continental Europe is due to the fact that a listed company with concentrated ownership has only a small "free float" and therefore a greater possibility arises of the share price being influenced by noise rendering equity-based compensation less attractive).

management, shareholders, financiers, and other stakeholders. This seems to be corroborated by the facts as it seems that management supervision by blockholers/controlling shareholders has limited the degree of reliance on equity-based compensation in Continental Europe.[398]

More importantly, equity-based compensation could itself become a source of agency difficulties.

The concentration of control, and the close relationship between blockholding/controlling shareholders and between those shareholders and management, recasts the agency problem which equity-based compensation is designed to resolve in dispersed ownership systems typical of the U.K. and the U.S. In that respect, protections may be needed to prevent collusion between blockholders and management.

In particular, where management and blockholders/controlling shareholders collude on equity-based remuneration, a conflict arises between their interests and those of minority shareholders, triggering a potential misalignment of interests and agency problems. Some authors argue that there should not be equity-based compensation in concentrated ownership to avoid that it be transformed into a process of skimming or rent extraction by the blockholding/controlling shareholder, who exercises influence on management.[399] For instance, unless confronted with powerful independent directors, if he sits on the board or influences the remuneration committee, he might grant itself excessive stock option packages which could eventually increase its controlling stake.

Even in the U.S., where equity-based compensation has a long history, its effectiveness is controversial, as showed by the many newspapers' frontlines relating to it since the 2007-2008 financial crisis.

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[398] See CLARA GRAZIANO, et al., *Executive Compensation and Firm Performance in Italy*, 19 International Journal of Industrial Organization 133, (2001). (for Italy) and RAFEL CRESPI, et al., Board Remuneration, Performance and Corporate Governance in Large Spanish Companies (1999). (for Spain).

[399] See generally the works of Professor Lucian Bebchuk. See also ANDREA MELIS, et al., Shareholder rights and director remuneration in blockholder-dominated firms. Why do Italian firms use stock options? (2008).(analysing the case of Italy).

In the same way as explained above in a concentrated ownership context, equity-based remuneration can be regarded as an agency cost in itself in that it provides a potentially fruitful and opaque device for self-dealing by conflicted managers in fragmented ownership structures.[400] As management compensation is not set by shareholders, but on their behalf by the board of directors, a conflicted board may extract rents in the form of compensation in excess of that which would be optimal for shareholders, given weaknesses in the design of remuneration contracts and in their supporting governance structures.

In addition, equity-based compensation has some design problems which arguably equally apply to a concentrated ownership structure as to a dispersed ownership structure. Equity-based compensation could generate perverse incentives for management to manipulate financial disclosure, and in particular to inflate earnings, and distort share prices which can lead to catastrophic corporate failures.[401] Equity-based remuneration offers such a big carrot in case of good corporate performance during their (limited) term of employment that managers could be pressured to do everything to increase short-term firm value, whatever the risks involved. Equity-based compensation also risks over-compensation of executives who preside over a period of market growth and under-compensation of those caught in a down market cycle. Equity-based compensation poses another design problem as it can incentivise management to take efficient but personally stressful decisions to promote greater efforts to increase the global value of the company and the share price.[402] Other difficulties exist, including the relative performance problem, dilution, entrenchment of management, increased risk aversion by non-diversified managers, and reductions in dividends.[403]

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[400] See LUCIAN A. BEBCHUK, et al., Pay without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press. 2004).; LUCIAN A. BEBCHUK, et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 University of Chicago Law Review 751, (2002).

[401] See JOHN C. COFFEE, What Caused Enron? A Capsule Social and Economic History of the 1990s (2003).; JEFFREY N. GORDON, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 University of Chicago Law Review 1233, (2002).; DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003).

[402] See JEFFREY N. GORDON, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 University of Chicago Law Review 1233, (2002).

[403] See for an explanation and references, GUIDO A. FERRARINI, et al., *Executive Remuneration in the EU: The Context for Reform*, 21 Oxford Review Economic Policy 304, (2005).

There also appears to be a difficulty with the strength of the link between management share ownership and performance.[404] Evidence of the link between share-price-based compensation and firm's performance in concentrated ownership structures is particularly scant.

Managers' remuneration is associated in the current financial crisis with wider securities market instability and there is a growing concern of a wide stakeholder community, including regulators, investors and the public generally, which considers high levels of remuneration unjustifiable.[405] The European Commission recently intervened one more time through non-binding recommendations in connection with directors' remuneration.[406] Member States' regulators and supervisory authorities as well as professional associations also came up with various reforms and other initiatives in that respect.[407]

To conclude, on the one hand, equity-based remuneration seems to have become part of the management landscape as a tool to attract and retain competent managers on both sides of the Atlantic, even if it is still less common or amounts to lower levels in Continental Europe.

On the other hand, there are heavy criticisms against equity-based compensation as corporate governance tool: instead of solving agency costs, it could be a source of

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[404] In the US context, see RANDALL MORCK, et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 Journal of Financial Economics 293, (1988).; CLAUDIO LODERER, et al., *Corporate bankruptcy and managers' self-serving behaviour*, 44 Journal of Finance 1059, (1989).; JOHN MCCONNELL, et al., *Additional evidence on equity ownership and corporate value*, 27 Journal of Financial Economics 595, (1990).; JOHN CORE, et al., *Performance Consequences of Mandatory Increases in Executive Stock Ownership*, 64 Journal of Financial Economics 317, (2002).

[405] For an overview of academic work, see LUCIAN A. BEBCHUK, et al., The State of Corporate Governance Research (2009).

[406] See Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, 2009/385/EC, OJ L 120/28, 15 May 2009 (hereafter the Remuneration Recommendations) (the latest recommendations focus along three themes: structure of remuneration policy to ensure pay for performance, shareholders' oversight of remuneration policy, operation and composition of remuneration committees).

[407] See, for instance, the French AFEP/MEDEF recommendations and the European Corporate Governance Forum recommendations. See also the UK FSA considering the adoption of a Code on executive remuneration which would have rule status for systemically important institutions: *The Turner Review. A Regulatory Response to the Global Banking Crisis* (2009), at 80. See also the high level Group on Financial Supervision in the E.U. chaired by Jacques de Larosière which published a report that adopted International Institute of Finance principles, underlying principles related to transparency and alignment with shareholder interests and long-term profitability.

agency conflicts itself. And notwithstanding the efforts of the European legislator and other bodies, it remains to be seen how the potentially costly reforms will work in concentrated ownership systems, where equity-based compensation is approved in advance by the controlling shareholders in the absence of a strong independent directors' body.

This of course underlines the importance of carefully designing equity-based compensation to meet its goals.[408] Given the conflicts of interests to which it could itself give rise, I believe that any remuneration system should be transparent and subject to appropriate governance controls.[409] The effectiveness of equity-based compensation depends on the management of agency problems between the board and shareholders and on adequate monitoring by, *inter alia,* independent directors[410] and, ultimately, shareholders.

In sum, provided that the effectiveness of equity-based compensation is proved in a concentrated ownership context as corporate governance mechanism, enhancing price accuracy would be relevant to decrease the risks associated with equity-based compensation for managers as explained above. However, the case still needs to be made.

d Conclusion

If prices accurately reflect the true value of the stock, accounts' manipulation or over-optimistic projects, which are believed to increase management profit in the short-term, should be reflected in the share price. The mis-managed firm could be subject to a change of control offer if the bidder believes that a change of management could be profitable. This way, mis-management would be corrected by the markets. Theoretically

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[408] See, Financial Times, End Bonus Culture, but Keep Bonuses, 9 February 2009 (arguing that bonuses are useful tool for the financial sector and must be retained. But not in their current form).

[409] See ANDREA MELIS, et al., Shareholder rights and director remuneration in blockholder-dominated firms. Why do Italian firms use stock options? (2008)., at 15 (setting out the characteristics of best practices in equity-based compensation); ALESSANDRO ZATTONI, Stock Incentive Plans in Europe: Empirical Evidence and Design Implications (2008)., at 15, 16 and 21 (setting out recommendations relating to equity-based compensation). See on the importance of disclosure of remuneration policies, GUIDO A. FERRARINI, et al., Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis (2009)., at 7 and 14.

[410] But see the inherent difficulties with respect to independent directors, as summarised in GUIDO A. FERRARINI, et al., Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis (2009)., at 11.

at least, the market to gain control of mis-managed firms could work as a corporate governance tool to align management and shareholders' interests.

Equity-based compensation of management is also believed to work as corporate governance tool to align management and shareholders' interests. Being itself a shareholder, management is believed to pay attention to shareholder value maximisation.

The doubts I have regarding the effectiveness of a market for corporate control and equity-based compensation as corporate governance tools, especially in concentrated ownership structures typical of Continental Europe, lead me to conclude that the case for an indirect positive impact of price accuracy on project's choice is not necessarily strong, and for sure not as strong on this side of the Atlantic as it is in the US context.

Should the case for market for corporate control and equity-based compensation be made as effective corporate governance tools as such, they might become more relevant for corporate governance purposes in the future, in case the trend toward increased dispersed ownership in Europe gets stronger.[411]

3. *Negative impact of price accuracy on cost of capital*

More accurate prices reduce the cost of external finance, as showed by empirical evidence.[412]

Seen from the investors' perspective on primary and secondary markets, it increases the attractiveness of capital markets. Indeed, if prices are more accurate, it implies that there is less private information about the true value of the shares of the issuer. More accurate prices make investors less demanding of price adjustment or of higher returns on their investments as there is more certainty and therefore investments

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[411] See Part II:Chapter III:II.C.3 in Chapter Corporate Governance.

[412] See for surveys of empirical literature, CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008).; LUZI HAIL, et al., *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 Journal of Accounting Research 485, (2006).; CHRISTINE A. BOTOSAN, *Disclosure and the Cost of Capital: What Do We Know?*, Accounting and Business Research 31, (2006).; Rodrigo Verdi, 2006. Information Environment and the Cost of Equity Capital. MIT Sloan School of Management Working Paper.

are less risky.[413] All else equal, investors, as risk-averse actors, prefer securities with low estimation risk, i.e., the element of risk that arises because investors are uncertain about the parameters of a security's returns or pay-off distribution. And estimation risk cannot be diversified.

Moreover, if prices are more accurate through disclosure, information asymmetries are reduced by displacing private information and transaction costs are lower for investors, which in turn positively impact cost of equity capital.

From the perspective of firms, more accurate prices also promote the use of capital markets. The issuer will be able to demand more per share as the company can credibly commit to a low level of diversion of corporate assets through the disclosure regime which aligns prices to fundamental value.[414] On primary markets, more accurate prices is thus a solution to the adverse selection cost for high-value firms which are forced to sell at a discount as investors are unable to distinguish them from low-value firms. On secondary markets, shareholders will be less demanding of a higher return.

4. Positive impact of an issuer-disclosure regime on price accuracy

a. Preliminary remark

Price accuracy depends on the "availability" of information relating to the company's future cash flows. The relationship between information and price accuracy is well captured by Professor George Stigler in his oft-cited statement that "[p]rice dispersion is

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[413] See CHRISTINE A. BOTOSAN, *Disclosure and the Cost of Capital: What Do We Know?*, Accounting and Business Research 31, (2006)., at 33 et seq (and the references therein cited); RICHARD LAMBERT, et al., *Accounting Information, Disclosure and the Cost of Capital*, 45 Journal of Accounting Research 385, (2007). (showing that greater disclosure has a direct effect which is to increase the precision with which investors estimate variances and covariances); LAWRENCE GLOSTEN, et al., *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 Journal of Financial Economics 71, (1985). (arguing that an uninformed investor fears that an informed investor is willing to sell (buy) at the market price only because the price is currently too high (too low) relative to the information possessed by the informed trader).

[414] See, *inter alia*, WILLIAM J. BAUMOL, *Earnings Retention, New Capital and the Growth of the Firm*, 52 Rev. Econ. & Stat. 345, (1970). For a critical review of this and several other studies, along with an estimate of the magnitude of the effects on the economy, see MERRIT B. FOX, Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy (Columbia University Press. 1987)., at 233-37. See also MICHAEL C. JENSEN, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 Am. Econ. Rev. 323, (1986)., at 325; REINIER H. KRAAKMAN, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 898, (1988)., at 898.

a manifestation - and, indeed, it is the measure - of ignorance in the market."[415] I think this sentence is to be interpreted broadly: it does not only mean that information should be provided but it also highlights the importance as to whom and how information is addressed, as well as the quality of information.

The length of time before liquidation of the issuer certainly plays an important role in connection with price accuracy. The fundamental value of a share at any point in time during the lifetime of the issuer cannot indeed be determined with certainty sooner than at the time of liquidation of the issuer.

This being said, and as pointed out by Professors Gilson and Kraakman in their seminal article of 1984, it is important to understand the mechanisms by which prices reflect information to design more effective regulatory reform to promote market efficiency during the lifetime of the issuer.[416] Professors Gilson and Kraakman posit that the initial distribution of the information among traders is paramount in determining which mechanism operates with respect to a particular piece of information, and, ultimately, how efficient the capital market is with respect to that information. They further argue that the distribution of information among traders is a function of information costs. In other words, as distribution of information is a function of the costs relating to information, *relative efficiency of capital markets is a function of information costs*: less "available" information, due to higher information costs, will require more time for "full reflection" in price.

Economising on information costs is thus crucial as it pushes the capital market in the direction of greater efficiency: if the cost of information decreases, it is more widely distributed and more efficiently (i.e., more quickly and more accurately) reflected in stock prices, making capital markets more (informationally) efficient. In other words, the lower is the cost of information, the wider is its distribution, the more effective is the efficiency mechanism and, finally, the more efficient is the market.

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[415] GEORGE J. STIGLER, *The Economics of Information*, 69 J. Pol. Econ. 213, (1961)., at 214.

[416] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984)., at 553 (explaining that information is impounded in the share price through at least four imperfect price-moving mechanisms: "universally informed trading", "professionally informed trading", "derivatively informed trading" (including both price decoding and trade decoding) and "uninformed trading", each mechanism having progressively decreasing relative efficiency).

I discuss below *how to reduce information costs* as they determine the distribution of information in the market. As a general starting point, it is important to realise that information is costly to acquire, to process and to verify. *Many market institutions or regulatory measures*, like mandatory disclosure, the intervention of market professionals and market gatekeepers, or the civil and criminal liability regime related to breaches of disclosure requirements, serve the function of reducing information costs, and thereby facilitate efficiency in the capital market.

I then explain the reasons why it might be difficult to assess the impact of issuer-disclosure on improvement of price accuracy.

Lastly, I discuss the extent to which price accuracy is an effective objective of issuer-disclosure. I suggest that mandatory periodic information and mandatory information in connection with secondary public offerings might be less relevant to promote market efficiency than mandatory disclosure at the time of an initial public offer and that issuer-disclosure might be less important to increase market efficiency with respect to well-established issuers than with respect to smaller companies which are less followed by analysts and less actively traded.

It should be noted that another area of research is important with respect to information integration into price to increase market efficiency: it relates to how people search and process information and how they make investment decisions. This issue is addressed in the sections of this dissertation which relate to the advances of behavioural finance and the need for cost-efficient financial competence/education.[417]

b. Regulatory measures to decrease information costs

i Mandatory disclosure

If the regulator sets out the content and language of disclosure as well as the means of dissemination and storage with a view to have all relevant information about the issuer and its shares disclosed to the relevant addressees, this should *a priori* reduce costs

[417] See Part II:Chapter I:IV.B.2 in Chapter Investor Protection; Part II:Chapter II:III.B in Chapter Market Efficiency; Part III:Chapter I:III.E.4 in Chapter Issuer-Disclosure Addressees and Consequences.

relating to the acquisition of information by market actors and, in turn, increase price accuracy.[418]

Although the US academic community continues to be divided about the merits of mandatory disclosure to meet investors' demand of reduced transaction costs,[419] it is safe to say that the international securities regulatory practice has come down fairly unambiguously in favour of mandatory disclosure, due to its social benefits. As already suggested, it is believed that entrusting regulators with the power to set disclosure rules will preserve market confidence, strengthen sound competition and encourage economic growth.[420] Even though regulation is not costless, it is strongly asserted that its benefits will, as a general case, over-ride the anticipated costs.

ii The role of informed traders and information traders

The question of the (quick and accurate) reflection of information in the stock price has led academics to focus on the role of a sub-set of all market actors, i.e., the market professionals, like investment bankers, analysts or institutional investors,[421] in enhancing market efficiency.[422]

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[418] See however, EDMUND W. KITCH, *The Theory and Practice of Securities Disclosure*, 61 Brooklyn Law Review 763, (1995). (arguing that while regulators chase the goal of enhancing price accuracy, the laws enacted under this banner actually work to reduce the flow of information relevant to accurate pricing of securities).

[419] See against mandatory disclosure and for regulatory competition either among US states or across countries, Roberta Romano (ROBERTA ROMANO, *Empowering Investors: A Market Approach to Securities Regulation*, 107 The Yale Law Journal 2359, (1998).; ROBERTA ROMANO, *The Need for Competition in International Securities Regulation*, 2 Theoretical Inquiry L. 387, (2001).) and Stephen Choi (STEPHEN J. CHOI, *Regulating Investors Not Issuers: A Market-Based Proposal*, Calif. L. Rev. 279, (2000).) (pointing out to the pathology of legal rules (over and under – inclusiveness, legal indeterminacy etc) and their side effects (constraints on competition and innovation) as well as to the classical arguments that markets can efficiently respond to qualitative uncertainty, that investors are capable of making informed choices, that moral hazard or adverse selection problems are overstated), who follow the thoughts of, *inter alia*, George J. Stigler, George Benston, Henry Manne and Barbara Banoff. These studies purported to show that the US mandatory disclosure regime had no apparent beneficial effect on investment decision-making and instead simply layered unnecessary costs on the capital formation process. Implicit was the view that the same private forces that make the market efficient would also produce optimal disclosure.

[420] See Part I:VII.C in General Introduction for a full discussion of the pros and cons of mandatory disclosure.

[421] I call them "informed traders" and "information traders": see, for a full definition, Part III:Chapter I:II.B in Chapter Issuer-Disclosure Addressees and Consequences.

[422] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984). See also INGO WALTER, *The Global Asset Management Industry: Competitive Structure and Performance*, 8 Financial Markets, Institutions, and Instruments 1, (1998)., at 46 (arguing that mutual funds tend to make a disproportionate contribution to capital market liquidity); STEPHANE ROUSSEAU, *The Future of Capital Formation for Small and Medium-sized Entreprises: Rethinking Initial Public Offering*

Two things need to be pointed out in that respect:

The studies showing evidence of possible gains in securities markets support the view that this sub-set of market actors initially obtains new information on the basis of which it trades or issues investment advice which cause the price to reflect this new information.[423] They further suggest that this sub-set may be ultimately responsible for a substantial percentage of all transactions in securities markets. In other words, rapid price equilibration does not require widespread dissemination of information, but only a minority of knowledgeable market professionals who ultimately control a critical volume of trading activity.[424]

Besides, the positive impact of market professionals on market efficiency depends on the legal and economic incentives to disseminate information, once gathered and analysed, and/or to trade on it. In that respect, market professionals must enjoy some informational advantage that permits them to earn a proportionate return, as informed trading/financial advise is costly. This being said, given competition in the market for arbitrage and in the market for analysts' services, it is believed that the long-run returns of market professionals are not likely to exceed the market average by very much.[425]

In sum, in my opinion, any information that is accessible to significant portions of the market professionals' community is properly called "public", even though it manifestly is not, as such information is rapidly assimilated into price, with only minimal abnormal returns to its professional addressees.

This is the reason why I suggest to direct information primarily to these market professionals, i.e., people who have the actual capacity to trade on the information

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Regulation after the Restructuring of Canadian Stock Exchanges, 34 Revue Juridique Thémis 661, (2000)., at 710 (arguing that institutional investors contribute to market efficiency).

[423] See Part II:Chapter II:III.D in Chapter Market Efficiency.

[424] *Accord* EUGENE F. FAMA, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 The Journal of Finance 383, (1970)., at 388 (conceding that "the market may be efficient if "sufficient numbers" of investors have ready access to available information"); Richard A. Brealey, An Introduction to Risk and Return from Common Stocks 17 (2d ed. 1983).

[425] See the studies on mutual funds performed by, *inter alia*, MICHAEL C. JENSEN, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. Fin. 418, (1968)., at 415 (sampled mutual funds earned risk-adjusted net returns slightly below market average); NORMAN E. MAINS, *Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios: Comment*, 50 J. Bus. 371, (1977)., at 384 (reanalysing Jensen's data to show mutual fund returns, net of operating costs, roughly equal returns on market portfolio).

and/or who contribute to the dissemination of the information, with a view to reduce the costs associated with the processing of information.[426]

iii The role of properly regulated gatekeepers and a proper liability regime

Market gatekeepers, like investment banks, lawyers or auditors, play an important role in controlling the quality of information disclosed to the market.

A proper civil liability regime, to complement the criminal and public liability regime as well as the reputation sanctions, might also provide the necessary incentives to promote quality of disclosure.

Together, they contribute to decrease the information costs relating to the verification of issuer-disclosure. I refer the reader to the developments made in other chapters in those respects.[427]

c. Difficulties in assessing market efficiency

The ECMH suggests that stock price movements mirror a random walk,[428] and, as long as stock price movements are random, outguessing the market is not possible.

Whether or not the random walk moves around, away from, or stumbles into the correct price is another matter.

To evaluate this, we must look to an asset pricing model. In other words, it is not possible to directly test market efficiency as this requires, among other things, knowledge of the market's anticipated net operational cash flows and anticipated required rates of return for all future periods until liquidation of the issuer. Thus, the validity of the ECMH cannot be tested alone: every test of the ECMH also assumes some particular theory of what the "right" price for an asset is, i.e., the validity of the asset pricing model used. It implies each empirical test of the ECMH to also contain a

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[426] See Chapter Issuer-Disclosure Addressees and Consequences.

[427] See Part III:Chapter I:III.E.2 in Chapter Issuer-Disclosure Addressees and Consequences; Part II:Chapter III:II.E.3.d in Chapter Corporate Governance and Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets**.**

[428] The term was popularised by the 1973 book of Professor Malkiel. See BURTON G. MALKIEL, A Random Walk Dow Wall Street (7th ed.) (1999)., at 242-43 (stating that stock market prices evolve according to a random walk and thus the prices of the stock market cannot be predicted). Economists have historically accepted the random walk hypothesis. They have run several tests and continue to believe that stock prices are completely random because of the efficiency of the market.

test for an "*asset pricing model*".[429] If the proxy test yields abnormal evidence, this could mean that either the market is inefficient or the asset pricing model is incorrect (or both).[430]

Among the variety of asset pricing models that have been used recently, *R^2* is described as a good inverse proxy for how much fundamental information concerning future shareholder distributions is impounded in share prices. R^2, i.e., firm-specific stock return variation, became a commonly-used measure of share price accuracy. Though there is some controversy about the correct interpretation of the metric, the dominant view among R^2 adherents is that the greater a stock's firm-specific return variation is (that is the lower is the R^2), the more accurate is its price.[431]

Contrary to the objective of investor protection, the effectiveness of the EU issuer-disclosure regime could, as a matter of principle, be assessed against the objective of price accuracy enhancement. This analysis should of course have happened prior to the enactment of the directives examined in this dissertation. And it should definitively happen with respect to any proposed amendment to the Prospectus Directive, the Transparency Directive or the MAD.[432]

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[429] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984).; EUGENE F. FAMA, *Random Walks in Stock Market Prices*, 21 Fin. Analysts J., (1965)., at 55. See also the works of John Lintner, Sandford J. Grossman and Joseph E. Stiglitz.

[430] See JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at 787.

[431] See MERRITT B. FOX, et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, (2003). See also ARTYOM DURNEV, et al., *Does Greater Firm-Specific Return Variation Mean More or Less Informed Stock Pricing*, 41 J. Acct. Res. 797, (2003).; QI CHEN, et al., *Price Informativeness and Investment Sensitivity to Stock Price*, 20 Rev. Fin. Stud. 619, (2007).; ARTYOM DURNEV, et al., *Value-Enhancing Capital Budgeting and Firm-Specific Stock Return Variation*, LIX The Journal of Finance 65, (2004).; PHILIPP HARTMANN, et al., The Performance of the European Financial System (2006). (showing at chart 12 that since 2000, the euro area has incorporated on average more firm-specific information into stock prices than the U.K. or the U.S.). But see Kewei Hou et al., R^2 and Price Inefficiency, Fisher Coll. of Bus., Working Paper No. 2006-03-007, 2006 (finding a negative relationship between R^2 and overreaction-driven price momentum, suggesting a connection between R^2 and inefficiency, and citing to other working papers skeptical of a positive relationship to efficiency). The other measures include C^2, GAM, ILL, FERC and FINC. For a review of each of these measures, see ARTYUM DURNEV, et al., Required Line of Business Reporting and share price accuracy (2008). The CAPM which allowed sophisticated tests of the semi-strong and the strong forms of the ECMH is no longer considered an accurate account of market processes, as, among other things, it relies on the rational expectations assumption.

[432] See in that respect, EUROPEAN COMMISSION, Commission Staff Working Document accompanying the Proposal for a Directive amending the Prospectus Directive and the Transparency Directive – Impact Assessment (2009). (identifying investor protection, consumer confidence, reduction of administrative burden and legal certainty as possible objectives of the proposed reforms).

d. Assessment of the positive impact of issuer- disclosure on price accuracy

i An assessment relating to secondary public offerings and secondary markets

Whether there is any value relating to price accuracy in mandating periodic updates of the information contained in an offering document or in mandating a full-fledged offering document for any further issue of securities depends on how fast information contained therein is impounded in the share price. If the information is fully reflected in the share price *before* the subsequent disclosure is made, there is little point in requiring periodic disclosure or a full fledged secondary offering document. Costs would exceed benefits.

According to the ECMH, in an efficient market, information is likely to be impounded into price before it is released on secondary markets, through analysts and other market professionals' activities, like industry or firm specific reports, press releases etc., or through the disclosure prompted by the legal requirement for issuers to disclose price sensitive information. Consequently, periodic updates should not lead to significant price adjustment, if any. Hence, depending on the level of efficiency of a market, it could be the case that periodic updates would not be relevant for price accuracy enhancement on secondary markets and therefore, not relevant for investors. The same would apply to full-fledged disclosure documents for a secondary public offering of the same class of shares.

So much for the theory.

There is some empirical evidence that imposition of periodic disclosure requirements under the US Securities Exchange Act reduced price dispersion and improved resources' allocation.[433] These studies analyse the price impact of a change in

[433] For recent studies by well-known academics, see, *inter alia*, ARTYUM DURNEV, et al., Required Line of Business Reporting and share price accuracy (2008). (in connection with line of business reporting); MERRITT B. FOX, et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, (2003). (in connection with MD&A requirements); ALLEN FERRELL, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. Legal Stud. 213, (2007). (focusing on the 1964 regulatory imposition of mandated disclosure requirements on the over-the-counter market in terms of stock returns (positive abnormal returns), volatility (reduced) and stock price synchronicity (no change)).

the US securities regulation relating to periodic disclosure. I do not know of any comparable study in the E.U. which would assess legal changes in the EU issuer-disclosure regime and the extent to which they are reflected into prices.[434]

Other empirical studies examine the announcement effects that show abnormal returns on both transaction dates and announcement dates even if there is no overlap between the two dates, suggesting that *ad hoc* disclosure is of some value to the market and contain information that investors use in pricing issuers' shares.[435]

With respect to secondary public offerings, there is some evidence of negative impact of the US Securities Act on price dispersion.[436] I do not know of any comparable study in the E.U. which would assess legal changes in the EU issuer-disclosure regime and the extent to which they are reflected into prices.[437]

However, empirical evidence is not unanimous.[438] Some has been heavily debated and repeatedly challenged.[439]

More fundamentally, the appraisal of specific legal arrangements is often controversial.[440] The overall assessment of SOx is a case in point.[441] Some academics

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[434] See however European Central Bank, Financial Integration 2008, at 34 and chart 28 (including R^2 statistics which show that informational efficiency of stock markets in the euro area is comparable to the U.K. and the U.S.).

[435] See FINANCIAL SERVICES AUTHORITY, Disclosure of Contracts for Difference (2007)., at annex 3 (analysing the impact on share prices of a sample of major shareholdings notifications to the UK FSA in the period from January 2006 to August 2006); Deminor, Information financière et performance de l'entreprise, Seminar Van Ham & Van Ham, Brussels, 9 October 2008 (showing price effect of disclosure in compliance with EU issuer-disclosure regime concerning European companies).

[436] See JOHN C. COFFEE, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review, (1984)., note 48 and accompaying text (including references to the studies by Stigler, Benston, Jarrell, and Friend's which have been interpreted by proponents of mandatory disclosures as supporting the notion that mandatory disclosures improve investors' assessment of risky securities).

[437] See however European Central Bank, Financial Integration 2008, at 34 and chart 28 (including R^2 statistics which show that informational efficiency of stock markets in the euro area is comparable to the U.K. and the U.S.).

[438] See, for instance, in the US context, JENNIFER B. LAWRENCE, et al., *Empirical study: the SEC Form 8-K: full disclosure or fully diluted? The quest for improved financial market transparency*, 41 Wake Forest L. Rev. 913, (2006). (showing that the market has reacted to only two particular filings relating to Form 8-K (Item 4 (Change in Registrant's Accountant) and Item 12 (Results of Financial Condition and Operations)), substantiating the theory that the new real-time disclosure regime further to SOx has had the unintended effect of diluting financial information while desensitising market investors).

[439] On the challenges faced by findings from studies evaluating the early US securities regulation, see CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008). and references therein cited.

[440] See AMIR N. LICHT, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 Va.J.Int'l L. 563, (1998)., at 582-83 (pointing to the complexity of assessing law's merits and arguing that the interaction between different legal regimes in the cross-listing context renders accurate pricing of individual rules difficult).

concluded that "the existing literature shows that measuring firms' financial reporting and disclosure activities is difficult and that commonly used proxies exhibit many problems".[442]

Given on the one hand the theoretical implications of the ECMH and on the other hand the lack of unambiguous empirical support for the assertion that mandatory disclosure relating to secondary markets and secondary public offerings positively impacts price accuracy, it seems that mandatory periodic disclosure and mandatory disclosure relating to secondary public offerings is more relevant in less efficient secondary markets, like markets for less established issuers who are less followed by analysts. This truism is the basis for my suggestion to suppress periodic reports for well-established companies in an efficient market to replace them by a single-document-driven disclosure system.[443]

ii An assessment relating to IPOs

The fact that issuer-disclosure increases price accuracy at the time of IPOs is supported by empirical evidence which shows that primary markets with respect to IPOs are less efficient than secondary markets and the market for secondary offerings.

A large number of studies show that IPO stocks are offered at a "discount" in the sense that there is, on average, a significant jump from the offering price to the price at which they trade in the initial days or weeks after the offering.[444]

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[441] See CHRISTIAN LEUZ, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 Journal of Accounting & Economics 146, (2007). (cautioning that, in light of the existing evidence, the overall cost-effect of SOx with regard to US firms remains unclear).

[442] CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008).

[443] See Part III:Chapter II:II.D.1 and Part III:Chapter II:II.B.2 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[444] See, *inter alia*, the works of Jay R. Ritter. See for a recent study, PETER-JAN ENGELEN, et al., *Underpricing of IPOs and Legal Frameworks around the World*, 4 Review of Law and Economics, (2008). See also for a summary of the studies for the Canadian market, STEPHANE ROUSSEAU, *The Future of Capital Formation for Small and Medium-sized Entreprises: Rethinking Initial Public Offering Regulation after the Restructuring of Canadian Stock Exchanges*, 34 Revue Juridique Thémis 661, (2000)., at 676. For the view that managers take advantage of market over-valuation to tap the equity markets, both with IPOs and equity offerings by well-established issuers, see *MALCOLM BAKER, Behavioral Corporate Finance: A Survey, in Handbook of Corporate Finance: Empirical Corporate Finance, (Espen Eckbo ed., 2007).*, at 164-65 and other references cited in WILLIAM W. BRATTON, et al., *The Case Against Shareholder Empowerment*, 158 University of Pennsylvania Law Review, (2010)., at 36.

Several explanations have been put forward, but the most recognition has been given to ones involving information asymmetry.[445] Particular attention has been paid in the literature to a model developed by Kevin Rock in which there are three kinds of actors - issuers (and their underwriters), uninformed investors, and informed investors - with the informed investors better able to determine the actual value of newly offered shares than the other two.[446] New shares are allocated in a process in which orders are placed by investors for a given number of shares at the offering price. The uninformed investors suffer from adverse selection because they cannot separate the good deals from the bad ones and thus order equal amounts of each.[447] They get a larger portion of the offerings for the bad deals because the informed investors do not place orders for them. In order to attract capital from the uninformed investors, IPOs need to be under-priced so that despite the adverse selection, these investors will earn a market rate of return on average. This model, and variants of it working on similar themes, have received considerable empirical support.[448]

The empirical work supporting the information asymmetry explanation of the discount shows that issuers about which more is known can offer their shares at a lower discount. This would suggest that, costs aside at least, issuers have an interest in being under a regime that assures a high level of disclosure at the time of IPO.

Consequently, price accuracy enhancement should be considered to be an effective goal of disclosure relating to an IPO.

iii An assessment relating to well-established companies as opposed to smaller companies

As small firms, whose shares are not actively traded, are not well followed by analysts and other market professionals, not much information is available about them on public markets except the information provided by the issuer himself. Therefore, price

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[445] See review of academic literature in Elisabeth Fonteny, Etude: la performance des introductions en bourse: revue de la littérature et application empirique à la France et au Royaume-Uni, in French AMF, Economic and Financial Newsletter, Winter 2008, at 7 et seq.; JANET COOPER ALEXANDER, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. Rev. 66, (1993).; ALEXANDER LJUNGQVIST, *IPO Underpricing*, *in* Handbook of Empirical Corporate Finance, (B. E. Eckbo ed., 2004)., at 375 et seq.

[446] See EDWARD ROCK, *Why New Issues Are Underpriced*, 15 J. Fin. Econ. 187, (1986).

[447] See LAWRENCE GLOSTEN, et al., *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 Journal of Financial Economics 71, (1985).

[448] See, *inter alia,* JAY R. RITTER, *The "Hot Issue" Market of 1980,* 57 J. Bus. 215, (1984).

accuracy is a more effective objective of issuer-disclosure for small companies than for larger companies whose securities are actively traded and widely followed by market intermediaries.[449] The amount of mandatory information that should be supplied to the market should vary inversely with the amount of information actually available and disseminated by analysts and other market professionals. This being said, there needs to be a trade-off given the limited resources of smaller companies.

The distinction between well-established issuers and the others makes the basis of the discussion in Part III relating to the design of a specific and less burdensome disclosure regime for those issuers whose shares are actively traded and widely followed on efficient markets, along the lines of the US regime.[450]

C. Liquidity and the Role of Issuer-Disclosure

1. Preliminary remark

Next to price accuracy, liquidity is the second component of market efficiency and is very much important for the economy.[451]

Briefly stated, a market is liquid when traders can buy or sell large quantities, with little uncertainty about the timing and settlement of the trades, without causing substantial price effect.

If it could be contested that stock prices always influence the allocation of capital to firms, it is beyond question that they always determine the terms at which investors trade stock among themselves.

If stocks are inaccurately priced, investors could anticipate trading on unfavourable terms, which may lead them to be reluctant to trade and therefore reduce liquidity.

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449 *Accord* JEFFREY N. GORDON, et al., Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U.L.Rev. 761, (1985)., at 810-11.

450 See Part III:Chapter II:II.B and Part III:Chapter II:II.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

451 For a discussion on how liquidity affects the required returns of capital assets and the empirical studies that test these theories, see, *inter alia*, YAKOV AMIHUD, et al., *Liquidity and Asset Prices*, 1 Foundations and Trends in Finance 269, (2005).

But apart from its indirect impact on liquidity through price accuracy, issuer-disclosure directly positively impacts liquidity by its impact on transaction costs, on cost of capital and on resource allocation.[452]

As the case for the positive impact of issuer-disclosure on liquidity is pretty straight-forward, this requires less developments than the case for issuer-disclosure to increase price accuracy. This is the reason why this section is shorter than the previous one.

2. Link between secondary market disclosure and reduction of transaction costs

As shown by empirical evidence, secondary market disclosure has a positive effect on liquidity by reducing the amount of non-public information and hence information asymmetries between insiders and outsiders, reducing in turn transaction costs.[453]

Disclosure reduces the opportunities for insiders to engage in trades based on non-public information which provide them with supra-normal profits, as it will become more expensive and harder for traders to become privately informed.[454]

Consequently, secondary market disclosure helps reduce transaction costs of market makers, as it reduces the bid/ask spread. The bid/ask spread is the way market makers protect themselves against information asymmetry. Stated otherwise, it is the extent to which the price at which they accept buy orders exceed the price at which they

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[452] See RONALD J. GILSON, et al., *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549, (1984)., at 554; ROSS LEVINE, *Financial Development and Economic Growth: Views and Agenda*, XXXV Journal of Economic Literature 688, (1997)., at 692; TARUN CHORDIA, et al., *Liquidity and Market Efficiency*, 87 Journal of Financial Economics 249, (2008).; CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008). (and references therein cited, *inter alia*, ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 Journal of Accounting and Economics 97, (2001).).

[453] See, for a discussion of disclosure further to accounting rules, EMAD MOHD, *Accounting for Software Development Costs and Information Asymmetry*, 80 The Accounting Review 211, (2005).; CHRISTIAN LEUZ, et al., *The Economic Consequences of Increased Disclosure*, 38 The Journal of Accounting Research 91, (2000).; ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 Journal of Accounting and Economics 97, (2001). See, for a discussion of consequences of institutional or blockholder ownership as well as insider ownership on bid-ask spread, ATULYA SARIN, et al., Ownership structure and stock market liquidity (1999).; FRANK HEFLIN, et al., *Blockholder ownership and market liquidity*, 35 Journal of Financial and Quantitative Analysis 621, (2000).; MICHAEL WELKER, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 Contemporary Accounting Research 801, (1995).

[454] The relationship between firm disclosure and insider trading profits is not necessarily negative though. See ROBERT BUSHMAN, et al., *Voluntary Disclosures and the Trading Behavior of Corporate Insiders*, 33 Journal of Accounting Research 293, (1995).

accept sell orders. The bigger the spread, the less liquid are the issuer's shares.[455] The lower the bid/ask spread, the more liquid is the stock market as uncertainty about firm value is reduced.

In addition, liquid markets provide indirect benefits by facilitating profitable informed trading, thereby contributing to increased price accuracy. More liquidity lowers the transaction costs associated with speculative trading based on acquiring a variety of bits of publicly available information and analysing them to make more accurate predictions of an issuer's cash flows. Informed traders make more money when they can trade with little price impact than when their trades move prices. They then can afford to collect more information about fundamental values and they can profitably trade on information of lesser significance than they otherwise would. Thus liquidity stimulates profitable informed trading and in the process increases share price accuracy. Hence, disclosure's enhancement of liquidity provides a way to improve share price accuracy, with the attendant social benefits.

3. Link between secondary public offering disclosure and reduction of cost of capital and better resource allocation

Increased liquidity, through increased disclosure, also impacts the market for secondary public offerings.

A lower expected spread, as a result of secondary market disclosure, lowers the cost of capital for issuers of secondary public offerings in primary markets in two ways: investors will be less demanding of a higher dividend to be paid by issuers as they will consider their investment to be less risky and the offering price paid by investors to the issuer will be higher.

Substantial evidence suggests a positive correlation between the liquidity of an asset and its price, as actors must be compensated with a lower price for purchasing an asset that is difficult to sell.[456] When an issuer offers shares in the primary market, the

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[455] See LAWRENCE GLOSTEN, et al., *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 Journal of Financial Economics 71, (1985).; MARCEL KAHAN, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 Duke L. J. 977, (1992)., at 1019-22; YAKOV AMIHUD, *Illiquidity and Stock Returns: Cross-Section and Time Series Effects*, 5 J. Fin. Markets 31, (2002).; LAWRENCE R. GLOSTEN, et al., *Estimating the components of the Bid/Ask Spread*, 21 J. Fin. Econ. 123, (1998).; HAROLD DEMSETZ, *The Cost of Transacting*, 82 Q.J. Econ. 33, (1968).

[456] See references in ROSS LEVINE, *Financial Development and Economic Growth: Views and Agenda*, XXXV Journal of Economic Literature 688, (1997)., at 712. See also NICOLAI GARLEANU, et

larger investors anticipate the spread in the future, the lower the price at which the issuer can sell the shares. Hence the issuer's cost of capital will be higher because the prospect of a larger bid/ask spread results in the same issuer expected future cash flow being discounted to present value at a higher discount rate.

Increased liquidity enhances social welfare through improved rewards to saving and entrepreneurship. Conversely, illiquid markets decrease the amount of savings supplied and lower entrepreneurial activity as cost of capital increases and thus dries out investment opportunities which can only be sold for a high price.[457]

V. Conclusions

Price accuracy and liquidity, the two components of market efficiency, are important for their positive impact on the overall economy: they contribute to reduce transaction costs and cost of capital and positively affect resource allocation. It is therefore important to promote market efficiency.

I contended in this chapter that issuer-disclosure effectively improves market efficiency, by positively impacting price accuracy, at least with respect to initial public offerings and smaller companies, and by increasing liquidity on secondary markets and with respect to secondary public offerings.

It should be noted that enhancement of price accuracy, as major component of market efficiency and the major focus of this chapter, and reduction of agency problems, the subject of Chapter Corporate Governance, are inseparable purposes. In other words, a valuation decision of a stock is impossible without an assessment of the risk that controlling parties or management will divert to themselves the otherwise expected stream of earnings.

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al., *Adverse Selection and the Required Return*, 17 Review of Financial Studies 643, (2004).; ROBERT E. VERRECCHIA, *Essays on Disclosure*, 32 Journal of Accounting and Economics 97, (2001).; MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at 32-33. See also, DAVID EASLEY, et al., *Information and the Cost of Capital*, 59 Journal of Finance 1553, (2004).; LUZI HAIL, et al., Cost of Capital and Cash Flow Effect of U.S. Cross Listings (2005).; HANS STOLL, et al., *Transaction costs and the small firm effect*, 12 Journal of Financial Economics 57, (1983). and YAKOV AMIHUD, et al., *Asset pricing and the bid-ask spread*, 17 Journal of Financial Economics 223, (1986).

457 See LARRY HARRIS, Trading & Exchanges: Market Microstructure for Practitioners (Oxford University Press. 2003).

Chapter III: Corporate Governance

I. Introduction

A. Some General Thoughts on Ownership Structures and Related Agency Costs

In the economic literature on agency costs,[458] it is commonly said that, in some companies around the world, share ownership is separate from managerial control.[459] Where this is the case, the firm's nominal owners, i.e., the shareholders (termed the principals), exercise virtually no control over either day to day operations or long-term policy. Instead, control is vested in the board of directors and in the managers to whom the board delegates authority (together the "management" or the "managers", also termed the agent),[460] which typically does not own more than a small portion of the company's shares. This situation reflects a pattern of *dispersed ownership*.

In contrast, most companies around the world present a *concentrated ownership* structure.[461] Although the literature on corporate ownership does not usually make an explicit differentiation between the various types of concentrated ownership structures, it is important to distinguish between three of them. Either control lays with one single shareholder, i.e., an "owner" who is then said to "run" the company.[462] Or one or

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[458] See definition below.

[459] In the Berle-Means tradition (see note 471 below and accompanying text), and for the sake of brevity, when one distinguishes between "ownership" and "control", "ownership" generally refers to rights to income streams, while "control" refers to governance/power rights/rights to allocate resources and conclude contracts. By contrast, the use of the term under property law generally encompasses both rights. See also, EUGENE F. FAMA, et al., *Separation of Ownership and Control*, 26 Journal of Law and Economics 301, (1983).

[460] For a view that executive officers/managers and directors should not be conflated under one single concept, as directors have incentives to control managers that work tolerably well, like equity-based compensation, market for corporate control or risk of litigation, see STEPHEN M. BAINBRIDGE, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment,* 119 Harv. L. Rev. 1735, (2007).

[461] It is relevant to note that the U.S. counts many blockholders although the working hypothesis in academia was, and is still, the opposite. Comp. CLIFFORD G. HOLDERNESS, *Myth of Diffuse Ownership in the United States*, 22 Review of Financial Studies, Forthcoming 1377, (2009). and AVIV PICHHADZE, *The Nature of Corporate Ownership in the US: The Trend Towards the Market Oriented Blockholder Model*, 5 Capital Markets Law Journal, (2010). with LUCIAN A. BEBCHUK, et al., *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan L. Rev. 127, (1999).

[462] His shareholding will be typically in excess of 50.1% of the firm's outstanding shares.

several large shareholder(s)/owner(s) have substantial influence on corporate decisions but not a complete lock on control.[463] These large shareholder(s) who make(s) control difficult to contest without making it *de facto* undisputable is/are commonly referred to as “blockholder(s)”. Or control may lay with “controlling minority shareholders”, who own only a minority of the company’s cash flow rights but control a majority of the votes and thus have a lock on control, through the use of dual-class stock, corporate pyramids or cross-holdings.[464] In all scenarios of concentrated ownership, the principals are the shareholders who have a too little voting power to influence corporate decisions (referred to as the “minority shareholders”) whereas the controlling shareholder, the minority controlling shareholder(s) or the blockholder(s) act as agent(s). For the sake of clarity, I use the term “controlling party” to refer to a controlling shareholder, a controlling minority shareholder or controlling blockholders, where no distinction between the concepts is required.

The relationship between principal and agent (management or controlling party) could give rise to conflicts where the agent seeks to run the company and to use its assets for its own personal benefit rather than those of the (minority) shareholders.

In a widely-held company, management is typically not the residual claimant to the firm’s income stream. Therefore, it could easily be tempted to act in its own interest while, because of the collective action and the free rider problems, dispersed shareholders, each holding a tiny portion of corporate capital, have no incentives to monitor the management they have mandated to run the company.

In a company with concentrated ownership, the controlling party, by either directly managing the company by being on the board or indirectly managing the

[463] Following La Porta et al., a large owner is a shareholder which directly or indirectly controls at least 10% of the voting rights. See RAFAEL LA PORTA, et al., *Corporate Ownership Around the World*, 54 The Journal of Finance 471, (1999). See section 13(d) of the US Securities Exchange Act, setting the disclosure filing requirement at 5%. See also AVIV PICHHADZE, *The Nature of Corporate Ownership in the US: The Trend Towards the Market Oriented Blockholder Model*, 5 Capital Markets Law Journal, (2010). (suggesting that blockholder ownership represents ownership levels between 5 and 50% of the firm’s outstanding shares). Comp. with article 9 of the Transparency Directive, setting the threshold at 5% to disclose major shareholding in European listed companies. In any case, the line should be flexible as the threshold may be lower for very large companies for the purposes of influencing management.

[464] See LUCIAN A. BEBCHUK, et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights*, *in* Concentrated Corporate Ownership, (Randall Morck ed., 2000).; MARA FACCIO, et al., *The Ultimate Ownership of Western European Corporations*, 65 J.Fin. Econ. 365, (2002).

company by appointing directors on the board, could have the ability to influence corporate decisions in its sole favour.[465] He could thus expropriate corporate resources and extract private benefits for its own account and to the detriment of other shareholders. As diversion reduces dividends and may entail other costs as well, a controlling party could be incited to divert corporate resources for its own private gain only when its cash flow rights are small enough. The lack of alignment between cash-flow rights and control rights is rather common in structures with a controlling party to make this possible to happen. Everything that a controlling party could get out of its position without minority shareholders receiving a proportionate share is referred to as "private benefits of control".[466] The existence of private benefits of control is illustrated, for example, by the fact that some sales of large blocks of shares occur at significant premia.[467] Private benefits of control result both in a less transparent market and over-payments to the controlling party to the detriment of minority shareholders.[468]

The tensions between principals and agents are referred to by economists as "*agency problems*" or "principal-agent" problems. They are opportunistic behaviours

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[465] Numerous academic papers show that directors are usually accountable and "loyal" to controlling shareholders. See, *inter alia*, PAOLO VOLPIN, *Governance with poor investor protection: Evidence from top executive turnover in Italy*, 64 Journal of Financial Economics 61, (2002).

[466] See for more precise definitions, KARL HOFSTETTER, *One Size Does Not Fit All: Corporate Governance for 'Controlled Companies'*, 31 N.C.J. Int'l L. & Com. Reg. 597, (2006)., at 617; ALLEN FERRELL, The Case for Mandatory Disclosure in Securities Regulation Around the World (2004)., at 12; I.J. ALEXANDER DYCK, et al., Private Benefits of Control: An International Comparison (2002)., at 6 et seq.; SIMON JOHNSON, et al., *Tunnelling*, 90 Am. Econ. Rev. 22, (2000).; ANDREI SHLEIFER, et al., *A Survey of Corporate Governance*, 52 The Journal of Finance 737, (1997). See also SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 Journal of Financial Economics 430, (2008). (for a survey of existing literature on self-dealing).

[467] For studies measuring the private benefits of control (control premium) from the market pricing of shares with superior voting rights and from the treatment of controlling shareholders in a take-over, see STEEN THOMSEN, et al., *Blockholder ownership: Effects on firm value in market and control based governance systems*, 12 Journal of Corporate Finance 246, (2006)., at 248 et seq.; MICHAEL J. BARCLAY, et al., *The law and large block trades*, 35 Journal of Law and Economics 265, (1992).; JOSÉ F. CORREIA GUEDES, et al., Are European Corporations Fleecing Minority Shareholders? Results From a New Empirical Approach (2002).; LUCIAN A. BEBCHUK, A Rent-Protection Theory of Corporate Ownership and Control (1999). For a recent study considering the issue of governance when cash flow rights and voting rights are separated, see PAUL A. GOMPERS, et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, Review of Financial Studies, (2009).

[468] See EUGENE FAMA, et al., *Agency problems and residual claims*, 26 Journal of Law and Economics 327, (1983).; RANDALL MORCK, et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 Journal of Financial Economics 293, (1988).; ANDREI SHLEIFER, et al., *A Survey of Corporate Governance*, 52 The Journal of Finance 737, (1997).

arising from the divergence of interests among participants in the firm.[469] The term "agency problem" derives from the economic literature and has by no means a strict legal meaning.

The costs of resolving agency problems are known as "agency costs".[470]

Because the agent has generally better information than does the principal, the principal cannot, without enduring costs, assure himself that the agent's performance is precisely what was expected.[471] Not only information asymmetry but also contract incompleteness are central features of the problem. Contract incompleteness refers to the fact that it is impossible to write in a comprehensive contract the obligations of each party for the lifetime of the relationship, as the future prevailing circumstances are not known at the time of execution of the contract.[472] Moreover, coordination costs faced by multiple principals inhibit their ability to engage in collective action, thereby exacerbating agency problems.[473]

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[469] See OLIVER WILLIAMSON, The Economic Institutions of Capitalism (The Free Press. 1985). (using the term "opportunism" to refer to self-interested behaviour that involves some element of deception, misrepresentation or bad faith). In economics, this is referred to as an opportunity cost, i.e., the value of the next best use of the same resources.

[470] For the first works on agency costs in dispersed ownership structures, see Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (1776); Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property (New York: Harcourt, Brace & World, [1932] 1968) and MICHAEL C. JENSEN, et al., *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J.Fin. Econ. 305, (1976)., at 354-55.

[471] See PAUL M. HEALY, et al., *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, Journal of Accounting and Economics 405, (2001)., at 407.

[472] See in that respect the works by Coase, Williamson, Klein, Crawford and Alchian and Grossman and Hart.

[473] See JOHN ARMOUR, et al., *Agency Problems, Legal Strategies, and Enforcement*, *in* The Anatomy of Corporate Law: A Comparative and Functional Approach, (Oxford University Press ed., 2009). and references therein cited.

B. Definition of Corporate Governance under Agency Theory

In this dissertation, I take *corporate governance from the angle of agency theory*,[474] even though it has received other definitions in the literature:[475] it is a matter of motivating the agent to act in the principals' interest rather than simply in its own interest. How does one minimise the loss of value due to conflicts of interests? In other words, I consider that corporate governance is concerned with how (equity) investors can assure themselves of earning a return which is commensurate with the risks they agree to bear.[476] I therefore focus in this dissertation on the relationship between (minority) shareholders and the company they have invested in, represented by the management or the controlling party depending on the share ownership structure.

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[474] See the definition suggested by US academics and, *inter alia*, *JONATHAN R. MACEY*, *Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008).*, at 1 ("[t]he purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors"); SANJAI BHAGAT, et al., *The Promise and Peril of Corporate Governance Indices*, 110 Columbia Law Review, (2008)., at 6 ("[t]he panoply of mechanisms by which managers are incentivized and/or constrained to act in the shareholders' interest constitute a firm's corporate governance."). Comp. with European academics who are more concerned about the relationships between controlling shareholder and minority shareholders, given the concentrated ownership structures in most Continental European listed companies (see Part II:Chapter III:II.C below), including, *inter alia*, MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007). ("[i]n a nutshell, the fundamental issue concerning governance by shareholders today seems to be how to regulate large or active shareholders so as to obtain the right balance between managerial discretion and small shareholder protection").

[475] See, *inter alia*, ALESSIO M. PACCES, Zeggenschap van bestuurders in de schijnwerpers - de economische analyse van het ondernemingsrecht herzien (2008) Erasmus Universiteit Rotterdam)., at 39-42; 149-206 and 331 (considering that corporate governance is not only about investor protection through the reduction of agency problems but also about supporting control powers vested in managers and controlling shareholders); ALESSIO M. PACCES, Why Investor Protection is Not All that Matters in Corporate Law and Economics (2008). Corporate governance could also be concerned by the relationship between other constituencies than the issuer, its management and its shareholders. See for broader definitions, including multi-principals (shareholders, creditors, suppliers, clients, employees and other parties with whom the CEO has relationships on behalf of the company) or even multi-agents, MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 842 and references therein cited. For researches relating to worker protection and creditor protection, see, *inter alia*, MATHIAS M. SIEMS, et al., *Comparative Law and Finance: Past, Present and Future Research*, Journal of Institutional and Theoretical Economics, (2010 (forthcoming)).; MATHIAS M. SIEMS, Convergence in Corporate Governance: A Leximetric Approach (2009). and references therein cited; JILL SOLOMON, Corporate Governance and Accountability (John Wiley & Sons 2nd ed. 2007)., at 13 et seq. and references therein cited.

[476] See ANDREI SHLEIFER, et al., *A Survey of Corporate Governance*, 52 The Journal of Finance 737, (1997). (defining corporate governance as "the ways suppliers of finance to corporations assure themselves of getting a return of their investment"). This definition has been endorsed by, *inter alia*, the European Association of Securities Dealers in Corporate Governance – Principles and Recommendations (Brussels, EASD, 2000).

For the purposes of this dissertation, I consider corporate governance mechanisms as aiming at reducing agency problems. In that respect, they could impact the way corporate decisions are made. Supervision by the auditors and by credit-rating agencies,[477] appointment of non-executive/independent[478] or "dissident"[479] directors on the board of directors, discipline imposed by, *inter alia*, the market for corporate control,[480] equity-based remuneration package[481] or the supervisory authorities are generally cited as illustrations of mechanisms of corporate governance to reduce agency problems.

Corporate governance mechanisms are classified either as firm-level/internal governance mechanisms, i.e., mechanisms that operate within the firm, like the board of directors, or as country-level governance mechanisms which include a country's laws, its culture and norms, and the institutions which enforce the laws, like the market for corporate control. I chose to discuss two particular internal corporate governance devices for which disclosure has much importance: shareholder vote and shareholder monitoring rights.[482]

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[477] *Contra* see JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008). (considering that credit rating agencies are no effective corporate governance device).

[478] See VALENTINA BRUNO, et al., *Corporate governance and regulation: can there be too much of a good thing?*, Journal of Financial Intermediation (forthcoming), (2007). (reviewing the mixed literature and evidence on the link between board independence and performance). The use of independent directors on the boards of concentrated companies could serve as a means to have the views of the minority shareholders taken seriously, where the independent directors duly fulfil the task they have been appointed for, but independent directors could also represent the controlling parties. This would not serve to reduce agency costs. See, for instance, GIFTY AGBOTON, et al., Do Codes of Corporate Governance Really Improve Board Effectiveness in Continental European Countries? Empirical Evidence from the Belgian Case (2009). On the trade-off between board independence and firm-specific expertise, which is necessary to certify and supervise certain disclosures, see, *inter alia*, YURI BIONDI, et al., Financial disclosure and the board: does independent directors always fit? (2009). and the references therein cited. See the numerous references cited in LUCIAN A. BEBCHUK, et al., The State of Corporate Governance Research (2009).

[479] *Contra* JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 90 (considering in a dispersed ownership context that dissident directors are not an effective corporate governance tool).

[480] But see Part II:Chapter II:IV.B.2.c.iib in Chapter Market Efficiency for a view that the market for corporate control could not serve as effective corporate governance tool.

[481] But see Part II:Chapter II:IV.B.2.c.iic in Chapter Market Efficiency for a view that equity-based compensation could not serve as effective corporate governance tool.

[482] For a view that increasing shareholders' rights (i.e., the shareholder democracy/shareholder empowerment doctrine) is not an effective/efficient solution to agency costs, whereas board governance/power is, see the works of Professors Lynn Stout, Iman Anabtawi and Stephen Bainbridge, including STEPHEN M. BAINBRIDGE, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 Harv. L. Rev. 1735, (2007).; LYNN A. STOUT, *The Mythical Benefits*

C. Importance of Corporate Governance as Objective of an Issuer-Disclosure Regime

1. Preliminary remark

It could be argued that issuer-disclosure which positively impacts price accuracy is relevant to corporate governance as it indirectly reduces agency costs by restraining management from manipulating share prices. To that extent, it could be said that the distinction between the two functions - market efficiency and corporate governance enhancement - has little significance.[483]

However, whilst there are corporate governance benefits in increased price accuracy, it is possible to identify a corporate governance-oriented role for issuer-disclosure which is distinct from the impact of issuer-disclosure on share price accuracy. For instance, the European recommendation that listed companies yearly disclose the compensation of individual directors, in addition to disclosing the total remuneration, has certainly been thought to counter a perceived agency problem rather than to enhance price efficiency.[484]

2. Importance of corporate governance

It is worth focussing on the relationship between issuer-disclosure and corporate governance as corporate governance is said to *positively impact shareholder value*, as proxy of firm value, by reducing agency costs.[485]

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of Shareholder Control, 93 Va. L. Rev. 789, (2007).; IMAN ANABTAWI, et al., *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255, (2008).

[483] In the opposite direction, Professor Paul Mahoney promoted an approach advocating agency problem-oriented disclosure regimes. See PAUL MAHONEY, *Mandatory Disclosure as a Solution to Agency Problems*, 62 The University of Chicago Law Review 1047, (1995).

[484] See article 5.3 of the first set of Remuneration Recommendations. Disclosure of remuneration takes place either in the annual accounts, or in the notes to the annual accounts or in a separate remuneration statement. Comp. with US directors' pay disclosure requirement which is more or less identical, SEC Reg. S-K, Item 402.

[485] Much of the literature has focussed on differences between countries' legal systems and has studied how such differences relate to differences in how economies and capital markets perform. See, *inter alia*, LUZI HAIL, et al., *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 Journal of Accounting Research 485, (2006).; SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 Journal of Financial Economics 430, (2008).; HOWELL E. JACKSON, et al., *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 Journal of Financial Economics 207, (2009).; ANDREI SHLEIFER, et al., *Investor Protection*

Some academics have established a method of assessing the quality of a firm's corporate governance, so-called "indices" or "ratings", to predict corporate performance and to be used to inform investment and corporate decisions.[486]

There is *however* a heated academic debate about methodology and about the measure for firm performance or the factors that have to be taken into account to

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and Equity Markets, 66 Journal of Financial Economics 3, (2002). (finding that firms are larger, more valuable and more plentiful, dividends are higher (and shareholder expropriation lower), ownership concentration is lower, and stock markets are more developed in countries with better protection of shareholders); MANUEL AMMANN, et al., Corporate Governance and Firm Value: International Evidence (2009). (based on evidence including evidence from the jurisdictions under consideration in this dissertation, finding strong and positive relation between firm-level corporate governance and firm valuation; see also references therein cited); Renato Grandmont, Gavin Grant, Flavia Silva, Deutsche Bank Research : Beyond the numbers: corporate governance implications for investors (2004); K.J. MARTIJN CREMERS, et al., *Governance Mechanisms and Equity Prices*, 60 Journal of Finance 2859, (2005).; STEFAN BEINER, et al., *An integrated framework of corporate governance and firm valuation*, 12 European Financial Management 249, (2006).; DAVIDE LOMBARDO, et al., *Legal Determinants of the Return on Equity*, *in* Convergence and Diversity, (Joseph McCahery ed., 2002). For surveys, see, *inter alia*, DIANE K. DENIS, et al., *International Corporate Governance*, 38 Journal of Financial and Quantitative Analysis 1, (2003).; MARCO BECHT, et al., *Corporate Governance and Control*, *in* Handbook of the Economics of Finance, (G.M. Constantinides, et al. eds., 2002). Given the magnitude of firm-level differences in governance, literature on international comparisons started to look beyond cross-country and to investigate firm-level differences. See, for instance, VIDHI CHHAOCHHARIA, et al., *Corporate Governance, Norms and Practices*, Journal of Financial Intermediation (forthcoming), (2009).; REENA AGGARWAL, et al., Did New Regulations Target the Relevant Corporate Governance Attributes? (2006).; REENA AGGARWAL, et al., *Differences in governance practice between U.S. and foreign firms: measurement, causes, and consequences*, 22 Review of Financial Studies 3131, (2009). (finding that the market rewards companies that are prepared to adopt governance attributes beyond those required by laws and common corporate practices in the home country); LAWRENCE D. BROWN, et al., *Corporate Governance and Firm Operating Performance*, 32 Rev. Quant. Finan. Acc. 129, (2009).; ENRIQUE FERNÁNDEZ RODRÍGUEZ, et al., *The Stock Market Reaction to the Introduction of Best Practices Codes by Spanish Firms*, *in* Corporate Governance: An International Review, 2009).; WOLFGANG DROBETZ, et al., *Corporate governance and expected stock returns: evidence from Germany*, 10 European Financial Management 267, (2004).; JOSEPH A. MCCAHERY, et al., *Role of Corporate Governance and Enforcement in The Netherlands*, *in* Perspectives in Company Law and Financial Regulation - Essays in Honour of Eddy Wymeersch (Michel Tison, et al. eds., 2009). See also LUCIAN A. BEBCHUK, et al., *The Elusive Quest for Global Governance Standards*, 157 University of Pennsylvania Law Review 1263, (2009). (contrary to previous work developing and employing a single global standard for making either country-level or firm-level comparisons, suggesting to develop separate standards for evaluating governance in firms with and without a controlling shareholder).

[486] See, *inter alia*, PAUL A. GOMPERS, et al., *Corporate Governance and Equity Prices*, Quarterly Journal of Economics 107, (2003). (finding that from 1990 to 1998 investors long on companies with good governance and short on companies with bad governance (as measured by an index they construct) would have earned abnormal returns of 8.5% on average per year.); LUCIAN A. BEBCHUK, et al., *What Matters in Corporate Governance?*, 22 Review of Financial Studies 783, (2009). See also LUTGARD VAN DEN BERGHE, et al., *Evaluating Boards of Directors: What Constitutes a Good Corporate Governance Board?*, 12 Corporate Governance: An International Review 461, (2004). See on the influence of governance ratings generally, THUY-NGA T. VO, *Rating Management Behavior and Ethics: a Proposal to Upgrade the Corporate Governance Rating Criteria*, 34 The Journal of Corporation Law 101, (2008).

compute the corporate governance indices. Consequently, some heavily caution about the ability of corporate governance ratings in predicting corporate performance.[487]

There is as well few counter-evidence showing a lack of correlation, or a limited impact, between corporate governance and shareholder value.[488]

In essence, the studies of opponents of a strong link between good corporate governance and shareholder value show that it is difficult to assess perfectly and accurately corporate governance rules to have them reflected into prices. Besides, it would be good to have more empirical studies on a large scale in Europe which assess the price impact of the actual compliance with corporate governance codes and regulatory provisions imposed on European companies.[489]

If there is no clear evidence of an indisputable overall positive effect of disclosures and corporate governance practices on market returns in general, it is

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[487] See, *inter alia*, SANJAI BHAGAT, et al., *The Promise and Peril of Corporate Governance Indices*, 110 Columbia Law Review, (2008). (arguing that existing indices fail to capture the diverse ways in which governance operates in firms as good corporate governance is context-specific); KENNETH LEHN, et al., *Governance Indices and Valuation Multiples: Which Causes Which?*, 13 Journal of Corporate Finance, (2007). (investigating the issue of causality concerning Gomper's finding of a correlation between governance and performance and arguing that causation runs from performance to governance and not the other way around); THUY-NGA T. VO, *Rating Management Behavior and Ethics: a Proposal to Upgrade the Corporate Governance Rating Criteria*, 34 The Journal of Corporation Law 101, (2008). (explaining the disconnect between governance rating criteria and corporate performance by the lack of evaluation of the behaviour and ethics of the management group); JOHN E. CORE, et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. Fin. 655, (2006).

[488] For a survey book, see JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008). See also, *inter alia*, NUNO G. FERNANDES, Board Compensation and Firm Performance: The Role of 'Independent' Board Members (2005).; DAVID F. LARCKER, et al., How Important is Corporate Governance? (2005).; ROBERTA ROMANO, *Less Is More: Making Shareholder Activism A Valued Mechanism Of Corporate Governance*, 18 Yale J. Reg. 18, (2001). (observing that "the empirical studies suggest that [activism by institutions] has an insignificant effect on targeted firms' performance. Very few studies find evidence of a positive impact, and some even find a significant negative stock price effect from activism"); STUART L. GILLAN, et al., The Evolution of Shareholder Activism in the United States (2007).; DIANE DENIS, *Twenty-Five Years of Corporate Governance Research…and Counting*, 10 Review of Financial Economics 191, (2001). (concluding that there is some evidence that outside blockholders and other activist shareholders have an impact on firm actions but little evidence that they do on firm performance).

[489] Comp. CAROL PADGETT, et al., The UK Code of Corporate Governance: Link Between Compliance and Firm Performance (2005). (concluding from the study they perform on listed companies in the U.K. that compliance matters for investors, not only as box ticking exercise but as a real change in the governance of large listed companies, for which investors are willing to pay a premium) with SRIDHAR R. ARCOT, et al., In Letter but not in Spirit: An Analysis of Corporate Governance in the UK (2006). (arguing that the stock market does not incorporate in prices information about explanation, as opposed to compliance, where a comply or explain approach is used). With respect to the issue of proper enforcement of codes of conduct, see EDDY WYMEERSCH, The Corporate Governance 'Codes of Conduct' between State and Private Law (2007). (describing the relationship of the codes with the legal environment).

nevertheless *beyond doubts that weak or bad corporate governance practices, including bad issuer-disclosure, has a negative impact on the company's share price*.[490] As the 2007-2008 financial crisis shows, this negative impact also concerns the overall market confidence, which is a paramount feature for strong capital markets, as already explained.[491]

Therefore, notwithstanding the lack of (yet) available compelling evidence, I believe it is essential to have a "well thought corporate governance system", which relies on appropriate issuer-disclosure requirements, for long-term shareholder value maximisation.[492]

Besides, corporate governance is said to *reduce the cost of capital* for issuers. Empirical evidence shows that investors on primary and on secondary markets are likely to be less demanding for a short-term large return on their investment with good corporate governance because of reduced risks, including risk of expropriation.[493]

In addition, corporate governance *positively influences the allocation of resources* in the economy. As empirically tested, improvement of corporate governance promotes issuer's choice of its investment projects that best maximise shareholder value.[494] Seen

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[490] *Accord* EDDY WYMEERSCH, The Corporate Governance 'Codes of Conduct' between State and Private Law (2007)., at 20 et seq. (and the US studies therein cited); CHRISTIAN LEUZ, et al., *Do Foreigners Invest Less in Poorly Governed Firms?*, Review of Financial Studies, (2009). (presenting evidence that firms with governance problems attract significantly less foreign investment); JILL SOLOMON, Corporate Governance and Accountability (John Wiley & Sons 2nd ed. 2007).

[491] See Part II:Chapter I:V.A in Chapter Investor Protection.

[492] See Part II:Chapter III:II.B.3 below for what I consider to be "a well thought" corporate governance system.

[493] See on primary markets, RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 Journal of Finance 1, (2006)., at 17 and 23; CHRISTIAN LEUZ, et al., Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research (2008)., at 9-10 and the numerous studies therein cited. On secondary markets, see LUZI HAIL, et al., *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 Journal of Accounting Research 485, (2006)., at 486-87 and at 524-25. See also BENJAMIN E. HERMALIN, et al., Information Disclosure and Corporate Governance (2009). and especially CHRISTIAN LEUZ, et al., *Do Foreigners Invest Less in Poorly Governed Firms?*, Review of Financial Studies, (2009). (finding that governance problems impede firms' ability to attract capital from foreign investors even more than it impedes their ability to raise capital domestically), for the view that increased disclosure makes a firm more attractive to all investors.

[494] See, *inter alia*, ROSS LEVINE, Bank-Based or Market-Based Financial Systems: Which is Better? (2002).; RANDALL MORCK, et al., *Corporate Governance, Economic Entrenchment, and Growth*, 43 Journal of Economic Literature 655, (2005). (and the numerous studies therein cited).

from the investors' perspective, it also means that their scarce resources are allocated more efficiently.

Lastly, considering corporate governance as objective of issuer-disclosure provides a nice way to *reconcile the sometimes artificial distinction between corporate and securities regulation*.[495]

When considering improvement of corporate governance within a firm, one focusses on investors in their capacity as shareholders. The perspective is therefore slightly different than where all investors are considered, former, potential or actual. One moves from securities regulation governing the way to attract and maintain funds on capital markets to the more restrictive company law area ruling the relationships within the firm once an investment has been made and trying to minimise agency problems.

Viewed with this insight, corporate governance is concerned with strict company law devices at the disposal of shareholders and disclosure serves to enhance the effectiveness of these devices to the benefit of their users.

3. *The case for corporate governance as objective of the EU issuer-disclosure regime*

If the promotion of corporate governance seems to be clear in some European regulations mandating disclosure,[496] improvement of corporate governance is not explicitly mentioned by European bodies as an objective of the EU issuer-disclosure regime.[497]

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[495] On the blurred line between securities regulation and company law, see JAAP W. WINTER, et al., Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002). For a US academic on the same topic, see ZOHAR GOSHEN, et al., *The Essential Role of Securities Regulation*, 55 Duke L. J. 711, (2006)., at 35 et seq.

[496] See, for instance, article 46(a) of the Fourth Company Law Directive, as amended by Directive 2006/46/EC (requirement to have a corporate governance statement in the annual report); recital (18) (referring to the importance of the exercise of voting rights) and article 10 (referring to all the information to be published by a target company) of the Take-Over Directive; and recital (3) of the first set of Remuneration Recommendations and recital (9) of the second set of Remuneration Recommendations.

[497] See however the preparatory works for the Transparency Directive, and, *inter alia*, Opinion of the European Central Bank of 30 September 2003 on the draft transparency directive (COM(2003) 138 final), OJ 9 October 2003, (CON/2003/21), (2003/C 242/06), at recital 6 ("[t]he justification of relating availability of funds to level of disclosure has been provided by agency theory. […] In addition, disclosure requirements have a beneficial effect on issuers by acting as a disciplinary device on corporate managers"). See also proposal of a transparency directive (COM(2003) 138 – C5-0151/2003 –

The corporate governance rationale of mandatory disclosure has been extensively developed by academics *in the US context of dispersed ownership*.[498] It has also been suggested by international fora.[499] It has far less been discussed in European academic literature.[500]

As significant contrasts exist among jurisdictions in company law and business practices on the one hand – the internal decision structures - and ownership structures and level of development of capital markets on the other hand – the external environment -, there could be differences among jurisdictions in the extent to which issuer-disclosure is effective in helping to align management's or controlling party's and (other) shareholders' interests and in assuring the best choice of real investment projects to increase shareholder value.[501]

2003/0045(COD)), recital 1 ("[i]n addition, the security issuers' responsibility for the disclosure of information constitutes an indirect tool for promoting corporate governance throughout the Community").

[498] See, *inter alia*, JOHN C. COFFEE, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review, (1984)., at 752; MARK J. ROE, *Corporate Law's Limits*, 31 J. Legal Stud. 233, (2002).; MERRITT B. FOX, *Required Disclosure and Corporate Governance*, 62 Law and Contemporary Problems 113, (1999). and subsequent contributions; LOUIS LOWENSTEIN, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 Colum. L. Rev. 1335, (1996).; REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004)., at 96-99; GERARD HERTIG, et al., *Issuers and Investor Protection*, *in* The Anatomy of Corporate Law - A Comparative and Functional Approach, 2004).; DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003)., at 16.

[499] See OECD, OECD Principles of Corporate Governance (2004)., at 463-72.

[500] See, for the few authors discussing it, KLAUS J. HOPT, *Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron*, *in* After Enron - Improving Corporate Law and Modernising Securities Regulation in Europe and the US, (John Armour, et al. eds., 2003).; EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 127-30; NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 321.

[501] *Accord* MERRITT B. FOX, The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities 97 Michigan Law Review 696, (1998).; MERRITT B. FOX, *Required Disclosure and Corporate Governance*, 62 Law and Contemporary Problems 113, (1999)., at 125; MERRITT B. FOX, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335, (1999)., at 1406-07; HENRY HANSMANN, *How Close is the End of History?*, 31 The Journal of Corporation Law 745, (2006).; WILLIAM W. BRATTON, et al., *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 Columbia Journal of Transnational Law, (1999)., at 223-26; JOHN C. COFFEE, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757, (2002).

Some argue that the EU issuer-disclosure regime is of little assistance in reducing agency costs in European firms:

Law and finance academics argue that an increased level of protection afforded to minority shareholders and creditors is associated with lower concentrations of share ownership.[502] These (mainly US) authors found that common law systems tend to out-perform civil law systems by adopting legal rules that offer better protection both against expropriation of shareholders by management and against the violation of the rights of minority shareholders by large shareholders. Applied to the European context, they assumed that most companies in Europe have concentrated ownership with at least one large shareholder, without further distinction between companies with a single controlling shareholder and companies with several large shareholders. They then allegedly showed that most European jurisdictions offer weak minority shareholders' rights and inadequate incentives to exercise them. If one had to follow their reasoning, it could ultimately be concluded that the EU issuer-disclosure regime can only be of minor use to improve corporate governance in European firms.

But this chapter shows that, contrary to conventional thoughts of the law and finance school just alluded to, the EU issuer-disclosure regime could effectively improve corporate governance in the E.U.

Sub-section B recalls the convergence-divergence debate in ownership structures and related corporate governance arrangements. As the type of agency problems corporate governance mechanisms try to solve depends on the ownership pattern present in a company, Sub-section C identifies the current ownership patterns of companies in the jurisdictions analysed in the dissertation. It also makes some predictions about future trends beyond the financial crisis. Sub-section D then summarises the agency problems faced by companies in the jurisdictions concerned. It also draws from the identified current ownership patterns and likely trends some implications relating to corporate governance arrangements of European firms. Lastly, Sub-section E, the core of Section II, shows that the EU issuer-disclosure regime can effectively mitigate the specific agency problems outlined above and faced by European firms. It argues that it can do so by positively impacting two specific corporate governance devices I chose to

[502] For references to law and finance academics, see note 190 above and accompanying text.

discuss, i.e., shareholder vote and shareholder monitoring. With a view to make the strongest possible case in the specific European context, I need to address the perceived obstacles to the exercise of voting rights and the right of shareholders to sue.

II. The EU Issuer-Disclosure Regime's Positive Impact on Corporate Governance of European Companies

A. Preliminary Remark

Assessing the effectiveness of the EU issuer-disclosure regime to meet the objective of enhancing the two corporate governance devices that I discuss, i.e., shareholder vote and shareholder monitoring, requires to define the ownership structure of European companies and the related agency problems they are likely to face.

I discuss in Sub-section C the current and likely future ownership structures of European companies in the seven European Member States I have selected.

I identify in Sub-section D the agency problems the EU issuer-disclosure regime should contribute to reduce with a view to enhance the corporate governance of European companies.

But I start by recalling, and taking position in, the convergence-divergence debate in ownership structures and corporate governance arrangements in Sub-section B.

Sub-section E, the core of this chapter, discusses the impact of the EU issuer-disclosure regime on corporate governance in European companies, on theoretical and practical grounds.

B. The Convergence-Divergence Debate

1. Preliminary remark

There is an on-going discussion in academic literature on convergence or persistence of diversity in ownership structures and related corporate governance arrangements around the world.[503] This debate takes place in a context of increasing globalisation of capital

[503] See for a recent work, MATHIAS M. SIEMS, Convergence in Corporate Governance: A Leximetric Approach (2009). (arguing, on the basis of a quantitative methodology taking the US, UK, French, German and Indian law into account between 1970 and 2005 that there has been convergence in

and product markets, which give firms an opportunity to, for instance, reincorporate or cross-list in other jurisdictions with different ownership structures. This debate is likely to receive renewed focus in the aftermath of the 2007-2008 financial crisis, if we consider that failures in corporate governance have contributed to the financial meltdown.[504]

The discussion has focussed on the following questions: (1) why company laws and ownership patterns differ around the world; (2) whether a particular corporate governance system and ownership structure has a competitive advantage over, i.e., is more efficient as judged by commonly accepted measures of economic performance than, all other systems with the necessary conclusion that the other systems ought to move toward it; (3) or whether different systems are efficient depending on surrounding circumstances.

As already explained, this is relevant because the choice of a corporate governance regime impacts the availability and cost of capital, the corporate performance, i.e., shareholder value, and the allocation of resources in a country.[505]

2. The debate

There are several leading views in comparative corporate governance literature relating to whether the dichotomy between dispersed and concentrated ownership can persist and relating to the differences in company laws around the world.

The *law and finance school* asserts that the dispersed shareholder structures in the U.S. and in the U.K. are a reflection of more advanced company laws, i.e., laws that better protect outside shareholders from expropriation by management, and more

shareholder protection but divergence in worker protection and a mix of convergence and diversion in creditor protection). See also LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 9 et seq.; JOHN C. COFFEE, JR., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, Nw.U.L.Rev. 641, (1999).; SANFORD M. JACOBY, *Corporate Governance in Comparative Perspective: Prospects for Convergence*, 22 Comp. Labor L. & Pol'cy J. 14, (2000).

[504] See for the view that corporate governance exacerbated losses in financial firms by encouraging executives to focus on short-term performance, DAVID ERKENS, et al., Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide (2009).; for the view that the case is not made for significant reform of current corporate governance arrangements in the companies removed in 2008 from the S&P 500, see BRIAN R. CHEFFINS, Did Corporate Governance 'Fail' During the 2008 Stock Market Meltdown? The Case of the S&P 500 (2009).

[505] See Part II:Chapter III:I.C above.

developed equity markets.[506] In contrast, under this view, controlling shareholder structures are explicitly or implicitly portrayed as second best, i.e., they show “weak” shareholder protection. With respect to the better laws, this (mainly US) position holds that the common law derivation of a legal system assures greater development of financial markets and greater economic growth.

Some authors favouring legal components do not go as far as linking legal origin with corporate governance, financial market/economic development and ownership structure. Instead, they stress the importance of *efficient rules*. They contend that efficient rules are the ones promoting the (UK/US) shareholder value model.[507] Among them, several legal commentators observe an evolutionary process in which national legislations aim to improve the quality of shareholder protection in a global economy.[508] They stress the importance of globalisation and of international securities markets, including cross-border mergers and acquisitions, the possibility to re-incorporate into a different jurisdiction, institutional investors investing abroad and firms listing on foreign stock exchanges, to suggest *convergence to the US/UK model*.[509] Other academics stress the fact that different corporate governance systems may solve the same agency problem through different institutions. That view, called the *functional convergence thesis*, posits that, if existing corporate governance systems possess sufficient flexibility so that their efficiency can be improved within their existing legal and regulatory parameters, then very different governance systems could have

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[506] See note 190 above and accompanying text.

[507] See HENRY HANSMANN, et al., *The End Of History For Corporate Law*, 89 Geo. L. J. 439, (2001)., at 11 (stressing the universal character of shareholder primacy, suggesting that rival models are inefficient and would, and actually do, lose out in competition); LUIGI ZINGALES, et al., Banks and Markets: The Changing Character of European Finance (2003). (idem); KLAUS GUGLER, et al., *Corporate Governance and Globalization* 20 Oxford Review of Economic Policy 129, (2004).

[508] See the work of Professor Siems. See for a more nuanced view in the sense that it highlights the limits of convergence in a world where national laws increasingly look alike, warning against implants of one corporate governance system to another, without enough concern of the specificities of legal, cultural and social environment, CURTIS J. MILHAUPT, et al., Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World (University of Chicago Press. 2008).

[509] See, *inter alia*, JEFFREY N. GORDON, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 Colum. J. Eur. L. 219, (1999). (examining cross-border mergers (such as Chrysler and Daimler-Benz) as a method to bring greater “equity culture” to Germany); MARCO BECHT, et al., *Why Has There Been So Little Block Holding in America?*, *in* A History of Corporate Governance around the World, (Randall Morck ed., 2005).

equivalent performance characteristics.[510] They argue that formal convergence faces too many obstacles, including interest and lobby groups.[511] Professor Gilson talks about "contractual convergence of best corporate practice", where the formal differences may be functionally relevant but equivalent effects can also be reached through contractual arrangements.[512] Few other authors argue that a *hybrid model of corporate governance* has emerged, based on the best features of the main governance models. On the basis of the behaviour of some institutional shareholders who are concerned with transparency and liquidity but also who wish to be more actively involved in the monitoring of the firms they invest in, they predict that the hybrid system could become the "ultimate combination of the future".[513]

A second position, the "*path dependency thesis*", also focusses on regulation but views it as the product of political forces that shape corporate governance.

More precisely, it postulates that ownership structure, at the firm-level, could heavily be impacted by path dependencies. In short, history matters because it impacts the way in which ownership structures can change, and efficiency does not necessarily prevail.[514] The implication is that firms subject to concentrated ownership do not necessarily unwind this structure in all cases where there may be cost advantages to doing so as legal and regulatory choices may impact the development of dispersed ownership. These choices are considered to be reflecting the political agenda. It is further suggested that nowhere else than in the U.S. and the U.K. was the system of

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[510] See the works of Professors Gilson and Coffee. See, *inter alia*, RONALD J. GILSON, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 American Journal of Comparative Law 329, (2001)., at 336-37; RONALD J. GILSON, *Corporate Governance and Economic Efficiency*, 74 Wash U.L.Q. 327, (1996)., at 332-33.

[511] See JOHN C. COFFEE, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, Yale Law Journal 1, (2001).

[512] See RONALD J. GILSON, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 American Journal of Comparative Law 329, (2001). (arguing that firms may choose to deviate from the national corporate governance standards by opting into another corporate governance regime. This implies convergence at the company level rather than at the national (or federal state) level).

[513] LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002).

[514] See the works of Professor Mark J. Roe. See also PAOLO F. VOLPIN, et al., Managers, Workers, and Corporate Control (2002).; LUCIAN A. BEBCHUK, et al., *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan L. Rev. 127, (1999).

corporate governance sufficiently changed for firms to move in sufficient numbers away from concentrated ownership.[515]

In the same line of thoughts, Professor Bebchuk advanced a *"rent protection" model* of shareholder ownership, which posits that, when the private benefits of control are high, concentrated ownership (continuously) dominates dispersed ownership.[516]

A further strand in literature focusses on a range of *firm or industry-specific determinants*, such as financial versus human capital intensiveness, the propensity to innovate and the level of competitiveness in the industry. It follows from this view that not all firms might be expected to move toward one specific ownership structure. Dispersed ownership could be better suited to the development of new technologies because of the necessity of quick strategical decisions which could happen more easily with small passive shareholders. On the other hand, a concentrated ownership structure may offer advantages for production in which there is human capital intensiveness, as a controlling party owner could commit more credibly to contracts with employees. Moreover, less reliance on equity markets invites greater reliance on bank finance, which also may have comparative advantages in relation to industries which employ relatively high levels of physical assets, rendering debt finance a suitable investment strategy.[517]

A last position[518] rests on the growth of *institutional shareholders* in the last decades and the global character of some firms around the world to predict more

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[515] See MARK J. ROE, Strong Managers, Weak Owners: the Political Roots of American Corporate Finance (Princeton University Press. 1994). (in the U.S., the New Deal of the 1930s broke up the power of financial institutions and pushed companies toward dispersed ownership) and BRIAN R. CHEFFINS, Corporate Ownership and Control: British Business Transformed (Oxford University Press. 2008). (in the U.K., a series of policies strongly supportive of private pensions - including, most importantly, a staggeringly large tax bias in favour of institutional rather than individual stock holding - led to the rise of powerful institutional investors who kept managers - and each other - in check).

[516] See LUCIAN A. BEBCHUK, A Rent-Protection Theory of Corporate Ownership and Control (1999).

[517] See Franklin Allen, Laura Bartiloro, and Oskar Kowalewski, Does Economic Structure Determine Financial Structure?, working paper, Wharton Business School (2006).

[518] To be exhaustive, I should also mention the position recently advanced by Professor John Coffee, arguing that private ordering, not mandatory laws, facilitated the move to dispersed ownership. Law follows the market, but does not create the preconditions that explain the market's evolution toward dispersed ownership. See JOHN C. COFFEE, JR., Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between 'Lumpers' and 'Splitters' (2010).

institutionally-based ownership dispersion.[519] The governance system linked to this ownership structure would focus on elaborated legal duties, robust mandatory disclosure, strong shareholder governance rights, checks against intra-shareholder opportunism, and reasonably intense enforcement. The move to this governance system is said to happen through regulatory competition and yardstick competition.

3. My view in the debate

It seems intuitive to assume that there is a link between legal systems and patterns of economic development. This being said, and as suggested by recent empirical evidence, the conventional distinction of the law and finance school between common law and civil law, common law being considered as the only law promoting economic development, is too crude: the implications of origin for efficiency are *a priori* unclear.[520]

Given the level of national income of the jurisdictions considered in this dissertation, which could be regarded as very long-run measure of economic growth, I believe that each ownership structure and thereto related corporate governance model is *a priori* good.[521]

Essentially, the two extreme ownership structures, i.e., dispersed or concentrated, lead to a *trade-off*: they both have their own comparative advantages and specific agency risks:[522]

Dispersed ownership encourages the development of a more efficient market with greater liquidity. The empirical link between secondary market liquidity and

[519] See, *inter alia, DONALD C. LANGEVOORT, The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 Virginia Law Review 1025, (2009).*; JEFFREY N. GORDON, The Berle-Means Corporation in the 21st Century (2008).

[520] For authors supporting the view that, contrary to the law and finance school, market-oriented systems do not necessarily imply a common law system, see, *inter alia*, MICHAEL GRAFF, Legal Origin and Financial Development: New Evidence for Old Claims? The Creditor Rights Index Revisited (2008)., at 8 et seq.

[521] See PETER A. HALL, et al., Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Oxford University Press. 2001). (suggesting that each country has its own form of capitalism and its own legal and regulatory institutions, and that there is no single development model which can cover all their needs).

[522] On specific agency problems related to each ownership structure, see Part II:Chapter III:II.B.3 below. Note that, pending systematic analysis, which is lacking at the time of writing, the current financial crisis arguably hit financial institutions and corporate firms showing both ownership structures and agency costs.

shareholder dispersion is well documented. Measures of liquidity such as trading volume and bid-ask spreads have been shown to depend on the number of shareholders, even when controlling for other factors. Equally, increases in the number of shareholders, for example after stock splits or decreases in the minimum trading unit, lead to higher secondary market liquidity.[523] In turn, enhanced liquidity is believed to facilitate long-term investments and higher return projects that positively impact economic growth and productivity.[524] Some empirical studies have tested the proposition that there is a link between ownership dispersion and firm performance.[525] However, as the scale of the company, and its capital requirements, grows, a point is reached at which a reduction in risk-bearing and liquidity costs achieved by the dispersed ownership more than offsets the consequent increase in "managerial" agency costs. In addition, dispersed ownership may also oblige the firm to maximise short-run profits to the detriment of stability, investment in human capital, and concerns of non-shareholder constituencies. This is best illustrated by the pressures on management exercised by some activist shareholders, seeking short-term profits to meet their own targets *vis-à-vis* their investors. This is referred to as the liquidity-monitoring trade-off.

Conversely, concentrated ownership may free the firm from the obligation to maximise short-run profits and thus permit both greater stability, greater investment in human capital, and more attention to the concerns of non-shareholder constituencies. But on the other hand, concentrated ownership leads to less liquidity and carries its own specific agency problems.

Besides, there does not have to be full convergence of ownership structures or of thereto related corporate governance arrangements as I ultimately think that *different*

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[523] See MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007). and numerous references therein cited at 892 (also suggesting that the inverse relationship also holds, i.e., an increase in ownership concentration, or a decrease in the "free float", depresses liquidity).

[524] See Part II:Chapter II:IV.C in Chapter Market Efficiency.

[525] See for a thorough review of such empirical evidence, MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 890 et seq.

types of ownership and thereto related corporate governance systems could be efficient if they are suited to different contexts and activities.[526]

In addition, together with the path dependency theorists, I believe it seems fair to assume that legal systems are endogenous, to some extent, to the political and economic contexts within which they operate.[527] Pre-existing regulatory choices lead and will continue to lead to indefinite persistence of divergence as it is not necessarily desirable or realistic to alter the specific institutions, ownership structures or cultural background of each jurisdiction. But divergence is not necessarily inefficient. It is inefficient if it is the result of domestic political preferences and entrenched interest groups, like controlling parties extracting private benefits.

This being said, I cannot ignore the considerable amount of *functional convergence toward the shareholder-oriented model* over time, at least on both sides of the Atlantic.[528] As already suggested, this evolution was aided by several factors.[529]

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[526] *Accord* WENDY CARLIN, et al., *How do Financial Systems Affect Economic Performance*, *in* Corporate Governance: Theoretical and Empirical Perspectives, (X. Vives ed., 2000). (proclaiming that concentration of shareholder rights to foster sufficient monitoring is necessary for certain businesses like those that require long-term committed investors and finding a strong relationship between country structures, industry characteristics and the types of activities undertaken in different countries); RONALD J. GILSON, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, (2006). (arguing that, conditional on the presence of good law, in some industries and in some circumstances, a controlling shareholder structure may be superior); COLIN MAYER, *Financing the New Economy: Financial Institutions and Corporate Governance*, 14 Information Economics and Policy 311, (2002). (arguing that the answer to the question which corporate governance structure is more efficient depends on national factors (quality of the judicial system, company law, protection of minority shareholders etc) and firm-specific factors (the industry in which the firm is active). The way in which a firm is "best" organised depends on what it is producing. Optimal institutions depend on industrial structure); see, for other references, MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007). See also the studies showing the merits of concentrated ownership, including a positive link with shareholder value, including ALEX EDMANS, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, Journal of Finance (forthcoming), (2009).; RONALD C. ANDERSON, et al., *Founding-family ownership and firm performance: evidence from the S&P 500*, 58 Journal of Finance 1301, (2003).; STEEN THOMSEN, et al., *Blockholder ownership: Effects on firm value in market and control based governance systems*, 12 Journal of Corporate Finance 246, (2006)., at 248 et seq. (for an overview of the (ambiguous) theoretical studies and empirical evidence relating to the relationship between blockholder ownership and firm value).

[527] *Accord* JOHN ARMOUR, et al., How do legal rules evolve? Evidence from a cross-country comparison of shareholder, creditor and worker protection, 57 American Journal of Comparative Law 579, (2009).

[528] See Part I:VII.B in General Introduction and Part II:Chapter III:II.B.2 above. For the view that the Anglo-American pattern of corporate governance is not universally valid as showed by the Japanese

However, the reader should recall here the discussion relating to the corporate objective and my position supporting an "enlighted shareholder value" model.[530]

Neither can I ignore the continuing trend toward blockholder ownership structure on both sides of the Atlantic.[531]

In sum, I believe that there will be increasing convergence toward a specific ownership structure, which presents *enough dispersion* to lead to liquidity and offers at the same time the tools to monitor management. In the "main structure of the future", I believe that a central role will be played by *large retail shareholders* and *institutional investors*, who are concerned by more transparency and liquidity and, at the same time, who wish to be more actively involved in the monitoring of the firms they invest in. I think that what matters is the *effective* contribution by shareholders to both the allocation and governance functions of the markets. And *different formal rules* could be used to attain *these results*.[532]

C. Ownership Structures in the European Union

1. Preliminary remark

It is important to determine the current and likely forthcoming ownership structures in the European Union because they are associated with particular types of agency problems, which in turn affect the extent to which the EU issuer-disclosure regime could improve the effectiveness of corporate governance mechanisms.

Next to a distinction between concentrated and fragmented ownership structures, one should distinguish between retail systems and institutional systems to assess the relevance of specific corporate governance devices.

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experience, see JOHN BUCHANAN, et al., The Limits of Shareholder Value? Hedge Fund Activism in Japanese Listed Companies (2009).

[529] See Part I:VII.B in General Introduction.

[530] See Part I:VII.B in General Introduction.

[531] See Part II:Chapter III:II.C.3 below.

[532] This is the functional convergence referred to under Part II:Chapter III:II.B.2 above.

2. The current situation

The degree of ownership concentration varies among the Member States under examination:

As of today, the *U.K.* is the only jurisdiction with a clear majority of firms with dispersed ownership.[533] However, there are signs of increased concentration.[534]

All the other jurisdictions analysed in this dissertation are characterised by a majority of firms with concentrated ownership.

However, ownership concentration decreased at a moderate pace between 1999 and 2007 except in Spain.[535]

And *most importantly*, a significant number of publicly listed firms has multiple *blockholders*.[536]

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[533] See CHRISTOPH VAN DER ELST, Shareholder Mobility in Five European Countries (2008)., at 30 – 48 together with CHRISTOPH VAN DER ELST, et al., Onderzoeksrapport ten behoeve van de SER Commissie Evenwicht Ondernemingsbestuur - Een overzicht van juridische en economische dimensies van de kwetsbaarheid van Nederlandse beursvennootschappen (24 October 2007)., at Tables 15, 17 and 18. See for legal reasons, ALESSIO M. PACCES, Controlling the Corporate Controller's Misbehaviour (2008).

[534] See for an historical perspective and a view that increased concentration is the likely future, BRIAN R. CHEFFINS, Corporate Ownership and Control: British Business Transformed (Oxford University Press. 2008). See also for the importance of concentration in the U.K., JILL SOLOMON, Corporate Governance and Accountability (John Wiley & Sons 2nd ed. 2007)., at 111.

[535] See, CHRISTOPH VAN DER ELST, et al., Onderzoeksrapport ten behoeve van de SER Commissie Evenwicht Ondernemingsbestuur - Een overzicht van juridische en economische dimensies van de kwetsbaarheid van Nederlandse beursvennootschappen (24 October 2007)., at 18-36 (analysing the concentration for Germany, Italy, France, Belgium, Spain, the Netherlands and the U.K. between 1999-2007 and showing an increasingly dispersed ownership structure in France, Belgium, Germany and the Netherlands); CHRISTOPH VAN DER ELST, Shareholder Mobility in Five European Countries (2008). (idem and suggesting that blockholders in a company with no controlling shareholder amount for a large number of Continental European firms); JULIAN R. FRANKS, et al., Evolution of Family Capitalism: A Comparative Study of France, Germany, Italy and the UK (2008). (analysing the growth of widely listed firms across France, Germany and Italy over 1996-2006 period ("[i]n 2006, in Germany the most frequent form of ownership is widely held; the proportion has increased from 26% to 48%. A similar trend occurred in France and Italy, from 21% to 37% and from 2.5% to 22%, respectively. About one third of this increase coincides with a decline in family controlled companies in all three countries. The rest is largely explained by the unwinding of majority blocks of widely held parent firms as well as privatizations of state owned companies. This pattern suggests that although family ownership continues to be an important form of ownership, there is a marked decline accompanied by a common movement across the large European capital markets to widely held ownership status."). Note the amendment to the German income tax code, which came into effect on 1 January 2009 (Sections 2, §1, nr. 5; 20, §1, nr. 1 ; 32d, §1 of the German income tax code (*Einkommensteuergesetz* (EstG))) which might have a further impact on ownership structures in Germany.

[536] See CHRISTOPH VAN DER ELST, et al., Onderzoeksrapport ten behoeve van de SER Commissie Evenwicht Ondernemingsbestuur - Een overzicht van juridische en economische dimensies van de

Besides, the *growth of institutional shareholders* is worth to be noted: according to empirical evidence, foreign and resident institutional investors together made almost 60% of total European share capital in 2005, in constant increase compared to previous years.[537] The E.U., including the UK market, is thus institution-oriented. In the U.K., institutional investors, mainly pension funds and insurance companies, own a large fraction of corporate stock.[538] But, in contrast to the US pattern,[539] the thirty or so largest funds together hold a sufficiently large share of the stock in many companies to exert substantial control. In Continental European jurisdictions, like in Germany, large commercial banks traditionally held substantial blocks of corporate stock on their own account, and also served as custodians for large amounts of stock owned by individuals, whose votes were often effectively exercised by the banks themselves.[540] Recent years

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kwetsbaarheid van Nederlandse beursvennootschappen (24 October 2007). (showing that, at 2007, about 20% of all companies in France, Belgium, Italy, Germany and Spain have a significant blockholder with a voting block between 30% and 50% of all votes; and between 20% and 30% of all firms have a blockholder with a voting power between 10% and 30%); LUC A. LAEVEN, et al., *Complex Ownership Structures and Corporate Valuations*, 21 Review of Financial Studies 579, (2007). (relying on more dated statistics (2000) but finding that publicly traded European companies with complex ownership structures, i.e., firms with more than one shareholder with greater than 10% of the voting rights, account for 34% of the firms and 18% of market capitalisation and for more than 40% of firms with at least one large shareholder); Dariusz Wojcik, Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997–2001, 35 Env't & Plan. A 1431 (2003).

[537] See EUROPEAN COMMISSION, Impact Assessment on the Proportionality between Capital and Control in Listed Companies (2007)., at Table 4 (with reference to a large sample of the companies making the Eurostoxx 50 Index, in 2005, foreign and resident institutional investors together made almost 60% of total share capital, in constant increase with respect to 2003 and 2004); see also BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007, at 87 et seq. See generally, PAUL DAVIES, Gower and Davies: The Principles of Modern Company Law, 8th Edition (Sweet & Maxwell. 2008)., at 337-38; PAUL DAVIES, Introduction to company law (Clarendon law series ed., Oxford University Press. 2002)., at 141-42.

[538] See Tomorrow's Company, *Tomorrow's Owners – Stewardship of tomorrow's company* (Centre for Tomorrow's Company, London, October 2008), at 49; Office for National Statistics (UK), Share Ownership: a Report on Ownerhsip of Shares as at 31st December 2006, 9 (2007).

[539] In the U.S., while individuals continue to hold a substantial amount of stock directly, the majority of stock is now owned by two types of institutional investors, i.e., mutual funds and employer established pension funds. In contrast with the U.K., there are many thousands of both types of funds and an individual fund rarely holds a significant fraction of a given company's stock. See Board of Governors of the Federal Reserve System, Flow of Funds Accounts in the United States: Flows and Outstandings (September 2009); Investment Company Institute, 2008 Investment Company Factbook, 110 (2008); The Conference Board, *U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations* (Jan. 22, 2007); DONALD C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Virginia Law Review 1025, (2009)., at note 4 and references therein cited; Jeffrey D. Bauman et al., Corporations: Law and Policy, 36 (6th ed. 2007); JEFFREY N. GORDON, The Berle-Means Corporation in the 21st Century (2008).

[540] But see for recent statistics on the identity of shareholders, FEDERATION OF EUROPEAN SECURITIES EXCHANGES, Share Ownership Structure in Europe (2007).

have seen the rise of new types of institutional investors as well. Among these are hedge funds, that often take substantial stakes in individual firms[541] to be able to directly engage with management on matters which include business strategy, capital structure, asset sales and adherence to corporate governance standards, with a view to raise levels of returns to shareholders, and that sometimes seek to exercise control over those firms. One could say that in such context "governance concerns offer a more compelling justification for mandatory disclosure than investor protection".[542] I come back to the implications of this move to an even more "institution-oriented European system" in further details below.[543]

3. The likely future

a. Likely continuing move to more "market-oriented blockholder model"

The E.U. seems to have chosen a market-oriented system, based on the importance of strong financial markets. Indeed, the FSAP is built on the presumption that the promotion of market finance and integration of capital markets are central to the achievement of the over-arching European objectives of economic growth and job creation.[544] One might consider as illustrations of European standards that converge on a market-based model, European regulation on, for instance, IFRS, audit committees, independent directors or on the remuneration policy.[545]

I believe that a market-oriented model of the kind the European Commission has, consciously or not, chosen goes together with some degree of dispersed ownership, i.e.,

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[541] 10% is the median according to ALON BRAV, et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 Journal of Finance 1729, (2008). (covering the U.S. between 2001 and 2006).

[542] JILL E. FISCH, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wisconsin Law Review 333, (2009)., at 336 (in the US context of increasing institutional shareholdership).

[543] See Chapter Issuer-Disclosure Addressees and Consequences.

[544] *Accord* NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 56 et seq. See Part I:I in General Introduction.

[545] See Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, OJ L 157, 9 June 2006, at 87; Commission Recommendation 2005/162/EC of 15 February 2005, on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52, 25 February 2002, at 51; and Remuneration Recommendations.

the level required for a liquid stock market, as liquidity is an important feature of a market-based system.[546]

This being said, it should be stressed that the E.U. is not promoting dispersed ownership as such. The European Commission had an opportunity to engage a move away from concentrated ownership by mandating one-share one-vote, thereby affecting the mechanisms controlling parties use to artificially maintain their (disproportionate) control. But it chose not to pursue it.[547]

The 2007-2008 financial crisis gives me reasons to believe that the European Commission was well advised not to support any move to true dispersed ownership structures in the E.U. Indeed, there are some examples of credit institutions with a strong dispersed shareholders' base which seemed to struggle more during the crisis.[548]

The European Commission is rather enhancing investors' access to equity markets by increasing disclosure requirements from issuers and protecting shareholders'

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[546] See ERNST MAUG, *Large shareholders as monitors: Is there a trade-off between liquidity and control?*, 53 Journal of Finance 65, (1998).; JEAN HELWEGE, et al., *Why do firms become widely held? An analysis of the dynamics of corporate ownership*, 62 Journal of Finance 995, (2007). See also references cited in MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 892.

[547] See the web-page of the European Commission in that respect. It should be noted that some European academics, supporting one-share one-vote and disappointed with the studies of the European Commission on the subject, predict that the debate will have to be re-opened again in the near future. See, *inter alia*, José M. Garrido, The European Company Law Action Plan 2003 Revisited, One Share One Vote: A Response, keynote at the Jan Ronsse Instituut Conference of 9 January 2009 (criticising the evidence gathered by the European Commission to ground its decision not to pursue proportionality). For the still pending concerns about the supervision of the deviations from one-share on-vote, see European Commission, 2006. Annex to the Proposal for the Shareholders Directive – Impact Assessment; Manifest, 2008. *Proxy Voting 2007 – A Pan-European Perspective*. Manifest Information Services; DSW, 2008. *Shareholders' Meetings in Europe*. DSW – Deutsche Schutzvereinigung für Wertpapierbesitz. Other commentators consider that the debate on one-share one-vote is mis-placed and should not be re-opened. According to them, the focus should be on the protection of minority shareholders' rights. See, for instance, Koen Geens, The European Company Law Action Plan 2003 Revisited, One Share One Vote, keynote at the Jan Ronsse Institute Conference of 9 January 2009 (also suggesting that one-share one-vote would lead to more concentration as shareholders would acquire more shares to maintain control).

[548] In Belgium, the Fortis' experience in the financial crisis could be an illustration, *a contrario*, of the merits of ownership concentration, even more so when compared to the experience of its competitor, KBC: ex-Fortis bank (now BNP Fortis), which had a widely dispersed ownership structure, has been struggling for a long time while KBC, with a concentrated ownership pattern, has been rather quickly rescued by a regional loan.). See also RANDALL MORCK, et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 Journal of Financial Economics 293, (1988). (documenting a robust empirical relation between large shareholdings and corporate performance). But see SIMON JOHNSON, et al., *Corporate Governance in the Asian Financial Crisis*, 58 Journal of Financial Economics 141, (2000). (arguing that excessive concentrated ownership structures and related corporate governance weaknesses were to be blamed for the severity of the Asian financial crisis in 1997).

rights.[549] This promotion of market access to investors and of shareholders' rights could lead to more dispersed ownership. But increased dispersed ownership is to be viewed as a consequence of the European move to more market-oriented policy and not as an objective *per se* of the E.U.

In this context, worth noting is the growth of European capital markets at unprecedented speed in the last years.[550] If the past trend is an indication of the future one, the numbers are bound to continue to increase in the future, however *subject to* the qualifications relating to the 2007-2008 financial crisis set out below. Subject to the qualifications set out below, this continued evolution should be helped by several factors: (1) the public sector needs of alternatives to secure adequate retirement funds,[551] (2) private equity firms increased calling for exit solutions by public bids or public offers, (3) on-line trading and other technological advances reducing transaction costs,[552] (4) trading is increasingly international attracting funds from abroad[553] and (5) European firms increasing needs of external funding as alternative to expensive banking solutions to support their growth.[554]

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[549] See for the importance of effective shareholders' rights from the European Commission's point of view, EUROPEAN COMMISSION, Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (2003)., at 8. For a US author, see BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001). In the U.S., even the regulation-hostile position, articulated by, *inter alia*, George Stigler, Stanford Grossman and Oliver Hart, and more recently with respect to disclosure requirements by Roberta Romano and Stephen Choi, relies in part on the legal system to protect investors interests, but considers the safeguards of general contract law and tort law sufficient (and thus no need for company law to be concerned with these matters).

[550] See Part I:I in General Introduction.

[551] I am well aware of the drastic decrease of equity portfolio, in terms of value and volume, further to the current financial crisis. However, as I said, the prediction of a continuing growth of European equity markets should be looked at from a perspective beyond the financial crisis.

[552] For instance, the creation of cross-border electronic networks that match buy-side and sell-side investors cut out intermediation, reduce costs and enhance international trading.

[553] Due to the globalisation of the economy and deregulation of investment rules, institutional investors increasingly spread their portfolios internationally. See LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 41 et seq.; JAAP W. WINTER, *Cross-Border Voting in Europe, in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 388; JOSÉ M. GARRIDO GARCIA, et al., *Institutional Investors and Corporate Governance: Solution or Problem? , in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003).; BERNARD S. BLACK, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, (1990).

[554] See LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 31; CHRISTOPH VAN DER ELST, *The Equity Markets, Ownership Structures and Control: Towards an International*

And if one considers that a growing capital market puts pressure on concentrated ownership for liquidity and risk-diversion reasons, it is very likely that European jurisdictions will continue their evolution to a market-oriented blockholder ownership model. In other words, although the precise pattern is hard to predict, I believe that European firms are likely to have more and more ownership dispersion in the future in the form of more numerous blockholders. This does not mean that significant ownership dispersion will increase overnight as ownership evolution is quite slow.[555]

b. Qualifications

This being said, the 2007-2008 financial crisis might heavily impact *at best the timing, at worst the relevance* of my opinion about the likely future of ownership structures in the E.U.

The facts are clear: as from the last quarter of 2007, and especially in the last quarter of 2008, large numbers of investors[556] have sold their stake in financial institutions, in publicly traded companies, in alternative investment vehicles, like hedge funds, in private equity firms and in collective investment schemes investing in equities alike.

The future is unclear. Sovereign wealth funds and other large investors seem to sit on their money, waiting for investment opportunities. It is impossible for anyone to predict whether they will invest in bonds, in equity, listed or non listed, or outside regulated or non regulated financial markets altogether. Likewise, nobody would be able to predict where companies will find their future funding: retained earnings, private equity, bank loans, private placements or public (debt or equity) markets.

Times are uncertain, especially for equity markets. It is commonly said that capital markets need four to six semesters to recover after an economic downturn.

Harmonization, *in* Capital Markets and Company Law, (Klaus Hopt and Eddy Wymeersch ed., 2003). See also the cases of capital dilution by public capital increase: some large family companies make the choice to become public in order to grow abroad and make acquisitions. Previous controlling shareholders are likely not to fear to get diluted (and thus in a minority position) as much as they used to because of the stronger corporate governance principles protecting minority shareholders around the world.

[555] See the path dependency theorists, at note 517 and accompanying text.

[556] Including financial institutions, publicly traded companies, alternative investment vehicles, like hedge funds, private equity firms and collective investment schemes themselves.

Besides, in my analysis of ownership structures, I did not take into account data from 2008 and 2009. However, the various governmental rescue plans in the context of the crisis led to an increase of government stake in publicly traded companies as from the second semester of 2008 in the U.S. and in Europe.[557] Is the current situation of increased ownership concentration due to government intervention merely episodic, or is it more structural and likely to persist for a long time, even once the financial crisis subsides?

It might be too soon to predict future ownership structures of European companies as the importance of nationalist reactions as well as the recovery of private equity, just to name two examples of factors which impact ownership structures, depend on how long and deep the crisis is.

Nevertheless, I believe it is sensible to say that the necessity of these large state interventions will weaken upon economic resurgence, leaving room for the forces supporting somewhat more shareholding dispersion, in the form of more numerous blockholders, to regain power in Europe.[558] At such time, the picture of the likely trend toward more dispersed ownership, in the form of more numerous blockholders, will regain its full relevance.

In short, I think that although the 2007-2008 financial crisis requires to qualify my analysis for the few years to come, the overall analysis remains valid for the future, beyond the 2007-2008 financial crisis. One question remains though: is economic recovery near or not? The 2010 sovereign debt crisis, which, at the time of writing,

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[557] In the vast majority of cases, governments have intervened in financial institutions to avoid systemic risk (see, for instance, in the U.K., Lloyds Banking Group or Royal Bank of Scotland; in France, Société Générale, BNP Paribas or Caisse d'Epargne; in Belgium, Fortis or Dexia; in the Netherlands, Fortis Nederland (Bank N.V.), indirectly, via Fortis Nederland Bank (N.V.), RSF Holding, corresponding with the parts of ABN Amro connected to the activities in the Netherlands, ING Groep N.V., Aegon and SNS Reaal Groep; in Germany, Commerzbank and Hypo Real Estate; in the U.S., AIG, Citi or Bank of America). But governments have also intervened in commercial companies, like General Motors and Chrysler in the U.S. or the companies in which the French government has intervened through the *Fonds Stratégique d'Investissement*.

[558] See in that respect the early repayments under the national rescue plans, *inter alia*, Société Générale in France. General Motors has also started repayment for German governmental loan for Opel in November 2009.

shows early signs in Greece, gives reasons to believe that market turbulences are far from being over.

It should also be noted that differences in terms of market development inside Continental European countries are important. Given the wide variances between, for instance, Germany and Romania, it is unlikely that all Continental European countries will move to market-oriented models and more dispersed ownership structures, in the form of more numerous blockholders, at an identical pace and with similar intensity.[559] But this divergence in a convergence trend should not be a cause for concerns. I believe that this will call for a reconsideration of the definition of "home country" under European directives, with a view to leave more flexibility to issuers along the lines of the regime applicable to bond issues.[560] In addition, this highlights the fact that corporate governance rules and regulations need to be flexible, because they have to answer to very different business circumstances and needs.

c. Concluding remarks

Predicting the evolution of ownership structures is quite a challenge. Even more so in the troubled times that we live in, that are aggravated by the 2010 sovereign debt crisis which follows the 2007-2008 financial crisis in Europe.

However, although the argument I develop in Sub-section E to support the view that issuer-disclosure promotes good corporate governance might be even more relevant in a dispersed ownership structure, it is also true for a concentrated one like the one currently present in the E.U.

This mitigates the relevance of the materialisation of the above-mentioned predictions relating to the likely future of European ownership structures.

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[559] *Accord* LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 48.

[560] It should be noted that the deficiencies relating to the current regime of the "home country control", highlighted in the current financial crisis, should be tackled, including the case where complex financial products, once approved in the somewhat more laxist home Member States, were passported and commercialised in other Member States without any further supervision.

D. Agency Problems in European Companies and Related Corporate Governance Arrangements

1. Agency costs

The locus and the severity of agency problems within a firm vary depending on the structure of its ownership.

In that context, the above analysis suggested that, if most European companies have a concentrated ownership today, the future might appear differently, with increasingly more firms with more dispersed ownership, in the form of more numerous blockholders.

The issues worth focussing on are the corrections the European regulatory system of corporate governance, including the EU issuer-disclosure regime which facilitates it, needs to implement in order to direct it to its optimal format.

At the end of the day, the corporate governance model should match the agency problems raised by the specific ownership structures present in the E.U.

2. Related corporate governance arrangements

From a normative point of view, the presence of various ownership structures means that *one size does not fit all*.[561] Starting from the premise that "every jurisdiction must have a system of corporate law that is adequate to handle the full range of ownership structures" present in the jurisdiction,[562] the presence of various types of ownership structures in European firms calls for a mixed corporate governance system addressing all possible agency problems likely to be faced. "The task of good governance [in Europe] is to secure the benefits of active shareholders as effective monitors of

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[561] See in another context, the acceptance, to a certain extent, by the European Commission of lower notification of major shareholdings thresholds depending on ownership structures: see EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008).

[562] HENRY HANSMANN, et al., *The End Of History For Corporate Law*, 89 Geo. L. J. 439, (2001)., at 11. See, for a European author, KARL HOFSTETTER, *One Size Does Not Fit All: Corporate Governance for 'Controlled Companies'*, 31 N.C.J. Int'l L. & Com. Reg. 597, (2006). (suggesting legal systems to provide for properly differentiated rules to accommodate the advantages of both ownership structures, starting from the truism that one size does not fit all).

management while at the same time preventing them from consuming excessive private benefits from control".[563]

In other words, the European regulator should not make one single corporate governance model mandatory. Fortunately, this is rather uncontroversial. Global and standard approaches should stay at a rather general level of basic principles while the more detailed provisions and recommendations should be tailored with a high degree of flexibility.

To reflect the different ownership patterns in Europe, one could suggest the European regulator to draw two or more separate disclosure regimes, one for each ownership structure.[564] However, I do not believe this solution to be cost-efficient. I would rather suggest to stay with the sort of European regulation that we currently have, provided that the competent supervisory authority is asked to remain flexible in reviewing the disclosure documents in order to take into account the presence of different ownership structures, i.e., the presence of blockholders or a controlling shareholder or dispersed shareholders, and to focus on the specific agency costs raised by each ownership pattern.[565] The possibility for the arguments of the issuer to be heard should be provided for to work for issuer's protection.

[563] LUTGARD VAN DEN BERGHE, Corporate Convergence in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers. 2002)., at 23. See, for a US author, RONALD J. GILSON, et al., Controlling Controlling Shareholders (2003).

[564] See generally LUCIAN A. BEBCHUK, et al., *The Elusive Quest for Global Governance Standards*, 157 University of Pennsylvania Law Review 1263, (2009). See, for European authors, GIFTY AGBOTON, et al., Do Codes of Corporate Governance Really Improve Board Effectiveness in Continental European Countries? Empirical Evidence from the Belgian Case (2009). (distinguishing between perceived effectiveness of corporate governance practices on the basis of corporate governance codes and actual effectiveness of corporate governance principles due to adoption of corporate governance standards which are not adapted to the specific Continental European context following a legitimising logic).

[565] See Part III:Chapter II:II.B.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

E. The EU Issuer-Disclosure Regime as Means to Improve the Effectiveness of Corporate Governance Devices and Mitigate Agency Costs in European Firms

1. Preliminary remark

I contend that the EU issuer-disclosure regime reduces agency concerns specific to the European ownership context. It does so by reducing the costs associated with the corporate governance tools that mitigate agency problems, thereby impacting their efficiency.

I consider here two corporate governance devices that the law provides to shareholders: shareholders' right to vote and shareholders' monitoring of management or the controlling party.[566]

2. The theoretical case

a. Issuer-disclosure to facilitate shareholder vote

From a theoretical point of view, voting by shareholders could be an important governance tool which could indirectly facilitate *control* of the internal corporate governance structures of the issuer, like the board of directors.[567] Shareholder vote could help to reduce agency problems which could occur in any ownership structure. Through their vote, shareholders could participate in, and increase control of,

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[566] See Chapter Market Efficiency for an analysis of equity-based compensation and market for corporate control, as other corporate governance tools which efficiency is promoted by issuer-disclosure and that are said to reduce agency costs.

[567] The European Commission makes a strong case for the importance of shareholder voting and proxy contests as a means to promote better resource allocation and higher economic growth: see EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids (2007).; see also recital (18) of the Take-Over Directive and recital (22) and article 17 of the Transparency Directive (information requirements for listed issuers). See also recital (10) of the second set of Remuneration Recommendations ("[i]n order to increase accountability, shareholders should be encouraged to attend general meetings and make considered use of their voting rights. In particular, institutional shareholders should take a leading role in the context of ensuring increased accountability of boards with regard to remuneration issues."). For academics supporting this view, see, *inter alia*, EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 422. See, in the U.S., the US SEC recent efforts, flowing from the contention that "the most effective means of ensuring corporations are accountable is to ensure that the shareholders' vote is both meaningful and freely exercised" (see speech of US SEC chairman, Mary Schapiro on 17 September 2009 for the sixth ECGI Transatlantic Corporate Governance Dialogue conference). For a US academic pleading in favour of increased shareholder empowerment, see the contributions of Professor Bebchuck, including LUCIAN A. BEBCHUK, *The Case for Increasing Shareholder Power,* 118 Harvard Law Review 833, (2005).

managerial selection and implementation of corporate projects; assess the use of retained benefits or free cash flow and control whether or not there are "empire building" strategies, i.e., investments or acquisitions which do not make economic sense;[568] avoid consumption of perks and too many risk-averse decisions by management which lead to under-investment; fight against risk shifting decisions which could lead to bankruptcy; prevent too much credit paid to short-term efficiency or executive pay without corresponding performance.[569]

Voting could be even more important as the market for corporate control may not always lead to efficient results[570] and as the exit option is not always available or attractive to investors.[571] The market could therefore not be a perfect mechanism to control the management of listed companies.

Shareholders could exercise their voting rights more effectively and at lesser cost on the basis of the information provided by the company.[572] Issuer-disclosure could directly improve corporate governance by facilitating the effective exercise of the voting rights by shareholders, thereby indirectly decreasing monitoring costs of management borne by shareholders.

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[568] Investors should be able to assess whether investments are made in their interests or if free cash flows would have been better used if distributed to them. On the link between dividends payments and agency theory, see FRANK H. EASTERBROOK, et al., *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, (1984)., at 657-58; MICHAEL C. JENSEN, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 Am. Econ. Rev. 323, (1986).

[569] See for an analysis of European pay recommendations and practices and the importance of shareholder voice in that respect, GUIDO A. FERRARINI, et al., Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis (2009).

[570] See Part II:Chapter II:IV.B.2.c.iib in Chapter Market Efficiency.

[571] On the merits of exercising voting rights instead of selling the stock, see JAAP W. WINTER, *Cross-Border Voting in Europe*, *in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 392.

[572] On the virtues of disclosure in connection with shareholder vote, see also OECD, OECD Principles of Corporate Governance (2004)., at 22; REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004)., at 98 (referring to the educative function of mandatory disclosure to reduce agency costs). See for a discussion of the combination of shareholder voice and enhanced informative disclosure to propel greater activism and improved performance in the area of directors' remuneration, GUIDO A. FERRARINI, et al., Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis (2009).

b. Issuer-disclosure to facilitate shareholder monitoring

Issuer-disclosure could reduce the costs associated with the monitoring of management or controlling parties:[573]

On the one hand, it could do so primarily by providing the necessary information for informed voting by shareholders. As explained above, issuer-disclosure could help shareholders to exercise their vote more effectively. Shareholder vote could be seen as the first monitoring device of management.

On the other hand, shareholders could monitor management in other ways than through their vote. And issuer-disclosure could facilitate this monitoring:

Issuer-disclosure provides information which could facilitate enforcement of the fiduciary duties of management and the duties of loyalty of controlling parties.[574]

The so-called "enforcement function" has two facets:

Issuer-disclosure has an enforcement function insofar as it could discourage "opportunism in its own right" and permit "other legal controls that deter self-dealing decisions by corporate insiders".[575] In that respect, increased monitoring could deter *ex ante* management and controlling parties from entering into questionable behaviours.[576]

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[573] See on monitoring costs, BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001)., at 842. See on the link between disclosure and monitoring costs, DAVIDE LOMBARDO, *Law and Equity Markets: A Simple Model*, *in* Convergence and Diversity of Corporate Governance Regimes and Capital Markets, (J.A. McCahery, et al. eds., 2002).

[574] *Accord* KLAUS J. HOPT, Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron, in After Enron - Improving Corporate Law and Modernising Securities Regulation in Europe and the US, (John Armour, et al. eds., 2003)., at 241; WERNER F. EBKE, *The Impact of Transparency Regulation on Company Law in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 195; GERARD HERTIG, et al., *Issuers and Investor Protection*, *in* The Anatomy of Corporate Law - A Comparative and Functional Approach, 2004). (referring in that respect to the "enforcement" function of disclosure); REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004)., at 97 (considering that such "enforcement role" is the most important function of disclosure in controlled companies, to the extent it can "aid minority shareholders in exercising whatever levers the law allows them to constrain related-party transactions initiated by controlling shareholders" (at 110)).

[575] REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004)., at 96.

[576] See, for instance, Amy P. Hutton, Alan J. Marcus and Hassan Tehranian, Opaque Financial Reports and the Distribution of Stock Returns, 2008 (using earnings management as a measure of

This refers to the prevention of fraud rationale of disclosure and to the famous words of US Supreme Court Judge Brandeis, "[s]unlight is said to be the best of disinfectants",[577] which have been endorsed by the European company law experts group.[578]

And if there is nevertheless mismanagement or extraction of private benefits of control to the detriment of (minority) shareholders, the shareholders could, to the extent permitted by applicable law,[579] and on the basis of information provided, enforce their rights by filing a legal action against the faulty party. In that sense, market monitoring of management or the controlling parties on the basis of disclosure could complement "public" oversight of agency problems,[580] if any under applicable law, and the internal monitoring provided by the supervisory committees over management, if any. The function of disclosure under that meaning is to lower monitoring costs enabling *ex post* enforcement. To be sure, disclosure documents could not be in all cases sufficient as such to file a legal action. In some instances, complementary information would be necessary to complement disclosure mandated by law.

In addition, by providing valuable feedback on the quality of management, issuer-disclosure may affect management's compensation package:

If the compensation package includes share-price-based compensation, control exercised by shareholders over under-performing management might negatively affect share price through the negative impact of a legal action or the negative impact of a media report relating to an angry shareholders' meeting. This might in turn decrease the value of management compensation.

If permitted by law, shareholders might encourage the remuneration committee to award lower remuneration package to underperforming management.

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opaqueness, finding that the passage of SOx has changed the picture, suggesting that earnings management has decreased or that firms can hide less information post-SOx).

[577] See note 36 above and accompanying text.

[578] See JAAP W. WINTER, et al., Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002).

[579] See for a comparative law analysis in the jurisdictions concerned by this dissertation, Part II:Chapter III:II.E.3.d.iii below.

[580] For instance, oversight by the supervisory authority of financial markets and by courts.

As evidenced in the context of the 2007-2008 financial crisis, shareholders' pressure, amplified by the media, can lead management to deny or give up golden parachutes or other ill-perceived remuneration in times of financial distress.[581]

3. The case in practice

a. Preliminary remark

Voting and other monitoring rights would not improve corporate governance within a firm if the actors supposed to exercise them do not exercise them appropriately. The onus could thus fall on shareholders' shoulders for not exercising their monitoring and enforcement responsibilities diligently.

But in order for shareholder vote and monitoring to properly operate, and so for issuer-disclosure to effectively promote these corporate governance devices, shareholders should have both the right incentives and the appropriate tools to process and act upon the information disclosed.[582] In other words, they should not only be *willing* to make the necessary efforts to hold management or controlling parties "accountable" but they should also be *empowered* to do so.

However, it is often argued in the literature that shareholders in the E.U. do not have these incentives and tools.

I examine this contention in the last two sub-sections.

And first, I determine with precision the market actors who should be expected to use information to positively impact corporate governance of European firms.

b. A distinction among shareholders

i Foreword

While shareholders of a limited liability company enjoy limited liability in respect of the company in which they invest, the taxpayer has been obliged to assume effectively

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[581] See to illustrate this point, Axel Miller, former CEO of Dexia in Belgium, who gave up on his golden parachute in October 2008; Sir Fred Goodwin, former Chief Executive of RBS, whose pension was reduced; Herbert Walter, former director of Dresdner Bank, who abstained from bonus payments for 2008.

[582] *Accord* EILÍS FERRAN, *The role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions*, 4 EBOR 491, (2003).

unlimited liability in the case of major banks, in the aftermath of the 2007-2008 financial crisis.

This has been perceived as largely unfair.[583]

Questions have consequently been raised about the culpability of shareholders along with management for failing to properly take their responsibilities. It appears that not only management but also shareholders were often insufficiently committed: they were often insufficiently demanding, favouring opportunistic behaviours and taking too short-term views.[584]

The 2007-2008 financial crisis underlined the importance of discharge of the responsibility of shareholders as *owners*.[585]

It could seem awkward at first sight to speak about "shareholders' responsibilities" as the ownership right that the shareholder has by owning its shares arguably gives him the right not only to use its assets or to collect any revenue linked to them but also to make any use of them as he thinks fit (*usus*, *fructus* and *abusus*). Consequently, shareholders are not required, for instance, from a strict legal point of view, to attend shareholders' meetings or to exercise their voting rights.

However, the case for those who have rights of ownership and enjoy the advantage of limited liability to see these as complemented by a corresponding duty to

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[583] Some authors point out to the company law principle of limited liability as important obstacle to responsible shareholdership. According to them, it offers little to encourage shareholders' activism "since the exposure of shareholders to risk is reduced to virtually nothing when applied together with separate personality". See CHARLOTTE VILLIERS, Has the Financial Crisis Revealed the Concept of the 'Responsible Owner' to be a Myth? (2009)., at 18 citing Paddy Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (2008) *Cambridge Journal of Economics*. I will not discuss this argument here, given the limited scope of this dissertation.

[584] See Wouter Bos, Speech to the ICGN as reported in Global Proxy Watch, Vol XIII, No. 10, 6 March 2009 ("[w]e cannot avoid asking ourselves what you, shareholders, have done to prevent and manage the crisis. Unfortunately, and I know you don't like to hear this, the answer is almost nothing"). See also Hector Sants (Chief Executive of the UK FSA), The Crisis: the Role of Investors, NAPF Investment Conference 2009, 11 March 2009 (stressing that the oversight role of shareholders is a duty; stating that although investors have extensive rights to directly or indirectly influence the governance of listed companies, they have been "too reliant and unchallenging" with regard to corporations); speech by Lord Myners delivered on 21 April 2009 at the conference at Association of Investment Companies (stating that investors themselves often acted as "absentee landlords").

[585] The reader should note that I do not refer in this dissertation to the distinction between "legal ownership" and "beneficial ownership" to the extent it exists under the national law of some Member States. I consider that the institutions that have, by law or by contract, the right to vote and to monitor the companies in which they have invested on behalf of end-beneficiaries, should be subject to a duty to engage in corporate governance matters, as further detailed below (see Part II:Chapter III:II.E.3.b.iii below). Consequently, I might refer to "shareholders" or "owners" although the institutions concerned might not qualify as such from a strict legal point of view.

seek the achievement of the corporate objective, seems appealing.[586] This duty is also referred to as a "*duty to engage*", i.e., a duty to ensure that value is derived from holdings by dealing effectively with concerns about under-performance.

The question of engagement/commitment became a central point of discussion, including in international fora.[587]

Initiatives to facilitate owner engagement with their boards, so that selling the shares comes to be seen as a last resort, are believed to lead to greater investor understanding of, and confidence in, the medium and longer-term strategy of the company, and in the board's capacity to oversee its implementation. A committed behaviour could shrink benefits a bit, at least in the short-term. But engagement could be seen as a sound move away from short-term capitalism to the extent that it is merely speculative.[588] This might be expected to lead to some reduction in investors' sensitivity to quarterly earnings announcements and other short-term indicators and developments, including sell-side analysts' reports which may influence the immediate trading strategies of some.[589]

Moreover, the full awareness of their responsibilities by investors is a prerequisite for the *proper functioning of the system of comply-or-explain* adopted by the European Commission to manage corporate governance.[590] Indeed, the comply-or-explain approach traditionally relies on investors to monitor and enforce corporate governance codes. Shareholders ought to place corporate practices under close scrutiny. This

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[586] See, to support the case, Walker Review of Corporate Governance of UK Banking Industry (26 November 2009) (recommending a stewardship code for institutional investors) (hereafter the Walker Review), at Chapter 5, 5.7 (speaking of a duty of stewardship for fund managers).

[587] See, *inter alia*, ICGN, second statement on the global financial crisis, March 2009 (stating that "shareholders must recognise that they should use their share-ownership rights responsibly in the interest of creating long-term value for their beneficiaries. If they do not act responsibly their rights will be at risk and their case for strengthened rights will be undermined"); statement by Mats Isaksson, Head of Corporate Affairs at the OECD, 17 June 2009 (stating that one of the most urgent steps to take now is to "act on the need for shareholders to be more active"). Of course these two abstracts refer to institutional investors' engagement. See Part II:Chapter III:II.E.3.b.ii below.

[588] For my opinion relating to the corporate objective, see Part I:VII.B in General Introduction.

[589] As a side remark, it will be interesting to see the position of the new institutional shareholder bodies created as governments' responses to the current financial crisis, including, for instance, the UK Financial Investments Ltd or the French *Fonds Stratégique d'Investissement*.

[590] See note 497 above and accompanying text.

requires shareholders to get involved and express their opinions against poor corporate governance standards and to make use of their voting rights.

However, not all shareholders can be expected to participate in corporate life, and to make use of their voting and monitoring rights, *with the same level of commitment/engagement*.[591]

ii The distinction between small retail investors and the others

As developed in more details above,[592] *small retail investors* do not have the same incentives as larger or more sophisticated shareholders to commit to the level contemplated by a legally mandated increase of information requirements. By lack of time, proper resources and/or competence, it seems rational that they do not usually, personally or directly, actively engage in corporate matters.

This being said, it does not mean that the size of their equity holding and their qualification as retail investors justify an apathetic behaviour on their part. Indeed, as already suggested,[593] I believe that *every* shareholder should be conscious that its ownership of equity carries risks calling for responsibilities to be taken, particularly through the exercise of the voting rights that can influence the way in which a business is conducted. This implies, with respect to small unsophisticated retail investors who do not have the right incentives to vote, that they should be encouraged to invest through financial intermediaries, who will exercise the voting and monitoring rights on their behalf.[594]

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[591] See in that respect the attendance rate at general shareholders' meetings in European firms. See RiskMetrics Group, Voting results in Europe, dated October 2008 (collecting results on a sample of 715 companies across Europe in 17 countries, including the ones under review, for the period from January 1st, 2008 to June 30th, 2008, showing average attendance of 60%); RiskMetrics Group, Voting results in Europe - Understanding shareholder behaviour at general meetings, dated September 8th, 2009 (same, showing average of 61% attendance rate). See as well MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008)., at 90 and references cited; study by PIRC (2007) (showing average voting levels from 36% in the Netherlands and about 50% in Germany and Italy to about 60% in the U.K. and Spain with France in between). For Germany, see as well Deutsche Schutzvereinigung für Wertpapierbesitz, HV-Präsenz der DAX-30-Unternehman (1998-2007) in Prozent des stimmberechtigten Kapitals (documenting an increase from 45.87 to 56.42% in the 30 largest listed companies).

[592] See Part II:Chapter I:IV.B.2 in Chapter Investor Protection.

[593] See Part I:VI in General Introduction.

[594] See Part III:Chapter I:II.C.1 in Chapter Issuer-Disclosure Addressees and Consequences.

I believe that the situation of *large retail investors* is a different one. Large retail investors are identified on the basis of the personal resources invested in a given company or on the basis of the size of the stake they have in a particular company. Their personal involvement or the size of their stake implies that they have, in theory at least,[595] appropriate incentives to vote and to monitor.

I believe as well, as a general matter, and from a theoretical perspective at least,[596] that *institutional investors* have appropriate incentives to engage in corporate matters, as contemplated by mandatory disclosure. This concerns in particular investment firms who invest on behalf of end-beneficiaries and who are subject to, *inter alia*, the conduct of business obligations under MiFID.[597] The *fiduciary relationship* between investment firms subject to MiFID and their end-beneficiaries[598] could indeed call for these investment firms to be involved in corporate governance matters. This concerns more generally the wider class of institutions acting as owners for ultimate beneficial owners and to asset managers.[599]

It could therefore be *a priori* important that institutional investors, including investment firms subject to MiFID, put proper resources into governance and, as the case may be, recognise their own accountability to their end-beneficiaries.[600]

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595 For the incentives in practice, see Part II:Chapter III:II.E.3.c below.

596 For the incentives in practice, see Part II:Chapter III:II.E.3.c below.

597 See the definition of "investment firms" under article 4.1 1) of MiFID (""Investment firm" means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities [as defined in Section A of Annex 1] on a professional basis;").

598 This fiduciary duty could arguably be based on article 19 of MiFID (Conduct of business obligations when providing investment services to clients) and article 44 of MiFID Implementing Directive (Best execution). See with respect to the private law nature of MiFID rules of conduct and their relationship with civil law duties of care, Veerle COLAERT, *De meerlagige rechtsverhouding financiële dienstverlener – belegger. Een onderzoek naar de verhouding tussen de MiFID gedragsregels, consumentenrecht en burgerlijk recht, getoetst aan de regels inzake pretransactionele informatieverplichtingen*, Thesis, Leuven, January 2010, 580 p., specifically at 126-35 and 294-313. See for authors pointing out to the narrow interpretation of fiduciary duties of institutional investors with strong focus on short-term profits, CARMEN JURAVLE, et al., *Identifying impediments to SRI in Europe: a review of the practitioner and academic literature*, 17 Business Ethics: A European Review 285, (2008)., at 288.

599 *Accord* OECD, Corporate Governance and the Financial Crisis – Conclusions and emerging good practices to enhance implementation of the Principles.

600 See CHARLOTTE VILLIERS, Has the Financial Crisis Revealed the Concept of the 'Responsible Owner' to be a Myth? (2009). (highlighting responsible ownership of shareholders as corporate governance principle and ethical concept); John Hendry, Paul Sanderson, Richard Barker and John Roberts, 'Responsible ownership, shareholder value and the new shareholder activism' BRESE Working Paper No 13, November 2004; JOHN HENDRY, et al., *Owners or traders? Conceptualizations of*

The field of shareholders' responsibilities is much less harmonised at European level than that of shareholders' rights.

Some corporate governance codes are nevertheless recommending institutional investors to make actual use of their voting rights.[601] Active monitoring by institutional investors is also encouraged by supranational institutions.[602]

Of course, a promotion of engagement should not over-ride the general rules relating to inside information. Promotion of commitment will not necessarily involve the acquisition of inside information. If it does, that information should only be provided with the prior agreement of the addressee who should agree to hold it confidential in accordance with the rules under the MAD.[603] Where, for example, advance notice is given of an intended change in the board of the company in which the addressee has invested or in some aspect of the company's strategy, arrangements within the addressee must be set up rigorously to ensure that such information does not leak, including to the trading desk of the addressee, for instance.

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institutional investors and their relationship with corporate managers, 59 Human Relations 1101, (2006).; CHRIS MALLIN, *Institutional shareholders: their role in the shaping of corporate governance*, 1 International Journal of Corporate Governance 97, (2008)., at 100.

[601] See especially Principle IV.4 of the Dutch corporate governance code. See also one of the guiding lines relating to Principle 8.5 of the Belgian corporate governance code (providing that the company should ask institutional investors and their voting agencies explanations about the exercise of their voting rights) and Principle E.3 of the UK combined code on corporate governance. See also Principle 6 of the Code on the Responsibilities of Institutional Investors, issued by the Institutional Shareholders' Committee, November 2009 (requiring institutional investors to disclose publicly voting records and if they do not, requiring them to explain why); "Responsible Voting - A Joint ABI - NAPF Statement" 19 July 1999; UK Cadbury Report (*inter alia*, §6.16); NAPF, *Institutional Investment in the UK: six years on*, (November 2007, London); the Hedge Fund Standards issued by the Hedge Fund Standards Board in 2007; HM Treasury, *Updating the Myners Principles: a response to consultation* (October 2008, London); speech made by the UK Financial Services Secretary, Lord Myners, 9 November 2009, All Parliamentary Group on Corporate Governance, Check against Delivery ("[b]ut as I have said on so many occasions, regulation and supervision is not enough. Shareholders and owners have to take responsibility and take action. When I spoke to you last I highlighted that there is a role for institutional investors in preserving and adding value to the investments made for their clients. As the Government is now part of that class - thanks to our investment in the banking sector - we have and will use our position to be an active and engaged investor"); ICGN's Statement of Principles on Institutional Shareholder Responsibilities, 6 July 2007, available on the ICGN web-site.

[602] See, *inter alia*, Principle II.F.1 of the Principles of Corporate Governance 2004 of the OECD; Investment Fund Managers as Shareholders, Recommendations for Best Practice on Corporate Governance of EFAMA (previously FEFSI) dated 5 February 2002; the United Nations Principles for Responsible Investment (recommending that investors "exercise voting rights or monitor compliance with voting policy (if outsourced)" and "disclose active ownership activities (voting, engagement, and/or policy dialogue)").

[603] See in particular articles 2 and 3 of the MAD.

iii Consequences for institutional investors, including those who invest on behalf of end-beneficiaries

Active ownership could be prompted by creating concrete incentives, like giving a "voting premium" to shareholders who exercise their vote (not to those who abstain from voting)[604] or linking dividends to the exercise of the voting rights. I do not favour these kinds of initiatives as they could be counter-productive.

Engagement by institutional investors could also be promoted by regulatory requirements, like mandatory voting and the disclosure of voting policy.

These requirements, where they already exist,[605] led to the emergence of third-party proxy advisory firms, like RiskMetrics,[606] Egan-Jones Proxy Services, Glass Lewis & Co., Marco Consulting Group, Proxy Governance, Inc., PIRC, Ethos, Eumedion or Deminor, which offer vote recommendations and sometimes cast votes on behalf of their clients. These firms solve the collective action problem relating to shareholder voting and could be a solution to any remaining apathetic behaviour of shareholders, especially those practicing index investments.[607] Their impact is quite significant as their institutional clients, primarily mutual funds and pension plans, even though they might hold relatively small stakes in the companies they invest in, due to regulatory restrictions,[608] have significant stock holdings when compared to other investors.[609]

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[604] See JOSÉ M. GARRIDO GARCIA, et al., *Institutional Investors and Corporate Governance: Solution or Problem?* , *in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 444.

[605] See note 616 and accompanying text.

[606] Institutional Shareholder Service (ISS), the predecessor of RiskMetrics, arguably got its start in the late 1980s when the US Department of Labour, which supervises pension funds, ruled that "[t]he fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies […]." The US SEC then adopted rules mandating that registered investment advisers vote proxies "in the best interest of clients" and that registered mutual funds disclose both their proxy voting policies and how they actually voted. See for further details note 616 and accompanying text. As a practical matter, cost effective compliance with those rules has meant hiring someone else to vote the shares, namely ISS (RiskMetrics) or its competitors.

[607] See the detailed voting guidelines indicating how votes will be cast on the web-site of RiskMetrics. See, for a concrete example, the Stork case, in the Netherlands, Ondernemingskamer, AZ6440, 17 January 2007.

[608] See, for European restrictions, article 50 and seq. of UCITS IV; see similar provisions in occupational pension funds regulations and insurance companies regulations. For MiFID regulated firms, see rules on safeguarding of clients assets, conflicts of interests and operating conditions under articles 16 to 39 of MiFID. Comp. with the U.S. (restricting holdings by institutions (alone or in a group) to no more

Although the idea has been discussed in some Member States, including in Germany in the early 2000's, the European Commission has refused to oblige institutional investors to exercise their voting rights.[610] It specified that a requirement for institutional investors to systematically exercise their voting rights is not considered desirable as they might simply vote in favour of any proposed resolution to fulfil this requirement without analysing the matter by lack of time. And this might be counter-productive.

The European Commission has not even implemented any measure to the effect that institutional investors disclose their voting policy and how the voting rights have been used (i.e., for, abstain or against a proposal), including a statement whether the full holding was voted or whether some shares were not voted, because they were lent for instance.[611] This lack of intervention of the European Commission has been criticised

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than 5% of a portfolio company's shares in order not to be submitted to the US Williams Act of 1968 regarding tender offers; and providing that institutions (alone or in a group) cannot own more than 10% of a portfolio company's shares, or place their nominee(s) on a portfolio company's board, or they risk becoming subject to the short-swing disgorgement rules under section 16 of the US Exchange Act; and providing that mutual funds must meet diversification rules to obtain flow-through tax treatment, thus no more than 5% of a fund's assets can be invested in any one company and no fund may hold more than 10% of any company's shares. Mutual funds that advertise themselves as "diversified" must meet these diversification limits as to 75% of the fund's portfolio. Open-end mutual funds (the prevalent kind) must also maintain liquid assets, thus limiting the ability to take control positions that may be difficult to sell quickly).

[609] For the impact of ISS/RiskMetrics and its competitors, see Robert D. Hershey Jr., *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. Times, June 18, 2006, §3, at 6 (noting that ISS recommendations affect the votes of "professional investors controlling USD25 trillion in assets–half the value of the world's common stock"); Chris Kettman, Ashton Partners, *Predicting and Impacting the Proxy Vote*, 2005, at 3 ("[m]any firms, especially those that practice purely quantitative or index investing, will vote in line with ISS' recommendations . . . [while] some firms claim they vote on a case-by-case basis but will always vote with ISS."); JAMES F. COTTER, et al., *The Effect of ISS Recommendations on Mutual Fund Voting*, (2009). (showing that RiskMetrics' ISS Corporate Governance Services' voting recommendations have an impact on voting by shareholders generally and an even greater impact on voting by mutual funds). *Contra* STEPHEN J. CHOI, et al., Director Elections and the Role of Proxy Advisors (2008). For risks inherent in proxy advisory firms, see Part III:Chapter I:II.C.1 in Chapter Issuer-Disclosure Addressees and Consequences.

[610] See EUROPEAN COMMISSION, Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (2003). (under the heading "Enhancing Corporate governance Disclosure").

[611] The recommendations to require investors to disclose their investment and voting policies, as well as voting records for their portfolio companies, were incorporated by the European Commission as medium-term objectives in its 2003 Action Plan (see EUROPEAN COMMISSION, Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (2003).) and later left aside due to indecisive public support on this issue. The 2002 Report of the High Level Group of Company

by some academics[612] as well as by a number of asset management associations[613] and international institutions or institutional investors associations.[614]

I tend to concur with the critics. As showed by empirical evidence, institutional investors, domiciled in the jurisdictions where some sort of framework of voting reporting has been implemented,[615] show a significantly higher level of voting

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Law Experts (see JAAP W. WINTER, et al., Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2002).) had however noted that shareholders, especially institutional investors, were "ideally placed to act as a watchdog" of good governance and that their traditional action tool was voting at general meetings. Hence, although the Group's consultation showed mixed responses concerning a possible formalisation of the institutional investors' role, the report recommended some form of regulation at Member State level in order to oblige shareholders to disclose their voting policies and voting records (see Recommendation III.7 of the Report). The current European Commission's position reflects the OECD current position: see OECD, Corporate Governance and the Financial Crisis: Key Finding and Main Messages, June 2009, at 49 (not in favour of a disclosure of voting records).

[612] See KLAUS ULRICH SCHMOLKE, *Institutional Investors' Mandatory Voting Disclosure - European Plans and US Experience*, 7 EBOR, (2006).; MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008)., at 117 et seq.

[613] Notably the *German Bundesverband Investment und Asset Management* and the European Fund and Asset Management Association. See also the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).

[614] See European Sustainable Investment Forum (Eurosif), press release, 16 April 2009 (stating that "European institutions should introduce a mandatory Statement of Investment Principles ("SIPs") for Investment Funds in which trustees would state […] their policy in relation to the exercise of the rights (including voting rights) attached to investments"); see also The International Corporate Governance Network (ICGN); see also OECD, Corporate Governance and the Financial Crisis – Conclusions and emerging good practices to enhance implementation of the Principles.

[615] See in France and in the Netherlands; see also in the U.K. Contrary to France and The Netherlands, the UK system is strictly voluntary. For details, see RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009). at 48 et seq. See the Belgian law of 6 April 2010, which came into force on 3 May 2010 (mandating the disclosure of the voting results on the company's web-site). Comp. with the U.S.: in 1988, the Department of Labour issued a set of guidelines, now known as the "Avon Letter", directing Employee Retirement Income Security Act of 1974 (hereafter ERISA) fund managers to vote proxies with the same diligence as making other fiduciary decisions. Although initially only pension funds subject to ERISA were targeted by the letter as they are the only ones subject to the US Department of Labour, in practice all pension funds, public or private, did obey by that rule. In a letter of February 2002, SEC then Chair, Mr. Pitt, clarified in writing the SEC's stance that proxy voting is an investment adviser's fiduciary responsibility, generally governed by state law. The SEC adopted in 2003 rule and form amendments under the Securities Act, the Securities Exchange Act, and the Investment Company Act of 1940 (Rule 30b1-4; Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47, 304), addressing investment companies and investment advisers. These amendments require registered management investment companies to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities. The amendments also require registered management investment companies to file with the SEC and to make available to shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities. On the US debate relating to disclosure of voting and corporate governance activities of mutual funds, see ALAN R. PALMITER, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 Cardozo Law Review, (2002). See also The Millstein Center at Yale School of Management (calling on institutional investors to be more transparent about the way they act as owners of public corporations by disclosing how they vote, what ownership policies they follow, and what resources they put into engagement efforts).

activity.[616] Consequently, the transparency requirement seems to be an effective tool to incentivise institutional investors to make an active use of their voting rights and mitigate the market failure of free-riding. Besides, disclosure of voting policy seems to be the best solution to encourage institutional investors to vote in the interests of their end-beneficiaries, if any. Indeed, it enables end-beneficiaries, if any, to understand what criteria are used to reach decisions under usual circumstances. And it demonstrates a commitment to accountability of institutional investors toward their end-beneficiaries, if any, and shows that conflicts of interests are being properly managed.

The institutional shareholder community will undoubtedly bear additional costs as a result of mandatory engagement and voting disclosure requirements. Today, these costs are borne by the minority of engaged investors, which may welcome to share the burden with other investors. Spreading the costs over all investors will help address the free-rider issue on this matter. Besides, costs need to be put in perspective with the benefits of raised corporate governance across the E.U., and should remain within respectable boundaries as long as the framework provides sufficient flexibility.

I expect that, under international pressure and through the forces of global convergence, there will be changes in that respect in the near future, preferably through a recommendation of the European Commission which would allow for non-disclosure of the voting records provided that the reasons behind non-disclosure are set out.[617]

To be sure, engagement should not be seen as uniquely best practice for institutional investors.

If a promotion of commitment/engagement implies active engagement on the basis of ownership on a longer-term basis, this does not exclude business models that involve greater emphasis on *active trading* of equities. In particular, all fund managers have the obligation to work within the terms of the mandate agreed with their clients. As long as the investment strategy has been clearly discussed with, and disclosed to,

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[616] See RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009).
[617] See below.

end-beneficiaries, *short-term investments* should not be prohibited.[618] I believe however that the regulator should not create incentives to pursue short-term horizons and speculative behaviours.[619]

Besides, *indexing* became a frequently used technique in institutional investing. And this investment strategy implies a passive attitude in terms of corporate governance monitoring.[620] There does not seem to be unanimous evidence relating to the performance of index funds.[621] This being said, there could be a business case for index

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[618] And any conflict of interests between clients' interests and shareholders' interests should be resolved in favour of the clients', at least where investment firms subject to MiFID are concerned.

[619] I believe in that respect that "flash trading" should be carefully scrutinised (see note 236 above and accompanying text). See the US SEC recent proposed new rule to effectively prohibit unfiltered access and maintain market access control (see Securities Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009) ("Flash Order Release") (eliminating the exception for flash orders from the US Securities Exchange Act quoting requirements)). See also, SEC Issues Concept Release Seeking Comment on Structure of Equity Markets, SEC, 13 January 2010. The reader should note that I do not discuss in this dissertation the opportunity for the regulator to create incentives for long-term investments. See in that respect in some Member States the differentially-weighted voting under which votes of shareholders who hold the stock for more than a specified minimum period are awarded extra voting capacity. See, for instance, the double voting right in France. It could be seen as a means of giving voting weight to ownership as against trading of stocks. But this could also be seen as running counter to the principle of one-share one-vote and given nominee holding arrangements, it could be impractical to administer. Another oft-cited criticism is that extra voting rights for long-term shareholders in controlled companies would probably serve the interests of the controlling shareholders and could therefore harm the interests of minority shareholders. See also, the loyalty dividend suggested by the Dutch company DSM which was over-ruled by the Enterprise Section of the Amsterdam Court of Appeal on the ground that it was in violation of the principle of equality, which ruling was reversed by the Dutch Supreme Court; see for academics in favour of the introduction of such loyalty dividend, Z. TALI, et al., *Loyaliteitsdividend, registratiedividend en institutionele beleggers: 'Vaste relatie of betaalde liefde?'*, 4 Ondernemingsrecht 45, (2007). See the latest developments in the Netherlands: at the end of August 2009, the Dutch minister of justice announced that it is preparing legislation that will facilitate extra dividend or voting rights for long-term shareholders. Comp. with the U.S. where, where the interests of long-term investors and short-term professional traders diverge, the US SEC repeatedly has emphasised that its duty is to uphold the interests of long-term investors. See, for instance, Flash Order Release, 74 FR at 48635-48636; Regulation NMS Release, 70 FR at 37499-37501; Fragmentation Concept Release, 65 FR at 10581 n. 26; see also S. Rep. No. 73-1455, 73rd Cong., 2d Sess. 5 (1934) ("[t]ransactions in securities on organized exchanges and over-the-counter are affected with the national public interest. […] In former years transactions in securities were carried on by a relatively small portion of the American people. During the last decade, however, due largely to the development of means of communication . . . the entire Nation has become acutely sensitive to the activities on the securities exchanges. While only a fraction of the multitude who now own securities can be regarded as actively trading on the exchanges, the operations of these few profoundly affect the holdings of all.").

[620] See JOSÉ M. GARRIDO GARCIA, et al., *Institutional Investors and Corporate Governance: Solution or Problem? , in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 440.

[621] According to Bloomberg data, difference in performance for 20 exchange-traded funds (following indexes) versus 159 active funds is as follows: returns over 12 months up to October 2009: -4.1% for exchange-traded funds , 10.1% for active funds; returns from January 2009 to October 2009: 3.4 % for exchange-traded funds versus 20.1% for active funds (hence an average of 14-17% of difference in performance (for this last year) in favour of active funds).

investments. Once again, as long as their investment strategy is duly disclosed to clients, index investment funds should not be prohibited.

Moreover, it is true that institutional shareholders who do engage in active monitoring *do not necessarily pursue long-term shareholder value maximisation* as sole objective.[622] To the extent this is the case, there is cause for concern.

In that respect, it should be noted that prominent academics believe in the overall positive effect of shareholder engagement, especially activism exercised by hedge funds.[623] Besides, the conflicting interests of some minority shareholders, like some hedge funds, could be dealt with by proper regulation and should not be an objection to my argument.[624]

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[622] See, *inter alia*, STEPHEN M. BAINBRIDGE, Investor Activism: Reshaping the Playing Field? (2008).; the studies cited by PETER CZIRAKI, et al., Shareholder Activism through Proxy Proposals: The European Perspective (2009)., at 6; MARCEL KAHAN, et al., *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review (2007).; DAVID PARTHIBAN, et al., *Investor activism, managerial responsiveness, and corporate social performance*, 28 Strategic Management Journal 91, (2008). For a discussion of the possible downsides of hedge funds, see JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 265 et seq. The increased attention of legal academics with respect to so-called “empty voting”, i.e., voting without economic interest at stake in order to reap trading gains, could be explained by the fact that empty voting goes against the basic assumption that shareholders exercise their vote with a view to maximising shareholder value (see with respect to empty voting in general, Michael C. Schouten, *The Case for Mandatory Ownership Disclosure*, 15 Stanford Journal of Law, Business & Finance (forthcoming 2010); HENRY T. HU, et al., *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 Journal of Corporate Finance 343, (2007).).

[623] See ALON BRAV, et al., The Returns to Hedge Fund Activism (2008).; APRIL KLEIN, et al., *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, Journal of Finance (forthcoming), (2009).; WILLIAM W. BRATTON, *Hedge Funds and Governance Targets*, 95 Geo. L. J. 1375, (2007).; MARCEL KAHAN, et al., *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review (2007). See also MARCO BECHT, et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, 21 Review of Financial Studies, (2008). (showing that Hermes has been earning returns net of fees of 4.9%).

[624] See in that respect, articles 9 to 16 of the Transparency Directive relating to disclosure of major shareholding, including shareholders acting in concert; see also the European proposal for a directive on alternative investment fund managers, European Commission, Proposal for a directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending directives 2004/39/EC and 2009/…/EC, COM(2009) 207 final (expected to be voted in July 2010). Comp. with the U.S., Private Fund Investment Advisers Registration Act, which requires, if and when adopted, registration with the US SEC by financial firms, including hedge funds, private equity firms, and other private pools of capital including offshore funds. See also the suggestion of Professors Stout and Anabtawi, for an expansion of the fiduciary duty of the controlling shareholder to any shareholder that would be triggered whenever a particular shareholder, whether or not it is technically a controlling shareholder capable of controlling the boards’ decisions as to all matters, in fact manages to successfully influence the company’s actions with regard to a particular issue in which that shareholder has a material, personal economic interest, IMAN ANABTAWI, et al., *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255, (2008).

I therefore *assume* in the rest of this dissertation the *positive effects of shareholders' engagement*, i.e., better risk and resource allocation in the economy as a whole and strengthened corporate governance.

What I am advocating in essence is that institutional investors' choice to engage or not to engage be a *considered* one, based on their investment objectives.[625]

The type of engagement I am advocating is more likely to apply to *long-only* funds. Among these long-only funds are life assurance companies and pension funds which are likely to be owners of significant stakes in major companies over an extended period, consistent with the long-term horizons of their business model (as in life assurance) or the underlying beneficiaries (as in pensions). Accordingly, they have at least a presumptive interest in long-term engagement with the boards of companies in which they invest.

This being said, it should never be forgotten that the duty of these institutional investors is to their clients and not to the wider public. This might imply that, even where a fund manager has committed to be active, a decision to sell in a particular instance will have to be taken where this is judged to be the most effective response to concerns about under-performance.

My position of promoting greater engagement from long-term institutional investors calls for the European regulator to set out, in a *recommendation*, *principles-based* measures to be further detailed in the section of the applicable best practice code of conduct relating to institutional investors' behaviours, including a disclosure of voting policy and voting records on a comply-or-explain basis. The recommendation should recommend institutional investors, and especially investment firms subject to MiFID who invest on behalf of end-beneficiaries, to be engaged shareholders, concerned with the corporate governance strengths and weaknesses of the companies they invest in, to balance their natural tendency to be only focussed on short-term performance because they win and lose business on the strength of it. Besides, the existence of fiduciary duties on the part of investment firms subject to MiFID should be duly acknowledged to the benefit of their clients. In addition, the specific code of

[625] *Accord* Annex 8 to the Walker Review (Stewardship Code).

conduct applicable to a specific institutional investor should be clearly specified according to objective criteria to increase legal certainty for institutional investors.

Professional organisations of investors should be closely involved in the drafting of the recommendation. These organisations are best placed to set the foundation of market driven principles for quality investor disclosure in each Member State to inform the European standards.

Further to the recommendation, national *best practice codes of conduct* for institutional investors should be drafted, to the extent this is not already the case.[626] Once again, professional organisations of investors should be closely involved in the drafting. Such principles of communication and engagement, including a disclosure of voting policy and voting records, should follow a comply-or-explain approach. In this framework, institutional investors would have to either comply with the principles of the code or explain why they elect to deviate from certain provisions of the code. Over time, these disclosure requirements should facilitate changes in investor behaviour, encouraging a more considered and informed use of their rights.

The choice of the institutional investor to commit and to report on its engagement or not to engage in corporate matters should be clearly *disclosed* on its web-site, so that any end-beneficiary or investor would be able to make an informed choice when having recourse to that financial intermediary or when investing in that institutional investor.

Prospective clients and shareholders of institutional investors should in turn take seriously their responsibility to consider the potential for engagement to add value to their portfolios, in particular over the medium and longer term.

These codes should not be seen as constituting an obligation to micro-manage the affairs of companies. It is not the role of institutional shareholders to second guess the management of the companies in which they have invested. I do not think that my position on shareholders' engagement jeopardises the conventional view that the

[626] See, as illustration of best practice code, the UK Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee (the so-called "Stewardship Code" (see the Walker Review)). *Accord* RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009).

decision-making power should stay with the board of directors. Shareholders are not generally, nor should they seek to be, in a position to identify and assess specific business risks.

Some observers are sceptic about the effectiveness of the comply-or-explain approach to corporate governance.[627] The questions they raise are as follows. What are the incentives for institutional investors to comply with the codes? Does the market really pay attention to compliance with the codes? If it does, to what exactly does the market pay attention: to the fact that there is an explanation in case of deviation from the recommendation of the code, whatever its quality, or to the relevance of the explanation given?[628] Are retail investors ready to monitor the compliance by the institutional investor in which they have invested, giving incentives to institutional investors to comply with the spirit, and not only the letter, of corporate governance codes?

Reflecting these doubts, my position calls for providing *appropriate monitoring*, which would not rely on end-beneficiaries. This monitoring should be subject to some form of independent oversight, to provide an authoritative assessment of the results of engagement activity for the benefit of prospective clients and other interested parties. Besides, should the voluntary compliance with the codes fail, the European regulator should consider to adopt a more binding regulation. This possibility should be provided for in the recommendation.[629]

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[627] See SRIDHAR R. ARCOT, et al., In Letter but not in Spirit: An Analysis of Corporate Governance in the UK (2006). (finding an increasing trend of compliance with the provisions of the UK Combined Code, but also a frequent use of standard and uninformative explanations when departing from best practice, which highlights a common conformity with the letter but not the spirit of the Code); ERIC NOWAK, et al., The (Ir)relevance of Disclosure of Compliance with Corporate Governance Codes - Evidence from the German Stock Market (2006). (finding that neither higher levels of compliance with German code nor improvements in governance quality have a (positive) impact on stock price performance compared to low levels of compliance and a reduction in the level of compliance).

[628] See SRIDHAR ARCOT, et al., One Size Does Not Fit All, After All: Evidence from Corporate Governance (2007). (finding that companies departing from best practice for valid reasons perform exceptionally well and out-perform the fully compliant ones. In contrast, mere compliance with the provisions of the Code does not necessarily result in better performance).

[629] Note the UK position where the Company Act 2006 gives the government power to require institutional investors to disclose how they have voted certain types of shares they own or in which they have an interest. The government has stated that it will only use this power if the voluntary regime of disclosure fails to improve disclosure and after full consultation.

I believe that these measures would be sufficient formal incentives for institutional investors to be more engaged.

Institutional investors and large retail investors' commitment/ engagement implies that they should research and analyse issuer-disclosure before exercising their voting rights and other monitoring rights. Issuer-disclosure could be useful for institutional shareholders, be they small or large shareholders of a given company, and for large retail shareholders, as it could decrease transaction costs related to searching and verifying relevant information.

c. The incentives in practice to vote and monitor in Continental European companies

i Foreword

Given the potential positive impact they could have on corporate governance, it is worth asking, first, whether institutional shareholders and large retail investors are, in practice, in a *position* to impact the outcome of the voting process in European companies and, second, *whether they are,* in practice, *engaged* shareholders in European firms. The effectiveness of commitment to influence corporate decisions in European firms hinges on a positive answer to these two questions seen from a practical point of view.

ii Position of institutional shareholders and large retail investors

Given the ownership structure of most Continental European companies, it is said that shareholder vote and shareholder monitoring that involves a vote by institutional investors and large retail investors, who are not large enough to be dominant shareholders/blockholders, are useless because of the presence of a controlling shareholder whose views cannot be contested. Some argue that, in a typical Continental European firm, the controlling shareholder often has such a dominant position that even if all other shareholders with a stake exceeding 5% enter into a voting agreement, they would still be unable to overrule the controlling shareholder.[630]

[630] See CHRISTOPH VAN DER ELST, Shareholder Mobility in Five European Countries (2008)., at 26 (showing that only in the U.K., smaller shareholders can overrule proposals of the largest shareholder at the general meeting of shareholders; suggesting that this situation has not changed between 1999 and 2007, although the relative importance of the voting blocks of all other shareholders *vis-à-vis* the largest shareholder increased in the countries under review); MARC GOERGEN, et al., *Strong Managers and*

However, this opinion ought to be nuanced along two lines:

As suggested above, more and more Continental European firms have *numerous blockholders*, the European market is (still increasingly) institution-oriented and controlling shareholders tend to disappear in some countries.[631] Consequently, minority shareholders, who are often holding blocks of shares and who are often institutions, could be in a position to have in the future more direct impact at shareholders' meetings.

In addition, the fact that a controlling shareholder or one or more blockholders could dominate corporate decisions does not mean that (other) shareholder vote is irrelevant:

To begin with, the law of the jurisdictions under examination in this dissertation affords protection to minority shareholders by requiring super/qualified majority voting for particular actions. These actions require accordingly the votes of the minority shareholders.[632] While shareholders are provided with specific information to inform their vote at shareholders' meetings, the information contained in periodic updates of the offering document could nevertheless also contain useful additional information to that effect.

In addition, where the controlling block consists of blocks of different shareholders who do not act together, the minority is *de facto* empowered to supply the needed votes.[633]

Besides, while the vote of the minority shareholders might not directly affect the decision because of the control exercised by the controlling shareholder or the

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Passive Institutional Investors in the UK, *in* The Control of Corporate Europe, (Fabrizio Barca, et al. eds., 2002). (finding that in the average UK firm, eight or more shareholders must join forces to attain a majority vote, which renders it fairly difficult to forge voting coalitions).

[631] See Part II:Chapter III:II.C.3 above.

[632] It is usually the case for increase or reduction of capital, waiver or settlement of a claim, change to the articles of association and change of control provisions. See for further regulatory changes in favour of the minority shareholders, the case of Italy, in DOMENICO FANUELE, et al., *Power to the Minority*, Int'l Fin. L. Rev., (2008)., at 48; the case of the Netherlands, in L. TIMMERMAN, et al., *Rights of Minority Shareholders in The Netherlands*, 6.4 Electronic Journal of Comparative Law, (2002).

[633] In the vast majority of European concentrated firms, the controlling block is formed by several blockholders. See note 536 above and accompanying text.

dominance of the blockholder(s), the fact that the matter is subject to a vote could change the behaviour of those in control or in a dominant position out of concerns of litigation or adverse publicity for instance. To support that view, it is commonly assumed that management today is influenced as much by financial considerations as by reputational concerns.[634] With increasing engagement from hedge funds, which have proven effective at bringing about significant changes while holding only a minority of shares, and associations representing minority shareholders, this in turn may provide an incentive to refrain from harmful conduct in the first place. In the same line of thoughts, controlling parties may consider the views of the minority shareholders to enhance their ability to attract equity capital through good corporate governance.

iii Shareholders' engagement in Europe

Some academics consider that institutional investors do not engage in much monitoring of the firms in which they invest.[635]

However, an important literature shows that monitoring has gained new importance because of engagement by some shareholders worldwide.[636]

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[634] See, *inter alia*, MELVIN A. EISENBERG, *Corporate Law and Social Norms*, 99 Colum. L. Rev. 1253, (1999).*Company law*; EDWARD B. ROCK, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, (1997).*Company law*; JONATHAN M. KARPOFF, et al., *The Consequences to Managers for Financial Misrepresentation*, Journal of Financial Economics (JFE), Forthcoming, (2008).

[635] For the U.S., see CLIFFORD G. HOLDERNESS, et al., *The Role of Majority Shareholders in Publicly Held Corporations - An Exploratory Analysis*, 20 J. Finan. Econ. 317, (1988).; Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 12–17 (UCLA Sch. of Law, Law & Econ. Research Paper Series No. 05-20, 2005) (advancing the view that institutional shareholders are rationally apathetic, except for union and state and local pension funds, which are the institutions most likely to engage in self-dealing); BERNARD S. BLACK, et al., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 Michigan Law Review 1997, (1994). (arguing that if an institutional investor is "underweighted", i.e., it owns a smaller share of the specific company than it owns of the market generally, it has a smaller incentive to intervene, because it will gain less from success than its competitors, while it bore a disproportionate share of the costs. Therefore, underweighted institutional investors have a tendency to remain passive because otherwise they would help their competitors at their own expenses whereas overweighted institutional investors are likely to be active monitors organising active coalitions).; STEPHEN J. CHOI, et al., *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 Vanderbilt Law Review 315, (2008). For a sceptic view of European academics on US activism, see JOSÉ M. GARRIDO GARCIA, et al., *Institutional Investors and Corporate Governance: Solution or Problem?* , *in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003). at note 17. For the U.K., see MARC GOERGEN, et al., *Strong Managers and Passive Institutional Investors in the UK*, *in* The Control of Corporate Europe, (Fabrizio Barca, et al. eds., 2002).; MARC GOERGEN, et al., *Do UK Institutional Shareholders Monitor Their Investee Firms?*, 8 Journal of Corporate Law Studies, (2007).

It should be noted that next to the engagement which consists of pension funds, insurance companies, mutual funds and hedge funds submitting proposals for shareholder vote, much shareholders' commitment actually takes place *behind the scenes*, by more informal pressures, making it difficult to observe and measure.[637]

In the E.U., a recent consultation of the European Commission points out that institutional investors are increasingly aware of the importance of preventing controlling shareholders' conflicts of interest.[638] The main instrument seems to be making more frequent use of voting rights, even if individual stakes are kept relatively small for reasons of portfolio diversification.[639]

It should be noted as well that monitoring through a sale of one's ownership could not be an available option, especially for large institutional investors, because of contractual limitations or specific investment policies or because of the costs further to

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[636] For the important monitoring role of shareholders in the European literature generally, see A.W.A. BOOT, et al., *Private equity en activistische aandeelhouders: Bestuur onder vuur*, *in* Private equity en Aandeelhoudersactivisme, (Preadviezen 2007 Koninklijke Vereniging voor de Staathuishoudkunde ed., 2007).; MARCO BECHT, et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, 21 Review of Financial Studies, (2008).; *Shareholder Activism is Taking Off in France. But It Has Yet to Achieve Much.*, The Economist 2008.; JOSEPH A. MCCAHERY, et al., Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (2009).; MIGUEL A. FERREIRA, et al., *The Colors of Investors' Money: The Role of Institutional Investors Around the World*, Journal of Financial Economics (forthcoming), (2007).; MIGUEL A. FERREIRA, et al., Shareholders at the Gate? Cross-Country Evidence on the Role of Institutional Investors in Mergers and Acquisitions (2007).; PETER CZIRAKI, et al., Shareholder Activism through Proxy Proposals: The European Perspective (2009). In the US literature, see The Financial Times 6 July 2001, "Survey – Global Custody: custodians are casting votes as they take on a more active role". See also for a general comment, LUIGI ZINGALES, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, (2009)., at 13 ("[t]his shift in ownership [from more retail investors to more institutional investors in the U.S.] has reduced coordination and other collective action costs. It has helped facilitate the rise of activist hedge funds (Brav et al, 2007; Klein and Zur, 2007) and has given rise to more general demands for a greater shareholder role in corporate governance.").

[637] *Accord* MARCO BECHT, et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, 21 Review of Financial Studies, (2008).; JOSEPH A. MCCAHERY, et al., Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (2009).; CARINE GIRARD, Comparative Study of Successful French and Anglo-Saxon Shareholder Activism (2009). See also WILLARD CARLETON, et al., *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA–CREF*, 53 Journal of Finance 1335, (1998).

[638] See EUROPEAN COMMISSION, Impact Assessment on the Proportionality between Capital and Control in Listed Companies (2007).

[639] See also RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009). (finding out of a sample of 100 institutional investors who responded to their survey, a vast majority of them having a corporate governance or voting policy; finding that the vast majority exercised their voting rights in the course of 2008, usually on all or the largest proportion of companies in their portfolio as well as all or the largest part of their assets under management; but also admitting that investors are often inactive and that more engagement is required; pressing Member States to put in place a framework to encourage transparency from investors).

the impact of the sale on the price of the shares.[640] Besides, selling requires a deep and liquid stock market.

As a last remark, I would like to say a word on engagement exercised by vehicles specialised in commitment, like certain hedge funds that purchase blocks in target companies with the intention to bring about changes.[641] Compared to the traditional active shareholders, like pension funds and insurance companies, they have the advantage of internalising a larger portion of their engagement, provided that they are successful. Some academics suggest hedge funds could form an important middle ground between internal monitoring by large traditional shareholders like pension funds and external monitoring by corporate raiders.[642]

To the extent these funds act with enlighted shareholder value maximisation in mind, their engagement should be welcomed as it should generally benefit firms and shareholders alike.[643]

I concur with observers that any report in the aftermath of the 2007-2008 financial crisis of the demise of this second category of engaged shareholder is premature.[644] To

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[640] See MARA FACCIO, et al., *Do occupational pension funds monitor companies in which they hold large stakes?*, 6 Journal of Corporate Finance 71, (2000).

[641] In terms of investment volume, activist hedge funds are thought to constitute 5% of the total (see MARCEL KAHAN, et al., *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review (2007)., at 1046).

[642] See in the U.S., JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 244 et seq.; ALON BRAV, et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 Journal of Finance 1729, (2008).; APRIL KLEIN, et al., *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, Journal of Finance (forthcoming), (2009).; MARCEL KAHAN, et al., *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review (2007).; Particia Vlakahis, Hedge Fund Activism, Possible Recession Will Play Roles in Upcoming Proxy Season, Corporate Law Daily, 1 February 2008. In Europe, see MARCO BECHT, et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, 21 Review of Financial Studies, (2008). Note that Europe already had its fair share of shareholder activism by hedge funds. Much publicised examples include events surrounding Deutsche Boerse's failed take-over attempt of the London Stock Exchange and its subsequent resignation of both its CEO and Chairman; the Stork case in the Netherlands where two hedge funds pressured Stork's management to break up its conglomerate structure; the merger of Euronext with the New York Stock Exchange, and the sale of the Dutch bank ABN Amro to a consortium comprising of Royal Bank of Scotland, Fortis and Santander, arguably set in motion by the UK based activist, The Children's Investment Fund (TCI).

[643] It should be noted in that respect that recent empirical studies in the U.S. show positive abnormal returns around the announcement of the filing of a Schedule 13D by hedge funds, i.e., the US SEC filing which is the equivalent in the U.S. of a notification of major shareholding in the E.U. See, *inter alia*, APRIL KLEIN, et al., *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, Journal of Finance (forthcoming), (2009).

[644] *Accord* Paul Betts, Reports of the demise of the activist are premature, Financial Times on line, 14 October 2008; Lina Saigol, Activists rise from the ashes, Financial Times on line, 13 November 2008; Haig Simonian, Ethos now targets ABB and Novartis, Financial Times, 27 January 2009.

be sure, some might well disappear (and have already disappeared) as investors withdraw their money or as they become insolvent. But others are likely to have increased workload in the near future as CEO's competence to adapt to the changed circumstances related to the financial crisis will unveil, giving new opportunities for hedge funds to intervene.[645]

d. *The right tools to vote and to monitor*

i Foreword

With respect to the tools provided to shareholders by European and national company laws, it is often argued that shareholders are not enough empowered to play an active role in corporate affairs.

Consequently, issuer-disclosure is of no use to them.

This statement is two-pronged:

On the one hand, it refers to the fact that investors most of the time do not read, understand or act upon the information disclosed, because they lack the personal ability.

I refer in that respect to the developments above where I explained that this is certainly the case with respect to small retail investors.[646]

However, further to the reasoning developed above, only large retail investors and institutional investors are expected to take engaged strategies.[647] Therefore, I suggest that issuer-disclosure be targeted at them, as they are supposed to have the corresponding expertise and they have the right incentives to read, understand and act upon the information.[648]

On the other hand, it relates to the availability and enforceability of voting and monitoring powers (or lack thereof):

[645] See Marco Becht, Der Aktionärsaktivismus wird die Finanzkrise überleben; Interventionen von Pensions- und Spezialfonds nützen allen Firmeneigentümern, Neue Bürcher Beitung, 29 November 2008.

[646] See Part II:Chapter I:IV.B.2 in Chapter Investor Protection.

[647] See Part II:Chapter III:II.E.3.b.iii above.

[648] For further details on this policy implication, see Chapter Issuer-Disclosure Addressees and Consequences.

Does the legal and judicial environment in the Member States considered in this dissertation enable effective monitoring by shareholders of management or the controlling party, through their vote or through their ability to file a claim?

I am concerned below with the latter side of the discussion.

One of the focuses of the current corporate governance debate is whether or not there should be greater and more active shareholder involvement in corporate matters.[649]

This translates in the U.S. in a heated debate in connection with the draft proposals making it easier for shareholders to add resolutions to the agenda of listed companies' general meetings and to vote on the company's remuneration policy.[650]

However, it should be noted that *I do not* generally discuss in this dissertation the accuracy of national law provisions determining the subject matters on which shareholders have a say and the thresholds for decision-making at shareholders' meetings. In Europe, shareholders' rights in connection with general meetings have been *for long* the centre of academic discussions *and* regulatory actions.[651] Therefore, I can safely assume that company laws of the European jurisdictions concerned by this dissertation are on average lenient enough with shareholders and provide for accurate voting thresholds, i.e., thresholds which duly protect minority shareholders.[652] I find support in recent empirical studies.[653]

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[649] I do not refer here to the debate relating to shareholder activism. I refer instead to the so-called "shareholder empowerment/democracy debate". See note 483 above and accompanying text (Bainbridge/Stout versus Bebchuck). See also LUCIAN A. BEBCHUK, *The Case for Increasing Shareholder Power*, 118 Harvard Law Review 833, (2005).

[650] See the requirement for an advisory vote on executive compensation (say-on-pay) which was contained in the House bill sponsored by Barney Frank that passed the House in July 2009. It is also contained in the draft bill released by Senator Dodd in November 2009. The US SEC has proposed rules that will make it easier for a shareholder to get certain shareholder proposals on the ballot. These rules have not been adopted yet.

[651] See, *inter alia*, RICHARD C. NOLAN, *The Continuing Evolution of Shareholder Governance*, 65 Cambridge Law Journal 92, (2006).

[652] See however my only objection in that respect under Part II:Chapter III:II.E.3.d.ii below.

[653] See the studies initiated by the Centre for Business Research of the University of Cambridge and *inter alia*, PRIYA P. LELE, et al., *Shareholder Protection: A Leximetric Approach*, 7 Journal of Corporate Law Studies 17, (2007). (showing the growing protection afforded to shareholders according to 60 variables (18 variables reflecting protection against other shareholders and the other variables showing protection against board) over the period from 1970 to 2005, for the U.K., France, Germany and comparing it to the U.S.); PRABIRJIT SARKAR, et al., *Legal Origin, Shareholder Protection and the Stock Market: New Challenges from Time Series Analysis*, *in* The Economics of Corporate Governance and Mergers, (Klaus Gugler, et al. eds., 2008).; PRABIRJIT SARKAR, et al., *Law, Finance and Development*

Consequently, I discuss below the *perceived obstacles to the exercise of shareholders' voting right*, where applicable rules provide that shareholders have a say. After that, I discuss the *alleged impediments under national laws to the due enforcement of management's or the controlling parties' duties*.

It is important to stress that the legal environment is determined not only by shareholders' rights *sensu stricto*,[654] but also by prevailing interpretation of legal rules, trends in private and public enforcement, as well as by the social, economic, political and cultural context.[655] These factors are far from being uniform across European jurisdictions. This could in turn result in differences in the degree of protection they provide.[656]

ii Obstacles to shareholder vote: a discussion of (the limits of) the Shareholders Rights Directive

The focus of the European regulator seems now to be the facilitation of the exercise of shareholders' rights in cross-border investments. This is at least one main goal of the Shareholders Rights Directive.[657]

Further Analyses of Longitudinal Data, Cambridge Journal of Economics, Forthcoming, (2009). (suggesting that, on the basis of aggregate legal indices of shareholder protection from 1970-2005 in France, Germany, the U.K. and the U.S., averaged over seven consecutive 5-year periods, in 1970-74 the U.K. had the lowest protection and Germany had the highest. It further found that shareholders protection increased throughout the 36 year period in all countries and that by 2000-2005, the U.S. had the lowest protection followed by Germany, then the U.K. and France. Besides, by averaging the indices of the two civil law countries, Germany and France, and those of the two common law countries, the U.K. and the U.S., it observed that the two civil law countries always had a higher protection of shareholders than the common law countries for each of the seven 5-year periods).

[654] Including contract law, the articles of association of a company (see TATIANA NENOVA, *The value of corporate voting rights and control: A cross-country analysis*, 68 Journal of Financial Economics 325, (2003).), company law, securities laws where they relate to shareholders as such and not to investors in general, civil procedure and criminal procedure.

[655] See, for instance, on the importance of the press, effective tax enforcement and effective enforcement of competition rules, I.J. ALEXANDER DYCK, et al., Private Benefits of Control: An International Comparison (2002).; the importance of enforcement, note 153 and accompanying text; the importance of moral norms, JOHN C. COFFEE, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, Yale Law Journal 1, (2001).; the importance of religion, RAFAEL LA PORTA, et al., *Legal Determinants of External Finance* 52 The Journal of Finance 1131, (1997).

[656] See, for instance, SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 Journal of Financial Economics 430, (2008). (showing, *inter alia*, that the dispersion among the 20 European jurisdictions they cover is considerable in connection with a self-dealing transaction involving a dominant shareholder).

[657] See, *inter alia*, article 5 of the Shareholders Rights Directive (minimum convocation period); article 7.1 (prohibition to impose deposit and blocking of the shares); article 8 (voting by electronic means); article 9.1 (right to ask questions); article 12 (voting by correspondence); article 11 (proxyholder).

The Shareholders' Rights Directive seeks, *inter alia*, to lessen the procedural costs related to cross-border voting through principles with respect to identification of shareholders, information, communication and voting, through the harmonisation of certain rules and through mandatory use of Internet technologies. More generally, it introduces and/or harmonises rules relating to equal treatment, information prior to general meeting, the right to put items on the agenda and to table draft resolutions, requirements for participation and voting, participation by electronic means, the right to ask questions, proxy voting and voting by correspondence.

I understand that the Shareholders Rights Directive has not been subject to heated debates during negotiations at European level.

This being said, there is not yet enough hindsight to assess its benefits in the national jurisdictions under consideration.[658]

However, the following general comments can be made:

Implementing national laws should seek to make shareholder right to vote effective[659] and should bring about legal certainty by a fair implementation of the directive, i.e., one that goes beyond the minimum harmonisation provided for by the directive, to the extent it does not raise any particular debatable issue under applicable law. For instance, implementing laws could provide that the notice of the meeting contains a list of documents attached and the full web-site address of the issuer where information can be found, including the draft resolutions. They could also make clear that the days mentioned are working days and not calendar days or that shareholders may appoint two proxies, one acting in case the other cannot for any reason. In addition, they could make sure that the record date is not set too close to the general meeting to

[658] The Shareholders Rights Directive was due to be transposed in national laws prior to 3 August 2009. See, *inter alia*, in Germany, the act implementing the Shareholders Rights Directive (ARUG) which largely came into effect on 1st September 2009; the Belgian draft law which was approved by the Council of Ministers and the State Council (*Conseil d'Etat*) before the resignation of the federal government in April 2010; the draft Dutch proposal referred to as *Wijziging van boek 2 van het Burgerlijk Wetboek en de Wet op het financieel toezicht ter uitvoering van richtlijn nr. 2007/36/EG van het Europees Parlement en de Raad van de Europese Unie van 11 juli 2007 betreffende de uitoefening van bepaalde rechten van aandeelhouders in beursgenoteerde vennootschappen* (PbEU L 184), Kamerstukken II, 31 746; the UK Companies (Shareholders' Rights) Regulations 2009, which took effect on 3 August 2009.

[659] See recitals (3), (4), (10) and (11) of the Shareholders Rights Directive.

allow for its proper holding. A proper balance should be stricken between two issues in that respect: on the one hand, the record date should allow enough time for the custodians/subcustodians/company to receive the notifications and proxies; on the other hand, it should not be set too far from the meeting to avoid that too many people vote without holding the rights attached to the shares as they transferred them after the record date and prior to the meeting.[660] Next, the deadline prior to the general meeting for shareholders to give voting instructions to custodians and proxy voting agencies should not be too short, as otherwise it may act as an impediment to hold proper shareholders' meetings because it would substantially reduce the time for the shareholders to prepare their opinions.

In addition, some (additional) points would be worth discussing (further) at European level:[661]

The European regulator could grasp the various practical issues and complexities that the directive raises. For instance, if an extended use of the Internet and electronic means is a laudable objective, various national law technical constraints and collateral legal obstacles, like the right to remain anonymous, the image right and the right not to be forced to use electronic means to enter into a contract, could make impractical remote interactive participation in general meetings, remote voting in real time or the availability of one effective method of notification of the appointment of proxyholder by electronic means, to name but a few examples. Some commentators therefore suggest not to recommend these means of participation and voting in Member States' legislations.[662] At the very least, the actual set up for remote participation and voting in listed companies requires listed companies to closely involve technical experts and legal

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[660] See, *inter alia*, the German implementing law (ARUG) (providing for a record date of 21 days in advance of the meeting, combined with a registration of the shares set at 5 days before the meeting); the last Dutch draft (referring to a 30 days period); section 360B of the Companies Act 2006 (inserted by the UK Companies (Shareholders' Rights) Regulations 2009) (providing for a record date of 48 hours prior to the meeting).

[661] For the suggestion to mandate more broadly than in the current state of affairs the use of the Internet in place of old-fashioned and costly communication means, see Part III:Chapter I:III.B.4 in Chapter Issuer-Disclosure Addressees and Consequences.

[662] See FRANÇOIS DE BAUW, *Les assemblées générales dans les sociétés cotées et la Directive 2007/36/CE*, *in* Le droit des sociétés aujourd'hui: principes, évolutions et perspectives, (Editions du Jeune Barreau de Bruxelles ed., 2008).

advisers, to make sure everything takes places in accordance with the law and without risk of failure of the system.

In addition, practices by companies, including bunching of meeting dates or mandated use of company's own document for proxies,[663] and by custodians, like slow transmission of order along the chain, lack of an audit trail to see if votes have actually been cast, still represent important barriers to (cross-border) voting.[664]

Moreover, it remains to be seen to what extent the E.U. will solve the problems relating to clearing and settlement in order to further improve specifically cross-border voting.[665]

Furthermore, the European regulator has provided a 5% threshold for shareholders to convene, or ask the company to call, a general meeting *but only if* Member States do not provide shareholders the right to put items on the agenda of, or to submit draft proposals to, general meetings outside the annual general meeting.[666] Hence, some Member States still provide for high thresholds, like 20%[667] or 10%,[668] to convene a general meeting. The European Commission could seek to lower these thresholds.

In addition, I do not see *a priori* the justification for not providing one single European record date to make things clearer for investors.[669]

There seems also to be concerns about the language to be used for shareholders' meetings-related documents.[670] In that respect, it could become good practice that there be a provision in each company's articles of association that the annual shareholders'

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[663] Although article 5.4(e) of the Shareholders' Rights Directive does not provide for a mandatory use of the proxy form made available by the company.

[664] See Manifest, Cross-Border Voting in Europe: a Manifest Investigation into Practical Problems of Informed Voting across EU Borders, 2007, London.

[665] See for European initiatives relating to clearing and settlement, the web-pages of the European Commission, including the Communication on Clearing & Settlement - COM(2004)312 Clearing and Settlement in the European Union – The way forward.

[666] See article 6.1, alinea 2 of the Shareholders Rights Directive. Comp. with the U.S. where shareholders are not allowed to call extraordinary meetings unless the corporate charter or by-laws allow otherwise; however, shareholders owning 1% of the voting shares or USD1,000 in market value may submit proxy proposals for shareholder vote.

[667] See article 532 of the Belgian Company Code and section 122, §1 of the German Stock Corporation Act (*Aktiengesetz*).

[668] See section 2:110 of the Dutch civil code.

[669] See article 7.3 of the Shareholders Rights Directive (providing that each jurisdiction is required to set out a single record date, identical for all listed companies but also providing that a different record date can be provided for listed companies which issue only registered shares and listed companies that only issue bearer shares).

[670] See the public consultation of the European Commission on that subject, EUROPEAN COMMISSION, Synthesis of the Comments on the Third Consultation Document of the Internal Market and Services Directorate-General: "Fostering an Appropriate Regime for Shareholders' Rights" (2007).

meeting votes on the language to be used for all company documents. It could be either the local language (unless the shareholders' meeting decides otherwise by a *quorum* of for instance 1/3 of the voting capital) or English (unless a qualified majority of the voting capital decides otherwise). This should strike the right balance between the needs of a foreign shareholders' basis and the costs to be borne by the issuer. I believe that the benefits of this measure in terms of increased shareholders' involvement in corporate affairs should exceed the additional costs to be borne by the issuer.

Improvements on the front of intermediation should also be brought. The European Commission was supposed to come up with a recommendation dealing with the particular issues of concern.[671] However, it has not done so yet. Moreover, a recommendation, which is not binding, is probably not the best way to regulate this quite important field. One would be better off with a regulation or a directive.[672] It is a fact that the proxy system organised by institutional investors is not effective.[673] This is important as companies cannot be expected to engage with shareholders if they do not and cannot know who they are. At present there is too much scope for error and delay. It is currently generally not possible to audit the process and to be sure that vote instructions have reached the issuers. There should be better visibility, audit trails, more decision time, and confirmation of investors' vote in a timely way.[674] The solution developed by SWIFT is promising in that respect.[675]

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[671] See recital (11) of the Shareholders Rights Directive.

[672] *Accord* EUROPEAN COMMISSION, Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (2003)., at 14 ("[…] specific problems relating to cross-border voting should be solved urgently. The Commission considers that the necessary framework should be developed in a Directive, since an effective exercise of these rights requires a number of legal difficulties to be solved. In view of the important benefits expected from such a framework, the Commission regards the relevant proposal as a priority for the short term.").

[673] See, *inter alia*, Manifest Information Services Ltd., Cross-Border Voting in Europe – A Manifest Investigation into the Practical Problems of Informed Voting across EU Borders, May 2007. For suggested solutions, see DIRK A. ZETZSCHE, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 Journal of Corporate Law Studies 289, (2008).; DIRK A. ZETZSCHE, Virtual Shareholder Meetings and the European Shareholder Rights Directive - Challenges and Opportunities (2007).; JAAP W. WINTER, *Cross-Border Voting in Europe*, *in* Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003).

[674] See the answers to the European Commission public consultation in that respect, EUROPEAN COMMISSION, Synthesis of the Comments on the Third Consultation Document of the Internal Market and Services Directorate-General: "Fostering an Appropriate Regime for Shareholders' Rights" (2007).

[675] See ISO 20022 standard messages for Proxy Voting on Swift web-site. See also the legal solutions based on an action of the European Commission against Member States before the European Court of Justice, suggested by Jaap Winter in JAAP W. WINTER, *Ius Audacivus. The Future of EU*

In addition, impediments to collective shareholder engagement should be removed to the extent feasible in order for (institutional) shareholders to be able to work together in connection with corporate governance issues.[676] Under current status, there is a risk that a collective shareholder engagement be considered as an action in concert from shareholders. And an action in concert triggers disclosure of significant holdings pursuant to the Transparency Directive. Besides, it drives the launch of a mandatory bid pursuant to the Take-Over Directive. However, the OECD Principles of Corporate Governance recommend that "shareholders, including institutional shareholders should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to the exceptions to prevent abuse" and further state that effective participation in general meetings "can be enhanced by developing secure electronic means of communication and allowing shareholders to communicate with each other".[677] I believe with other observers that there should be European intervention to eliminate at least the different definitions of action in concert in Member States.[678] Some Member States are however of the opinion that enough concerted action can be

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Company Law, *in* Perspectives in Company Law and Financial Regulation, (Michel Tison, et al. eds., 2009)., at 59.

[676] See for such impediments, *inter alia*, EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008)., at §18; ESME, Preliminary Views on the Definition of "acting in concert" between the Transparency Directive and the Takeover Bid Directive, November 2008; PAOLO SANTELLA, et al., A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US (2009)., at 22 et seq.

[677] See Principle II.G of the OECD Principles of Corporate Governance; see also, further to such principle, OECD, DAF/CA/CG(2008)3 of 3 April 2008, Shareholder cooperation or acting in concert? Issues for consideration.

[678] See ESME, Preliminary Views on the Definition of "acting in concert" between the Transparency Directive and the Takeover Bid Directive, November 2008. In the Member States, comp., for instance, the new definition in Germany adopted in the Risk Limitation Act in 2008 (section 22, § 2 WPHG and section 30, §2 WPÜG); article 233-10 of the French Monetary and Financial Code (see for an interpretation, the Gecina and Eiffage case law of the Paris Court of Appeal); Note 2 on Rule 9.1 of the UK Takeover Code; article 3, §1, 5°(a) of the Belgian law of 1st April 2007 (the take-over bid law); article 1.1 of the Dutch *Wet Financiële Toezicht*. Comp. with the U.S., Regulation 13D, 17 C.F.R. § 240.13d-1 to -7 (2006); Schedule 13D, 17 C.F.R. § 240.13d-101 (2006); Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 39,538, 63 Fed. Reg. 2854 (Jan. 16, 1998); see also case law, such as Hallwood Realty Partners, L.P. v. Gotham Partners, L.P., 286 F.3d 613 (2d Cir. 2002). See also Practice Statement number 26 from the Takeover Panel and the UK FSA letter to trade associations on how its rules apply to activist shareholders, as recent developments in the right direction of creating a "safe harbour" protection. See also the Walker Review and the developments relating to memorandum of understanding among institutional investors related to collective action, Walker Review at chapter 5, 5.44 et seq.

performed without triggering the obligation to launch a bid.[679] Besides, I believe that the rules and formalities for proxy solicitation should allow the activist sponsor to gather support of other shareholders at no prohibitive costs.

To conclude, shareholder voting powers in the jurisdictions under consideration in this dissertation cannot be said to constitute a major concern, as evidenced by recent comparative law studies of the Centre for Business Research of the University of Cambridge.[680] Besides, the Shareholders' Rights Directive is an important step in the right direction to provide even more effective (cross-border) voting. This being said, there are still some areas of concern relating to the due exercise of shareholder vote, especially with respect to the technicalities to make cross-border voting effective. This calls for European scrutiny *vis-à-vis* implementing national legislations of the Shareholders Rights Directive, once there will be enough time elapsed to make a proper assessment. This calls as well for further European intervention in order to bring about legal certainty and to make shareholder vote a totally effective corporate governance tool in the European Union. But nothing really to worry about too much.

iii Obstacles to shareholder monitoring: a discussion of (the limits to) enforcement of directors duties and, in particular, of the duty to comply with issuer-disclosure requirements

a Foreword[681]

The Prospectus Directive requires Member States to ensure that responsibility for the information in the prospectus is well provided for. It follows by providing that "Member States shall ensure that their laws, regulation and administrative provisions on

[679] See for instance the UK FSA position, in a letter addressed by Sally Dewar to Keith Skeoch on 19 August 2009 (stating that "existing market abuse, changes in control and disclosure of substantial shareholdings regulations do not prevent collective engagement by institutional shareholders designed to raise legitimate concerns on particular corporate issues, events or matters of governance with the management of investee companies". To remain compliant with current regulations, the UK FSA emphasised that collaboration by investors must be on an *ad hoc* basis and not result in an "agreement between two or more persons which obliges them to adopt a lasting common policy towards the management of the issuer through the exercise of their voting rights").

[680] See note 654 above and accompanying text.

[681] I do not consider liability in the context of insolvency.

civil liability apply to those persons responsible for the information given in a prospectus.”.[682]

I fully share what seems to be the European Commission’s view that it is socially desirable to have civil liability as part of the system of incentives for compliance with issuer-disclosure requirements, next to administrative, monetary, criminal and reputational sanctions imposed by public authorities and next to reputational sanctions imposed by the market.[683]

Civil liability serves two policy objectives: compensation and deterrence:[684]

On the one hand, civil enforcement of the EU issuer-disclosure regime could *compensate* shareholders for losses resulting from misbehaviours. As public enforcement generally focusses on deterrence,[685] civil enforcement is said to add, to the risk of administrative, reputational or criminal sanction by public enforcement authorities, the risk of having to compensate the harm caused to the claimants. This is

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[682] See article 6 of the Prospectus Directive.

[683] *Accord*, in connection with US securities regulation, *inter alia*, MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009). ; RANDALL S. THOMAS, et al., *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 ECFR 165, (2009). (reviewing the most significant empirical research that has been conducted in recent years on the public and private enforcement of US securities regulation).

[684] Deterrence is to be understood as prevention of wrong-doing. See, *inter alia*, THIERRY VANSWEEVELT, et al., Handboek Buitencontractueel Aansprakelijkheidsrecht (Intersentia. 2009)., at 7 et seq.; GARY T. SCHWARTZ, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75, (1997).

[685] See, for instance, that the French AMF, the Italian Consob, the Spanish CNMV, the Dutch AFM or the German BaFin do not have the power to order compensation for those suffering losses as a result of regulatory breaches, although they have the powers to impose monetary penalties on defendants. Comp. with the UK FSA which can secure compensation for those people (for instance, investors) who suffer losses arising from a regulatory breach by a firm. It can do so by making (or in some circumstances applying to the court for it to make) a restitution order, which requires the disgorgement of profits or the payment of compensation for losses arising from the regulatory breach (see sections 382 and 384 of the UK FSMA). The UK FSA and/or the court have discretion as to whether to make a restitution order. Comp. with the U.S., where the US SEC can seek disgorgement of all ill-gotten gains. Historically, these funds were paid to the U.S. Treasury. Since the introduction of the “Fair Funds” provisions of SOx (15 U.S.C. § 7246 (2006)), the US SEC has the power to divert financial penalties to disgorgement funds for the benefit of victims (including shareholders), rather than having those penalties paid to the US Treasury. Besides, the requirement to implement a package of remedial measures, including the payment of compensation to injured parties, is a common feature of many settlement agreements with the US SEC.

one reason why civil liability actions are said to “complement” public enforcement.[686] In that respect, civil liability actions are also said to widen the scope of enforcement to cases not dealt with by the public authorities because of public authorities’ poor information, limited resources, mixed and often weak incentives.[687]

On the other hand, if a potential responsible person faces the threat of civil liability, accurately framed and enforced, he could be deterred from engaging in inaccurate disclosure. However, the desired policy objective in this context is not deterrence as such but “*optimal deterrence*” as insufficient deterrence will not deter and over-deterrence could have adverse consequences, including chilling disclosure by fear of a lawsuit or leading to information over-load to prepare against a potential lawsuit and, in the extreme case, discouraging issuers from accessing public markets.

The application of policy objectives of compensation and/or optimal deterrence is discussed under the scheme of civil liability I suggest for the EU issuer-disclosure regime, drawing from the debate that is currently taking place in the U.S.[688]

The question is whether private enforcement in the E.U. is a good complement to public control of the EU issuer-disclosure regime.

I am concerned in this dissertation by the *private enforcement of directors duties under the EU issuer-disclosure regime* with a view to discuss *to what extent it works for corporate governance purposes*.[689] This is important as empirical studies show a link between private enforcement and the strength of financial markets.[690] Compliance with

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[686] See for a discussion of the assertion that private enforcement, in the form of class actions, “supplement” public enforcement by the US SEC, MICHAEL KLAUSNER, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis (2009).

[687] See for an interesting comparison between the US SEC and the French then-COB sanction powers in US and French securities regulation, PIERRE-HENRI CONAC, La régulation des marchés boursiers par la Commission des opérations de bourse (COB) et la *Securities and Exchange Commission* (SEC) (Bibliothèque de droit privé ed., L.G.D.J. 2002).

[688] See Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[689] See for the importance of enforcement for corporate governance, Erik Berlöf and Stijn Claessens, Corporate Governance and Enforcement, World Bank Policy Research Working Paper 3409, September 2004.

[690] See, *inter alia*, RAFAEL LA PORTA, et al., *What Works in Securities Laws?*, 61 Journal of Finance 1, (2006). (finding almost no evidence that public enforcement benefits stock markets, and strong evidence that laws facilitating private enforcement through disclosure and liability rules benefit stock markets). See as well HOWELL E. JACKSON, et al., *Public and Private Enforcement of Securities Laws: Resource-Based Evidence,* 93 Journal of Financial Economics 207, (2009). (finding that public enforcement is at least as important as private enforcement in explaining important financial market

disclosure obligations can be seen as a microcosm of the more general problem of securing agent compliance. The general comments developed below are therefore equally applicable to enforcement of any other director duty.

It is commonly assumed that European Member States are far less enforcement-oriented than the U.S., in terms of outputs.[691] Only few cases have been so far brought in European courts by investors.[692]

However, I believe that this ought to be nuanced, given the statistics of the cases dealt each year by relevant public bodies.[693] In addition, in assessing whether the lower

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outcomes around the world). See also BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001).; UTPAL BHATTACHARYA, et al., *The World Price of Insider Trading*, 57 The Journal of Finance 75, (2002). (finding in a global sample of 87 countries that the mere existence of insider prohibitions did not affect the cost of equity but the first prosecution did); SIMEON DJANKOV, et al., *The Law and Economics of Self-Dealing*, 88 Journal of Financial Economics 430, (2008). For a discussion of the importance of enforcement with respect to competitiveness, see JOHN C. COFFEE, *Law and the Market: The Impact of Enforcement*, University of Pennsylvania Law Review, (2007)., at 309. (arguing that although the cross-listing decision involves a complex interaction of bonding, signaling, self-selection, and reduced informational asymmetry, the overall evidence supports the "bonding hypothesis" and suggests that U.S.' greater emphasis on enforcement reduces informational asymmetry and gives it a lower cost of equity capital).

[691] See JOHN C. COFFEE, *Law and the Market: The Impact of Enforcement*, University of Pennsylvania Law Review, (2007). On the rarity of litigation against directors in the U.K., see Simon Deakin and Alan Hughes, Directors' Duties: Empirical Findings, Report to the law commissions, 15-16 (1999); HANS C. HIRT, The Enforcement of Directors' Duties in Britain and Germany: a Comparative Study with Particular Reference to Large Companies (Peter Lang Publishing 2004)., 79-80.

[692] See, for instance, for Belgium, the Barrack Mines, Confederation Life and Keytrade cases. See in the Netherlands, next to the cases mentioned above, *inter alia*, the rare liability cases relating to periodic reporting, like Dutch Supreme Court, 11 December 1931, NJ 1932, 147 (Aeilkema-Veenkoloniale Bank) or Jomed case (Hof Amsterdam 16 September 2008, JOR 2008/33 (Eriksson and Ristinmaa – curator Schimmelpenninck (acting qq Jomed NV) (liability denied)) ; with respect to prospectus liability, Dutch Supreme Court, 2 December 1994, NJ 1996, 246 (ABN Amro/Coop), Dutch Supreme Court, 30 May 2008 iDe Boer/TMF (JOR 2008/209) and Dutch Supreme Court, 27 November 2009 VEB c.s./World Online e.a., LJN: BH2162. See in Germany, after the Imperial Court (Reichsgericht) had relied on the rules on prospectus liability (sections 44, 45 of the German Stock Exchange Act (*Börsengesetz*) of 22 June 1896, RGBl. [Imperial Law Gazette] at 157) in a few cases to accord defrauded investors damages (RG BankArch 1910/11, 123; RGZ 80, 196), the last one dating from 1912, it was to take 70 years for the first major recovery to occur (BGH WM 1982, 862 – Beton- & Monierbau); see also, for instance, BGH, *Urteil* vom 12-07-1982 - II ZR 175/81; OLG Frankfurt a.M., Urteil vom 1.2.1994 AZ: 5 U 213/92.

[693] See, generally, for an overview of the relatively active investigations and enforcement by competent public bodies in the U.K., the Netherlands, Spain, Italy, Germany and France, with a comparison to the U.S., the local counsels' briefings on the web-site of Freshfields Bruckhaus Deringer (FSnet, Investigations and Enforcement). Note as well that the field of insider dealing recently received increased focus of enforcement bodies (see especially the active approach taken by the French AMF and the UK FSA in that respect). Note that, in the limited scope of this dissertation, I do not assess the suitability of Member States' supervisory authorities in performing their enforcement tasks. See for a review of empirical studies in connection with an assessment of the US SEC, RANDALL S. THOMAS, et al., *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 ECFR 165, (2009). I am not discussing either the absence of a

private enforcement rate in European Member States with respect to the EU issuer-disclosure regime is negative, the *low litigation mind-set* of European investors should be taken into account. In that respect, it will be interesting to see whether shareholders will bring more actions and succeed in their claims involving the EU issuer-disclosure regime's violations in connection with the 2007-2008 financial crisis.[694] Besides, as the European capital market grows and shareholders become more active, one might expect greater (formal and informal) enforcement intensity in the future in the E.U.[695] More importantly, it is not because a country has, generally, less budget, less staff, less formal cases by the relevant agencies or judicial bodies or lower penalties, that its general enforcement system is *a priori* of lower quality. It should be assessed whether there is in fact *enough enforcement in the system as a whole* to act as sufficient deterrent when seen in combination with existing auditing standards, the presence of active institutional investors, including a majority shareholder, who engage systematically in informal private enforcement activity, the existence of strong shareholder powers.[696] In that respect, it is interesting to note that enforcement in the US markets is viewed by some commentators as substitute for weaker corporate governance.[697]

Nevertheless, in the meantime, some academics believe that the balance in the E.U. between public and private enforcement must be reconsidered *now* because of the inherent limitations of public enforcement alluded to above.

In this context, I discuss below the procedural and substantive rules which determine the extent to which the national law of the jurisdictions under consideration in this dissertation provides for collective actions by shareholders against directors and

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private attorney general in Europe. See on this, from a US perspective, WILLIAM B. RUBENSTEIN, *On What A "Private Attorney General" Is – And Why It Matters*, 57 Vand. L. Rev. 2129, (2004).

[694] See the legal actions brought in the aftermath of the current financial crisis. See, *inter alia*, Euroshareholders acting against Fortis in the Netherlands; the lawyer Michael Modrikamen and the shareholders' association Deminor acting in Belgium against Fortis Holding and Citibank.

[695] See, for instance and as already alluded to, the tougher approach adopted by the UK FSA.

[696] This refers to enforcement in its broad sense which embraces a wide range of strategies. *Accord* KATHRYN CEARNS, et al., Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors (2008).; JOHN ARMOUR, et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US*, 6 Journal of Empirical Legal Studies, (2009).; JOHN ARMOUR, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment (2008).; EILIS FERRAN, Capital Market Competitiveness and Enforcement (2008).

[697] See *JEFFREY N. GORDON, The Berle-Means Corporation in the 21st Century (2008).*

for suits against directors brought by shareholder(s) on behalf of the company (i.e., so-called derivative suits) in case of breach of the EU issuer-disclosure regime.[698]

Besides, as agency problems can occur because of conflicts of interests between a controlling party and (minority) shareholders, I also briefly discuss in the next section enforcement of controlling parties' duties.

Throughout the discussion below, the following should be kept in mind:

To ensure due compliance of legal duties, it is important to develop effective, proportionate and dissuasive sanctions but also to have proper enforcement of the legal requirements.[699] A combination of both sanctions and enforcement works as incentive to prompt behaviours complying with legal requirements. In other words, a liability regime, *accurately framed and enforced*, seems to be the best incentive to make responsible persons comply with their duties. Deterrence to breach legal obligations requires an appropriate balance between the size of the sanction and the frequency of detection and enforcement.

But this balance should seek for the *right level of robustness* of the liability regime as a liability regime might be costly. In addition to funds spent on abusive or frivolous cases,[700] the issuer will indeed spend more or less resources depending on the robustness of the liability regime, complying with the legal requirements and defending

[698] This section needs to be read together with the suggestion relating to the more general European civil liability scheme made under Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[699] See for the determinants of the relative social desirability of liability and regulation, STEVEN SHAVELL, Liability for Harm versus Regulation of Safety (1983). See for the importance of enforcement generally, MITCHELL POLINSKY, et al., *The Optimal Use of Fines and Imprisonment*, 24 J. Pub. Econ. 89, (1984). (suggesting that actors are more sensitive to the probability of detection than to the size of the sanction if caught and convicted). See for the importance of sanctions, GARY BECKER, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169, (1968)., at 178-79 (showing that the frequency of anti-social behaviour is a function, in part, of the probability of conviction per offense and the punishment per offense).

[700] See ERIK P. VERMEULEN, et al., *The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism*, ECFR (forthcoming), (2009). (analysing claims for annulment of shareholders' meetings resolutions by minority shareholders under German law between September 2005 and January 2009, finding that most cases are abusive, under the authors' definition of the term). See also the possibility under some national laws for the defendant issuer to file for damages if the claimant files abusive actions, frivolous actions or suits without merits. But these laws should lead to predictable outcomes to work as effective deterrent of frivolous suits. See for the fear that the Dutch inquiry proceedings be used opportunistically, the Dutch Social and Economic Council (SER) recommendations of 15 February 2008 on "balanced entreprise governing" (*Evenwichtig Ondernemingsbestuu*r) aiming, *inter alia*, at curbing the powers of the Entreprise Section.

himself in case of a lawsuit while these resources could have been otherwise spent. This could constitute a cost to shareholders and to society as a whole.[701]

There is consequently a need for a *trade-off by the regulator* in regulating access to, and the procedure in, courts.

b *Collective actions in connection with a breach of the EU Issuer-Disclosure Regime*

There is not yet a European-type securities law collective action, not to mention a European-type class action.[702]

This being said, the assessment by European instances of the necessity of European-level intervention with respect to collective redress in health and consumer protection as well as in competition matters should be mentioned as it may lead to political and institutional interest in retail investor redress.[703]

Nevertheless, the current lack of a European-type securities law collective or class action is cited by some academics as a flaw of the European securities laws' civil liability system. Some of them advocate for the introduction of class actions arguing that it is difficult to deter substantial breach of disclosure requirements through private actions in the absence of effective aggregation mechanisms.[704] The only issue would be

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[701] See ERIK P. VERMEULEN, et al., *The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism*, ECFR (forthcoming), (2009). (pointing out to the costs relating to time-consuming, costly proceedings with uncertain outcomes, and to "litigation costs", including where management is more concerned with countering the claim than with doing business or where settlements are beneficial to claimants but not to all shareholders by limiting the issuer's free cash-flow).

[702] There is arguably a distinction between collective actions and class actions, collective actions being opt-in procedures and class actions opt-out procedures thus creating a class. For the procedure relating to "class actions" in the U.S., see DOUGLAS W. HAWES, *In Search of a Middle Ground between the Perceived Excesses of US-Style Class Actions and the Generally Ineffective Collective Action Procedures in Europe*, *in* Perspectives in Company Law and Financial Regulation - Essays in Honour of Eddy Wymeersch, (Michel Tison, et al. eds., 2009).

[703] See for the latest status, the web-site of the Health and Consumer Protection as well as of the Competition Directorates General of the European Commission.

[704] See, *inter alia*, GUIDO A. FERRARINI, et al., Financial Scandals and the Role of Private Enforcement: The Parmalat Case (2005).; GERARD HERTIG, et al., *A Legal Options Approach to EC Company Law*, 2 revue trimestrielle de droit financier 18, (2007).; LUCA ENRIQUES, *The Comparative Anatomy of Corporate Law*, 52 Am. J. Comp. L. 1011, (2004).; MATHIAS M. SIEMS, Convergence in Shareholder Law (Cambridge University Press. 2008)., at 212 et seq; GÉRARD HERTIG, *Regulatory Competition in EU Financial Services*, *in* Regulatory Competition and Economic Integration, (Daniel Esty, et al. eds., 2001).

to control the defects associated with class actions, as highlighted mainly by the experience of the US system.[705]

I do not see the urgency to introduce a European type securities law collective or class action. Indeed, I believe that investors do not totally lack the ability to bring a suit under their national laws, most of the time on the basis of a specific law.[706]

The following recent changes in that respect in the laws of the Member States under consideration in this dissertation are worth to be mentioned:

The German 2005 Capital Markets Model Case Act applies to claims for compensation of damages due to false, misleading or omitted public capital market information.[707] It is a step toward collective actions.[708] Under this law, shareholders can file actions in groups of ten against companies they say misled them: they may initiate proceedings to certify a model case proceeding. The filing temporarily suspends all similar cases brought until a regional court has certified the case. Once a court has heard a duly certified model case, the ruling is binding on other courts trying the same matter.

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[705] See for the arguments against class actions in the U.S., the works of, *inter alia*, Professors Cox, Thomas and Klausner, including RANDALL S. THOMAS, et al., *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 ECFR 165, (2009).; MICHAEL KLAUSNER, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis (2009). (setting forth the lack of deterrence effect and the many costs associated with class actions). See also, RICHARD A. BOOTH, *The End of Securities Fraud Class Action?*, 29 Regulation 46, (2006).; MERRITT B. FOX, Fraud-on-the-Market Class Actions against Foreign Issuers (2009). For a comprehensive statistical report, see Stephanie Plancich & Svetlana Starykh, *2008 Trends in Securities Class Actions*, NERA Economic Consulting report of December 2008.

[706] See for overviews of applicable regulation, FRESHFIELDS BRUCKHAUS DERINGER, Developments in Class Actions and Third Party Funding of Litigation - Maturing Themes across Europe? (2009).; Freshfields Bruckhaus Deringer, Recent Developments in Class Actions and Third Party Funding of Litigation – A Rapidly Evolving Landscape, February 2008 (analysing, *inter alia*, the U.K., France, Germany, Italy, the Netherlands and Spain); Linklaters, Class Actions, February 2008 (analysing, *inter alia*, Germany, France, the U.K.); for Belgium, see ARNAUD COIBION, et al., *Shareholder Suits against the Directors of a Company, against other Shareholders and against the Company itself under Belgian Law*, 2 ECFR 270, (2009)., at 305; for Italy, see also PAOLO GIUDICI, *Representative Litigation in Italian Capital Markets*, 6 ECFR 247, (2009).; for the Netherlands, see also the web-site of the shareholders' association, VEB, discussing all (pending or past) case law, including Philips in 1999 and World Online in 2009; for France, see MARIE-CLAUDE ROBERT HAWES, *Some Modest Proposals to Provide Viable Damages Remedies for French Investors, in* Perspectives in Company Law and Financial Regulation - Essays in Honour of Eddy Wymeersch, (Michel Tison, et al. eds., 2009).

[707] See *Gesetz zur Einführung von Kapitalanleger-Musterverfahren* (KapMuG), 16 August 2005, BGBI I, at 2437. It came into force on 1st November 2005. It is also referred to as the "Act on Lead Cases of Private Investors".

[708] See however, BRIAN R. CHEFFINS, et al., *Outside Director Liability Across Countries*, 84 Texas Law Review 1385, (2006)., at note 247 (this "modest reform falls well short of a viable class action procedure").

It has already been used on several occasions.[709] In addition, since 1st of July 2008, contingency fees have been permitted in exceptional cases where such fees are necessary to permit claimants to file a claim.

Italy introduced contingency fees in 2006.[710] Besides, the Italian-style collective action came into force on 1st of January 2010, after many modifications, and allows collective actions for damages (or refund of unduly paid sums) by, *inter alia*, any investors group or association sufficiently representative of the collective interests as assessed by the relevant judge, for, *inter alia*, unfair commercial practices.[711]

In Spain, contingency fees are allowed under certain circumstances following a 2008 Supreme Court decision.[712]

In the Netherlands, the Dutch law concerning settlements of collective damages came into force on July 2005.[713] It has already successfully been used in several cases.[714] It is currently subject to review to improve the system.

As a last illustration, the U.K. carried out reforms in 2000 to facilitate multiparty litigation by letting those launching proceedings bring a case under the control of a single court at a very early stage under a "group litigation order".[715]

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[709] See the cases referred to in FRESHFIELDS BRUCKHAUS DERINGER, Developments in Class Actions and Third Party Funding of Litigation - Maturing Themes across Europe? (2009)., at 32 et seq. It should be noted that the KapMuG will expire on 1st November 2010 unless extended.

[710] See Decreto Bersani, law decree n. 223/2006. However, they seem to be somewhat limited by the lawyers' code of conduct.

[711] See article 140bis of the Italian consumer code, approved by the Italian Parliament on 9 July 2009. See FRESHFIELDS BRUCKHAUS DERINGER, Developments in Class Actions and Third Party Funding of Litigation - Maturing Themes across Europe? (2009).; DOUGLAS W. HAWES, *In Search of a Middle Ground between the Perceived Excesses of US-Style Class Actions and the Generally Ineffective Collective Action Procedures in Europe, in* Perspectives in Company Law and Financial Regulation - Essays in Honour of Eddy Wymeersch, (Michel Tison, et al. eds., 2009)., at 215 and PAOLO GIUDICI, *Representative Litigation in Italian Capital Markets*, 6 ECFR 247, (2009)., at 260 et seq.

[712] See the Spanish Supreme Court decision of 4 November 2008. See for a commentary, CARLOS GÓMEZ LIGÜERRE, et al., *Lawyers' Fees, Competition Law and Contingent Fees*, 1 InDret, (2009).

[713] See articles 7:906 to 7:910 of the Dutch civil code (the Dutch act on collective settlement of mass damages); see also articles 1013 to 1018 of the Dutch code on civil procedure.

[714] See FRESHFIELDS BRUCKHAUS DERINGER, Developments in Class Actions and Third Party Funding of Litigation - Maturing Themes across Europe? (2009).

[715] See Civil Procedure Rules, Part 19 III. See also the Civil Justice Council's final report published on 12 December 2008 entitled "Improving Access to Justice Through Collective Actions" and making recommendations to change the law regarding collective redress. See the Government's reponse dated July 2009, rejecting the central and most controversial recommendation to introduce a new generic right of class action that at the judge's discretion could have been on an opt-out basis, favouring instead a piecemeal approach on a sector-by-sector basis.

c Derivative actions in connection with a breach of the EU Issuer-Disclosure Regime

Preliminary remark

Derivative actions are brought by shareholders in the name of the company against directors.[716] They are a common tool in the litigation regulation of most developed countries, including the jurisdictions under consideration, except the Netherlands.[717]

I believe that, if accurately regulated, they should offer a means to control the accurate execution of directors' tasks. Accordingly, they could be an important corporate governance tool.[718] Even more so in concentrated ownership structures where the controlling shareholder either appoints himself or his representative as director and therefore rarely sues for directors' misconduct.

As already alluded to, it is well important to have safeguards against the development of a litigation culture, including frivolous claims that would unduly

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[716] Note that in some jurisdictions liability suits can be brought not only against directors formally elected but also against anyone *de facto* managing the company, typically a controlling shareholder. See for instance Italian, German and French laws. See also article 530, §1 of the Belgian company code (in case of insolvency of the issuer) and the practice of some courts to pierce the corporate veil in groups of companies for the parent company to bear the consequences of certain acts of its (under-capitalised) subsidiary. See also article 2:138/248, part 7 of the Dutch civil code (specific for liability in case of bankruptcy) and Dutch case law. See as well the concept of "shadow director" in the U.K.

[717] See articles 225-251 of the French commercial code; article 562 et seq. of the Belgian company code; article 134 of the Spanish company law; article 129 of the Italian Consolidated Financial Services Act and articles 2393, 2393bis and 2395 of the Italian civil code, as modified in 2003; Part 11 (sections 260-269) of the UK Companies Act 2006 (and UK Civil Procedure (Amendment) Rules 2007 (SI 20007/2204) which provide a new CPR r19.9, rr19.9A–F, which replaces former r19.9, the new Practice Direction 19C, which offers further details on claim form and other procedural requirements (hearing, discontinuance, etc)) (for a commentary, see the works of Arad Reisberg on the subject); articles 147, §2 and 148 of the German Stock Corporation Act (*AktienGesetz*) (see *Gesetz zur Unternehmensintegrität und Modernisierung des Anfectungsrechts* (UMAG), 22 September 2005, BGBI I, at 2860 (altering since 1st November 2005 the relevant provisions of the German act on publicly traded companies)) (for a commentary, see references cited in DARIO LATELLA, *Shareholder Derivative Suits: A Comparative Analysis and the Implications of the European Shareholders' Rights Directive*, 6 ECFR 306, (2009)., at note 24). Dutch law does not have derivative actions as such. However, see the right of shareholders to require an inquiry under note 752 and accompanying text. Comp. with the U.S., see rule 23.1 of the Federal Rules of Civil Procedure (see for a commentary of the law of the State of Delaware relating to derivative suits, ROBERT B. THOMPSON, et al., *The Public and Private Faces of Derivative Lawsuits*, Vand. L. Rev. 1747, (2004).).

[718] See *contra* in the US context, ROBERTA ROMANO, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. Econ. & Org. 55, (1991). (portraying derivative suits in the US context as "mainly serv[ing] as a means of transferring wealth from investors to lawyers.").

constrain directors' freedom hindering the proper functioning of the company as well as "strike suits" or "nuisance suits" that would not benefit shareholders as a group.

However, it seems to me that the hurdles relating to the bringing of a derivative claim are still likely to deter shareholders to use the control device. In other words, I do not think that the right balance between directors' freedom and investor protection has been stricken although there have been recent improvements in national laws to facilitate derivative suits. It seems that derivative suits still suffer from a free rider problem, each shareholder waiting for the other to sue due to the obstacles related to the bringing of a case, which in turn leads to few suits.

I discuss below the most important obstacles to the bringing of a derivative suit, i.e., the formal requirements to be met by claimants to bring an action (pre-screening devices and standing considerations), the question of who bears the costs associated with the suit as the claimant will proceed to a costs-benefits analysis prior to filing a claim, the insufficient information rights of claimants and the liability standard. I suggest solutions, most of the time derived from a specific national law. I trust the solutions I suggest strike the right balance to avoid frivolous suits and to focus on the deterrence rationale to fight self-dealing and intentional misconduct.

Obstacles to derivative suits and suggested solutions

Some jurisdictions impose a preliminary decision of the shareholders' meeting to exercise a derivative action.[719] In that respect, article 6 of the Shareholders Rights Directive should be recalled. It provides for the right to put items on the agenda of shareholders' meetings and to table draft resolutions. But it also specifies that the

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[719] See, for instance, Spanish law; German law (providing for a majority vote of the shareholders' meeting and the appointment of a special representative by the court. However, in case the company does not want to sue, shareholders holding at least 1% of the shares or shares in the nominal amount of €100,000 may apply to the court for admission of their claim under certain additional conditions set out in article 148 of the German Stock Corporation Act (*Aktiengesetz*), including that the claim is not contrary to corporate interests); article 2393 of the Italian civil code (providing that an action against directors can be started by means of a resolution of the shareholders' meeting or a resolution of the board of the statutory auditors (vote in favour of 2/3 of the members). The action can be revoked or settled by the shareholders' meeting, provided that there is not the contrary vote of minority shareholders representing at least 1/20 (5%) of the share capital. However, pursuant to article 2393bis of the Italian civil code, the action can also be exercised by shareholders representing at least 1/40 (2,5%) of the share capital or the different quorum provided for in the by-laws. In any case, pursuant to article 2395 of the Italian civil code, each shareholder may start a claim toward directors in connection with damages arising from direct actions carried out by directors with wilful misconduct or gross negligence).

minimum stake in the company required under national law to benefit from these rights, if any, cannot exceed 5% of the share capital *if* Member States do not provide shareholders the right to put items on the agenda of, or to submit draft proposals to, general meetings outside the annual general meeting.

Furthermore, some jurisdictions impose discretion of the court as to the legitimacy of the claim.[720]

Other jurisdictions require that the shareholders initiating the suit not have voted for the discharge of the defendant.[721]

I think that, if at all possible given the thresholds to convene a shareholders' meeting and to put items on the agenda of the shareholders' meeting, the aggrieved shareholders should first request the company itself to initiate the action. This is a derivative action after all.

If this is not possible given the requested thresholds, or if the company does not acquiesce to this demand, the requesting shareholders should be able to initiate the action themselves.[722] In that respect, I am not in favour of a too high threshold requirement for the following reasons.[723] I think there is little justification for a high threshold as it does not contribute to the deterrence objective of derivative suits. And

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[720] See UK law (*prima facie* case and permission hearing) (for a discussion of the procedure, see ARAD REISBERG, *Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (In)Action,* 6 European Company and Financial Law Review 219, (2009)., at 222 et seq.) and German law, which are sorts of statutory codifications of the business judgement rule. Comp. with the US Model Business Corporation Act drafted by the American Bar Association's Committee on Corporate Governance (providing that a derivative action shall be dismissed by the court where a committee of independent directors (or "Special Litigation Committee") has determined in its business judgment that the action is not in the best interest of the company) and with the American Law Institute Principles of Corporate Governance: Analysis and Recommendations Proposed Final Draft, 1992, 725–66 (allowing more scope for judicial review of the recommendations of Special Litigation Committees). See as well the US requirement to have a decision of the board of directors to maintain a derivative suit (rule 23.1 Federal Rule of Civil Procedure and New York State and Delaware State laws), unless the judicial doctrine excuses a demand on the board of directors. See James D. Cox and Thomas Lee Hazen, Cox & Hazen On Corporations, 2nd edition, Wolters Kluwer Law & Business, Aspen Publishers, §15.06.

[721] See article 562 of the Belgian company code.

[722] An alternative could be to request approval by a majority of the minority shareholders as the suit could be against the director appointed by the controlling shareholder.

[723] Note that there have been concerns in some jurisdictions about a too high threshold. See the 5% threshold under Italian law which was considered too high and later reduced to 2.5%. See in Germany, where the threshold for minority shareholders to file a claim against directors has been lowered to 1% of outstanding shares or €100,000 of the par value. See for other standing requirements, Belgian law (1% of voting rights or holder of €1,250,000), French law (shareholders may act through an association representing at least 5% of the registered capital to spread the costs of litigation); Spanish law (providing that shareholders representing at least 5% of the capital can ask to convene a shareholders' meeting which will decide whether or not to initiate the derivative action).

more importantly, a too high threshold does not make sense in European jurisdictions which all apply the loser pays principle. Indeed, I do not think that a high prescribed level of ownership adds much to the *ex ante* assessment of costs-benefits-risks that the shareholder will make prior to initiating the suit.

In some jurisdictions, it is unclear whether the claimant has to keep the minimum shareholding required to launch a derivative suit during the whole length of the legal proceedings.[724] In most jurisdictions, solely shareholders who remain shareholders during the proceedings can bring a claim. I think the claimant should not be required to be a shareholder at the time of the occurrence of the act or the omission, although he should have been holding the shares before he knew or should have known about the breach or the damage.[725] And he should be free to dispose of the shares as the suit is likely to cause a decrease of the price of the stocks.[726] The requirement to remain shareholder and to retain at least one share until judgement becomes final is not satisfying in a world in which the decoupling of economic ownership from voting ownership is totally possible.[727] But as this dissertation does not deal with these instances but is only concerned with full equity ownership, this is not the place to dig more deeply into this very new and difficult subject.

The rule according to which the loser pays the court and all legal fees and expenses, including the winner's, as decided by the court, and the potential reluctance of

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[724] See under Italian law, PAOLO GIUDICI, *Representative Litigation in Italian Capital Markets*, 6 ECFR 247, (2009)., at 250-51.

[725] See UK law and Italian law (not providing that the shareholder be a shareholder at the time of the act or omission that is the subject of the suit). See article 148 of the German Stock Corporation Act (*AktienGesetz*) (providing that the shareholder must have held the shares before he knew or should have known about the breach of duty or the damages caused). See article 562 of the Belgian company code (requiring that the claimant(s) hold(s), *at the time of the general assembly deciding on the discharge of the directors*, at least 1% of the voting rights attached to the financial instruments existing at the time of said general assembly). Comp. with the U.S. where there is a requirement to hold the shares at the time of occurrence of the breach (see rule 23.1 of the Federal Rules of Civil Procedure; see also for state law, 19 AM. JUR. 2D *Corporations* § 2010 (2007); see for a commentary, James D. Cox and Thomas L. Hazen, Cox and Hazen on Corporations, 2nd edition, Wolters Kluwer Law & Business, Aspen Publishers, §15.09). See however the suggestion made by Professor Fox not to have an ownership requirement at the time of the misdeed because of the role of entrepreneurial claimants' lawyers, see MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at 79.

[726] See article 562 of the Belgian company code (not requiring to keep holding the shares after the general assembly which voted on the discharge of the defendants).

[727] See HENRY T. HU, et al., *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 University of Pennsylvania Law Review 625, (2008)., at 722 et seq. (referring to the fact that under US federal securities laws, economic ownership suffices to file a suit as holders of equity swaps are proper plaintiffs in securities class actions under section 10(b) of US Securities Exchange Act).

courts to order the issuer to reimburse a shareholder's legal expenses, are likely to discourage many reasonably-based suits from being pressed.[728] As the shareholder who initiates the suit must advance legal costs and expenses without certainty to be fully reimbursed even if he wins,[729] in practice, derivative actions are only brought by activist shareholders.

I think that, where the shareholders' meeting approved the submission of the claim and consequently gave a sort of *imprimatur* of the company to the suit,[730] the shareholders who have initiated the action should receive just compensation from the company to cover their expenses, should they win or lose the case, unless the claimant lost the case because of incorrect statements that he knew or should have known were incorrect. In all other cases, the same solution should apply if the suit does not appear to be abusive or otherwise misguided.[731]

Attention should also be paid to the difficulties in accessing the information. One should consider inserting a broad right of inspection, the possibility of disclosure orders or a discovery rule. There should be a right to access corporate documents, without

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[728] See UK rule, CPR r.19.9E (providing that the court may order the company to indemnify the claimant for costs incurred in the permission application or in the derivative claim or both. However, even if it is possible that the company will be ordered to pay the shareholder's costs in making the application for permission, this is unlikely where the application has failed); article 567 of the Belgian company code (providing that the company reimburses only in case the suit is admitted and to the extent the costs are not to be incurred by the losing defendant; otherwise the claimant might have to incur the litigation costs and, as the case may be, damages to be paid to the defendant). Comp. with more lenient German law, see article 147 of the German Stock Corporation Act (*Aktiengesetz*) (providing that the costs of shareholders' application to the court to appoint a special representative and, to a reasonable extent, the expenses of the special representative, are borne by the company) and article 148, §6 of the German Stock Corporation Act (*Aktiengesetz*) (providing for costs to be borne by claimant in the case the claim is not admitted, unless it is because it conflicts with corporate interests, for costs to be borne by the company if the company takes over the claim, for costs to be borne by the company if the claim is not successful, although admitted, unless admission was granted on incorrect statements, given wilfully or in bad faith). Comp. with the U.S. (providing that each party pays its attorney's fees, if not otherwise provided by contract or by law (the so-called American Rule)).

[729] Hence, the possibility, in French law, if legal charges cannot be met by the single shareholder, to form a "group" of shareholders representing at least 5% of the voting capital (article L.225-120, §1 of the French commercial code).

[730] And even more so in the case any proceeds of the derivative action flow to the company.

[731] Comp. with Israel (proposed amendment No. 10 to the Israeli Companies Act 1999 (May 2008) providing that the Israeli Securities Exchange Commission shall be authorised to fund derivative claims, in cases that are of general importance to the public and where there is a "reasonable chance" the court will grant leave to continue the action. It is expected the funding would cover expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave). With a view to strike the right balance between claimant's and defendant's interests, if the loser-pays-principle is changed in the E.U., there might be a need to introduce a threshold to file a claim.

charge, like board minutes, with a view to reduce information asymmetries between management and shareholders or between large and small shareholders.[732] These information rights could decrease to a significant extent the efforts required by the claimant when preparing the suit. Therefore they are an essential factor for the effectiveness of minority suits. Some suggest that there be a special audit at the request of the shareholders initiating the suit. Or that a special representative of the minority shareholders be appointed who would be bound to confidentiality and who would have full access to internal corporate information.[733]

Another oft-cited criticism against derivative suits is the fact that derivative suits do not deliver with regard to the compensation rationale.

This is due to several factors:

In the absence of an insurance paid by the issuer (hereafter D&O insurance), directors have limited resources.

In the presence of a D&O insurance, the costs, borne by the company, are indirectly borne by the shareholders initiating the suit.

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[732] See section 261(3) of the UK Companies Act 2006 (providing that the court may grant a discovery order to investigate the substance in the complaint) and sections 146, 431, 432 and 1145 of the UK Companies Act 2006 (entitling shareholders to request without charge a copy of some corporate documents, like annual accounts and auditors' report); the Dutch commercial code (giving a minority shareholder the right to ask the court to require the disclosure of the books and documents that the company is obliged to keep by law during legal proceedings; containing the obligation to submit the entire accounts to the other party in legal proceedings which is however restricted in the sense that it only exists with regard to "partners", while it is uncertain at best whether a minority shareholder qualifies as a partner) and sections 2:344-359 of the Dutch civil code (providing for the right to demand an inquiry) (see on this L. TIMMERMAN, et al., *Rights of Minority Shareholders in The Netherlands*, 6.4 Electronic Journal of Comparative Law, (2002)., at 195 et seq.); article 145 of the French civil procedure code (establishing a pre-trial judicial investigation allowing shareholders to gather proofs for a potential lawsuit); article 166 of the Belgian company code (providing that in companies where there is no auditor, shareholders have the inquiry rights and the control rights otherwise exercised by the auditors; in companies with an auditor, they may access only the documents disclosed prior to shareholders' meetings; providing also for the publication of some documents, such as excerpts of board minutes and special reports). Comp. with amendment No. 10 (May 2008) to the Israeli Companies Act 1999 (granting the court with powers to provide for a discovery order, prior to applying for the court to grant permission to continue the action, this order being made "if there is a preliminary evidential basis for meeting the criteria to grant leave to continue the action" on the basis that "the shareholder will not normally be exposed to the relevant information needed to establish the cause of action"). Comp. with the U.S. (where ownership of shares in a US company carries with it rights under state law to access the books and records of the company provided that the requesting shareholder establishes a proper purpose; where discovery procedures under federal law enable litigants to gain access to information in their opponent's possession once all defendants' pre-trial motions have been resolved).

[733] See SUSANNE KALSS, *Shareholder Suits: Common Problems, Different Solutions and First Steps towards a Possible Harmonisation by Means of a European Model Code*, 6 ECFR 324, (2009)., at 342.

But most importantly, this is due to the fact that damages are paid to the company and not to the shareholders initiating the suit. Besides, even a successfully prosecuted derivative action is not likely to boost the share value.[734]

In that respect, I think that one should take into account both rationales for civil enforcement, the strong presence of one of which might compensate for the weakness of the other in a given case. I believe that derivative actions should be considered as part of an overall system of regulation and enforcement, where one could bring a derivative action on behalf of the company and at the same time sue the directors in its own name[735] or sue the company.[736] Derivative suits' function should be defined not so much as compensatory but as *deterring* misconduct.[737]

A last criticism relates to the standard of liability for derivative claims. Some jurisdictions require that directors acted in bad faith or grossly violated the law or the articles of association.[738] Others provide that permission to continue a derivative claim will be refused in respect of a claim against a director based upon an act or omission that could be authorised or ratified by the company. In practice, the latter solution is likely to exclude the possibility of such claims in respect of ordinary negligence by directors.[739]

I favour a deceit basis.[740] I believe that the focus of derivative claims should be self-dealing and intentional misconduct.[741]

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[734] See ROBERTA ROMANO, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. Econ. & Org. 55, (1991). (studying the outcomes of derivative suits by focusing on their impact on the firm's market price and concluding that they produce no detectable benefits).

[735] The bringing of a claim in its own name would require the proof by the shareholder of a personal damage, separate from the one suffered by the company. This could be hard to establish. See, for instance, criminal chamber of the French Supreme Court, 13 December 2000, Bull. Crim. 2000, n° 373 (ruling that the depreciation of company's shares arising from its managers' tort does not harm the shareholder but the company itself).

[736] See article 2395 of the Italian civil code (interpreted by the majority of legal academics as not preventing investors from suing the company).

[737] *Accord* JAMES D. COX, et al., Common Challenges Facing Shareholder Suits in Europe and the United States, 6 ECFR 348, (2009)., at 351.

[738] See German law.

[739] Comp. with section 263 of the Canada Business Corporations Act (providing that the action shall not be stayed or dismissed on the basis that the wrong has been ratified but this can be taken into account by the court when deciding on an appropriate remedial order).

[740] See Part III:Chapter II:IV.D.5 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets. Comp. with UK law (providing for derivative actions for acts or omissions involving negligence, default, breach of duty or breach of trust).

There should also be national law provisions allowing for "multiple" derivative actions,[742] i.e., claims where wrongdoers defraudred the subsidiary of the parent company,[743] and shareholders of a parent company should be allowed to bring claims on behalf of a subsidiary even though they do not hold shares in that subsidiary.[744] In other words, derivative claims should also be made possible to sanction breach of the EU issuer-disclosure regime in the case of a corporate group where a blind eye has been shown by the board of directors of the parent company toward breach by directors in subsidiaries.

iv Obstacles to shareholder monitoring: enforcement of the controlling parties' duties[745]

As already suggested, it may seem awkward to speak about "controlling parties' duties".[746] In fact, outside the specific circumstances of groups of companies and related-party transactions,[747] it seems that contemporary company law and doctrine pay far more attention to directors duties than to shareholders'. Directors are believed to owe deep and broad fiduciary duties constraining the ways a company is managed. Shareholders, on the other hand, are thought to have far more limited obligations, if any at all.

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[741] *Accord* JAMES D. COX, et al., Common Challenges Facing Shareholder Suits in Europe and the United States, 6 ECFR 348, (2009)., at 349.

[742] See ARAD REISBERG, *Multiple Derivative Actions*, 125 Law Quarterly Review 209, (2009).

[743] See, for instance, the decision of the Final Appeal Court of Hong Kong in Waddington Ltd v. Chan Chun Hoo Thomas and others (FACV 15/2007).

[744] See, for instance, Civil Case 1931/00 (22 August 2002) (Israel).

[745] Some might ask where the U.K. fits into the discussion of controlling parties' duties, as the U.K. is mainly characterised by dispersed ownership. However, the section relating to the proper tools for shareholders' engagement considers all jurisdictions concerned by this dissertation, and not only jurisdictions where companies are mainly subject to agency problems between management and shareholders.

[746] See Part II:Chapter III:II.E.3.b.i above.

[747] It is widely assumed that controlling shareholders owe a loyalty duty which asks them to place the interests of the company and its shareholders above their own interests in the narrow context of related-party transactions. See in all jurisdictions concerned, the accounting laws implementing the IFRS which require disclosure of related-party transactions. See also in that respect, the national law provisions related to approval of directors' transactions involving a conflict of interests, keeping in mind that in concentrated ownership structures typical of Continental Europe, a director may be the representative of the controlling party.

However, at closer inspection, it seems that the national laws examined in this dissertation provide for enforcement of a *duty of loyalty which extends beyond the limited scope of self-dealing transactions*:

They all provide minority shareholders with a right to sue for abuse of the voting right of the majority, including seeking nullification of a resolution of the shareholders' meeting.[748]

Exclusion rights, i.e., the right to exclude another shareholder,[749] and withdrawal rights, i.e., the right to be bought out to exit the company,[750] also exist for minority shareholders in most jurisdictions.

Some jurisdictions provide for the appointment of a court-designated trustee in the event of serious difficulties preventing normal operations,[751] to manage the company for a limited period of time.[752]

Others provide for a court-designated expert or a special auditor to review the books and the accounts of the company as well as the acts performed by the organs of the company.[753]

Under Italian law, any shareholder can report facts deemed censurable to the board of statutory auditors which shall respond to any such complaint in its annual report to the shareholders' meeting. If the complaint is submitted by shareholders representing at least 2% of the share capital, the board of statutory auditors is obliged to investigate without delay the facts described in the complaint and submit its findings and possible recommendations to the next shareholders' meeting. If the facts reported

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[748] See, *inter alia*, article 1844, §1 of the French civil code (providing for annulment of acts or deliberations) and article 1382 of the French civil code (providing for damages); articles 64 and 178 et seq. of the Belgian company code; article 2376 of the Italian civil code; section 2:15 of the Dutch civil code; sections 243 et seq. of the German Stock Corporation Act (*Aktiengesetz*) (*Nightigkeits- und Anfechtungsklage* which can be initiated by any shareholder).

[749] See article 636 of the Belgian company code; section 327a to 327f of the German Stock Corporation Act (*Aktiengesetz*); sections 2:336 and 2:201a of the Dutch civil code).

[750] See article 642 of the Belgian company code (see also under Belgian law the sell-out further to the law implementing the Take-Over Directive); section 2:343 of the Dutch civil code.

[751] For instance, deadlock among the directors or serious conflict between two groups of shareholders threatening both their particular interests and the company's interests.

[752] See French law.

[753] See article 168 of the Belgian company code (in case there are indications that the interests of the company are or will be severely endangered); section 142 of the German UMAG dated 22 September 2005, BGBl. I 2005, 2802 (providing for a special auditor to be appointed by the court at the request of 1% of the shareholders).

are serious and there is an urgent need to take action, the board of statutory auditors is under an obligation to convene an *ad hoc* shareholders' meeting.[754]

The Netherlands provide for the possibility of minority shareholders to ask the Enterprise Section of the Amsterdam Court of Appeal to start an inquiry (*enquêterecht*), i.e., a special audit which costs are paid by the company, into the policy and the conduct of business of the company, in order to seek (immediate) measures, excluding damage awards.[755] According to some observers, the Enterprise Section defined a number of situations in which there are reasonable doubts whether a company is properly managed, including the situation where the company does not comply with the disclosure requirements.[756] They argue further that the court has gradually increased its ability to improve corporate governance, especially in conflicts of interests and take-over cases.

v Concluding remarks

Saying, without more, that national laws of the jurisdictions concerned by this dissertation do not provide for adequate shareholders' powers to make directors and controlling shareholders comply with their obligations is a little bit too crude.

There exists under the national laws concerned possibilities to make directors and controlling shareholders accountable for their misbehaviours. To be sure, the systems

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[754] See articles 2408 and 2409 of the Italian civil code (providing also that, if there are serious reasons to believe that the directors, in violation of their duties, have committed severe irregularities in the management of the company, shareholders representing at least 5% of the share capital are entitled to report the facts to the competent court).

[755] See sections 2:344-359 of the Dutch civil code. For a full commentary of this very much used means of minority shareholders' protection, see L. TIMMERMAN, et al., *Rights of Minority Shareholders in The Netherlands*, 6.4 Electronic Journal of Comparative Law, (2002)., at 195 et seq. See also M.W. JOSEPHUS JITTA, *Dispute Resolution in The Netherlands: Recent Decisions of the Enterprise Chamber and their Impact on the Corporate Governance of Dutch Companies*, *in* The Quality of Corporate Law and the Role of Corporate Law Judges, (L. Bouchez, et al. eds., 2006).; ERIK P. VERMEULEN, et al., *The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism*, ECFR (forthcoming), (2009). (reviewing inquiry proceedings from 2002 to 2008, finding an upward trend in requests for inquiry proceedings in listed companies outside a context of bankruptcy proceedings; finding also that certainty, predictability and speed of inquiry proceedings increased over-time); K. Cools, P.G.F.A. Geerts, M.J. Kroeze, A.C.W. Pijls, Het recht van enquête - een empirisch onderzoek, February 2009 (empirical evidence on the *enquêterecht* from 1971 to 2007). See also the recommendations made by the Social and Economic Council with a view to seek a more accurate balance between different competing interests in a company, under note 755 above.

[756] See ERIK P. VERMEULEN, et al., *The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism*, ECFR (forthcoming), (2009).

could be improved. But it remains that the picture is less dramatic than conventional wisdom would like to make us assume.

III. Conclusions

Some academics suggest that issuer-disclosure is less important in concentrated ownership structures than it is in dispersed ownership patterns. They start from the premise that the controlling or dominant shareholder(s) is(are) able to monitor management and mitigate management agency costs, thereby reducing the need of (other) shareholders for issuer-disclosure.

I explained in this chapter that this contention does not take into account the specific agency problems faced by companies in a concentrated ownership structure where tensions are likely to arise between the controlling shareholder or dominant blockholder(s) and the minority shareholders.

The contention that agency problems are of a different nature and scope under each pattern of ownership does not undermine the fact that issuer-disclosure serves equally important social benefits in terms of agency costs' reduction under all patterns of ownership. Hence issuer-disclosure should be equally promoted, i.e., with a similar intensity under each pattern of ownership. It means that the focus on issuer-disclosure to solve agency problems should be similar.

The corporate governance rationale that I identify for European issuer-disclosure regulation extends beyond investor decisions to trade, which play a role in allocational efficiency, to the mechanisms that govern internal operational decisions. In fact, transparency does not merely improve investor ability to choose among competing investment opportunities, it increases the likelihood that those opportunities will be profitable.

The case of a corporate governance rationale for the EU issuer-disclosure regime is even stronger when one considers that issuer-disclosure, through agency problems mitigation, has a positive impact on investors' trust in the principal-agent relationship. This in turn should decrease transaction costs[757] and indirectly agency costs by reducing

[757] *Accord* HEICO KERKMEESTER, et al., De economische structuur van het ondernemingsrecht. Een inleiding in de economische theorie van de onderneming (Deventer. 2000)., at 18-19.

the necessity of deeper monitoring by investors.[758] To the extent necessary, it should be reminded that, because 100% trust does not exist, people make mistakes and external factors bring uncertainty, trust could never be a perfect substitute for monitoring of agency costs.[759] Hence there is a need for minimum issuer-disclosure.[760]

Other academics further consider that Continental European jurisdictions, which are still characterised by a majority of firms with concentrated ownership structures, do not provide the proper incentives and tools to minority shareholders to act upon the information received to promote the exercise of corporate governance devices, like shareholder vote and shareholder monitoring of management and controlling parties.[761]

This contention takes a particular flavour in the context of the 2007-2008 financial crisis. Some have partly attributed the occurrence and the causes of the 2007-2008 financial crisis to shareholders. They have started to speak about shareholders' duties/responsibilities. Others have pointed to the fact that equity investments are necessarily risky and have argued that shareholders ought to accept the risk they take by losing part or all of their investment. But one cannot expect shareholders to take up their responsibilities and accept the risk related to their investment if they do not have the proper tools to supervise and control the decision-making process of the company they have invested in.

In that respect, I tried to argue against the commonly accepted view that company laws of European jurisdictions are not lenient with (minority) shareholders:

I showed that many Continental European companies currently have blockholders who do *not* have a lock on control and whose proposals and actions are contestable by other (minority) shareholders. I even suggested that there are reasons to believe that

[758] *Accord* KEES COOLS, Controle is goed, vertrouwen is nog beter (Van Gorcum. 2005)., at 102-06.

[759] *Accord* KEES COOLS, Controle is goed, vertrouwen is nog beter (Van Gorcum. 2005)., at 103. See also LYNN A. STOUT, et al., *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 University of Pennsylvania Law Review 1735, (2001)., at 1755 ("no combination of legal rules and markets forces can bring agency costs in firms down to zero.").

[760] See MELVIN A. EISENBERG, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J.Corp.L. 819, (1999)., at 835 ("[t]he corporate system operates most efficiently where corporate actors act loyally – that is, deal fairly and in a trustworthy manner – and are perceived to do so").

[761] See Part II:Chapter III:I.C.3.

there will be increased fragmentation of ownership structures in Continental Europe *beyond* the current financial crisis.

Moreover, I argued that issuer-disclosure improves the effectiveness of shareholder vote and shareholder monitoring in the E.U. by decreasing costs relating to the exercise of these corporate governance devices, no matter the specific ownership structure. I reviewed the measures at European level to facilitate voting rights, and most importantly the Shareholders Rights Directive, the initiatives by the individual Member States in the area of enforcement, and I discussed market pressure to show that they all contribute to increase minority shareholders' protection in the E.U. This is confirmed by recent comparative law studies.[762] This being said, I conceded that national (company) laws of the jurisdictions concerned by this dissertation could still be improved to offer those who can be expected to impact corporate behaviours, i.e., institutional shareholders and large retail shareholders, even more appropriate incentives and tools to effectively vote and monitor management and the controlling party. In that respect, practicalities relating to the effective exercise of cross-border voting and impediments to derivative actions are the main areas of concern that I examined. I also suggested proper disclosure of voting policy and voting behaviours by institutional investors.

Of course, the specific content of issuer-disclosure should be different depending on the "internal decision structure and the corporate finance environment" of the issuer in order to tackle its specific agency costs.[763] For instance, in the European context, selective private disclosure of firm-specific information might be more relevant than in the U.S. as well as disclosure about shareholder behaviour, particularly ownership levels, shareholders' intentions and related-party transactions, to help mitigate the risks of intra-shareholders' opportunism.

Another issue is the efficiency of the specific requirements mandated by the EU issuer-disclosure regime. This requires a costs-benefits analysis to assess if costs of a specific provision under the Prospectus Directive or the Transparency Directive do not exceed its benefits in terms of improvement of corporate governance. Only upon this

[762] See note 654 above and accompanying text.

[763] MERRITT B. FOX, *Required Disclosure and Corporate Governance,* 62 Law and Contemporary Problems 113, (1999)., at 1405.

determination, a full and reliable assessment of the specific provision will be possible. As already stated, I am leaving any costs-benefits analysis for further studies, involving economists, especially for the areas where there could be heated controversy, like interim management statements required under the Transparency Directive.

As concluding remark, I would like to discuss the fact that the world's most extensive and accurate regime of issuer-disclosure will never be enough to guarantee good corporate governance to protect shareholders. Suffice it to consider that the US heavy disclosure regime did not prevent Enron to happen, nor the 2007-2008 financial crisis. This contention refers to the limits of issuer-disclosure. There is an irreductible element of discretion in disclosure that will always allow corporate insiders leeway in deciding how much of information to reveal, while still complying with the letter of disclosure rules.[764]

More tangible forms of corporate governance could be required to complement disclosure. These could include the composition, election, role, independence, conflicts of interest and remuneration of boards and board members. These could also include the same with respect to supervisory boards and internal committees, like audit, remuneration or nomination committees. These should tackle as well important issues in connection with the general assembly of shareholders, like its powers or the provision of information to its members.

There could also be a need to check, and to create the incentives to increase, quality of issuer-disclosure. This is further discussed in Part III of the dissertation.[765]

The limits of disclosure underline as well the risk relating to corporate governance conceived as corporate fashion trend. Indeed, persons responsible for the compliance with corporate governance codes could consider them as a mere box-ticking exercise, without more.[766] Evidence shows in that respect that many addressees of corporate governance codes do not explain the reasons for departing from best practice

[764] *Accord* JEFFREY N. GORDON, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 Conn.L.Rev. 1125, (2003). See also JOHN ROBERTS, *No One is Perfect: The Limits of Transparency and an Ethic for 'Intelligent' Accountability*, Accounting, Organizations and Society (forthcoming), (2009)., at 12 and references therein cited.

[765] See Part III:Chapter II:III and Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[766] See EFFECT (VEB-magazine – 'Journal of the Dutch investors' association' – 24 December 2005) (mentioning ten tricks that firms use to circumvent the Dutch corporate governance code).

encouraged by the codes and that some others give standard, general and uninformative explanations which are unlikely to protect investors.[767]

And this also gives support to my regulatory suggestion to target issuer-disclosure to more sophisticated actors.[768] Indeed, these are market actors who are more skilled and have better incentives to understand the information disclosed and ask for further explanations if necessary. They have the incentives and abilities to benchmark the disclosures to assess their quality. They are also more likely to file a claim in the event of incorrect or misleading statement.

[767] See the Dutch Corporate Governance Code Monitoring Committee (having therefore decided to put more emphasis on the way management, shareholders and auditors perform their respective duties instead of focusing on the explanations of their behaviour they give *ex post*). See also Part II:Chapter III:II.E.3.b.iii above.

[768] See Chapter Issuer-Disclosure Addressees and Consequences.

Part III:

Regulatory Implications

Chapter I: Issuer-Disclosure Addressees and Consequences

I. Introduction

This chapter raises a classical yet fundamental question: to whom should the EU issuer-disclosure regime be directed?

In theory, there are three answers based on the degree of sophistication of the investor: the unsophisticated investor, the investor of average sophistication or the financial expert.

The "*unsophisticated*" *retail investor* protection dimension of the EU issuer-disclosure regime is questionable as explained above.[769]

It is at best useless as unsophisticated retail investors do not read, understand nor act on the information provided to them. It does not provide the necessary protection unsophisticated retail investors need in order for them to be confident in investing in financial markets. From that perspective, the EU issuer-disclosure regime fails to serve the growth of European capital markets as it does not contribute to increase unsophisticated retail investors' participation in capital markets.

It is at worst counter-productive because information and information over-load could induce an over-confidence bias which makes unsophisticated retail investors think that they can avoid careful analysis and blindly rely on the information provided to them.

Besides, from an issuer's perspective, it constitutes an additional cost, as further illustrated in this chapter, not matched by any corresponding benefit and tehrefore not worth the additional cost. This in turn hinders entrepreneurship, weakens the competitive position of the European economy and restricts the real choice for investors as to the investment products offered.[770]

[769] See Chapter Investor Protection.
[770] See also Part I:II in General Introduction.

The concept of the "*investor of average sophistication*" is rather difficult to grasp with any legal certainty and, therefore, is useless for the purposes of this dissertation.[771]

I suggest to address the EU issuer-disclosure regime to "*more sophisticated actors*".

This suggestion reflects the specificities of today financial world where institutional investors are increasingly important in numbers.[772]

It is also a logical consequence of the developments made in Part II where I stressed that only large retail investors and institutional investors can impact the two immediate objectives of issuer-disclosure, i.e., market efficiency and corporate governance.

The necessary consequence of my suggestion for issuer-disclosure to target more sophisticated actors is that unsophisticated retail investors are *encouraged to* "*indirectly*" instead of "directly" *invest* in investment products. In my definition of the term, "indirect investment" means either requesting professional advice or portfolio management services or investing in equities through an institutional investor. This would duly take into account the inherent risks of financial investments by implying the intervention of people who are supposed to have more expertise. Getting expertise

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[771] *Accord* ESME Report, Market Abuse EU Legal Framework and its Implementation by Member States: a First Evaluation, 6 July 2007, at 9 (in the context of the MAD, questioning the meaning of "reasonable investor" test and suggesting that the benchmark be that of a professional investor when assessing whether a piece of information would be appreciated by the market as a determinant of an investment decision). See for a critique of the reference to the closely related concept of "reasonable investor" under the Belgian implementing law of the MAD, XAVIER DIEUX, et al., *La transposition en droit belge de la directive "abus de marché" et de ses mesures d'exécution*, Droit bancaire et Financier, (2007). See however, the concept of "*maatman belegger*" (average investor) in the recent Dutch Supreme Court ruling, VEB v World Online, Goldman Sachs, ABN Amro, 27 November 2009, LJN: BH2162 (holding that, for primary market liability, account should be taken of the reasonable expectations of an average informed, rational and prudent investor, to whom the disclosure is addressed ("*uitgegaan moet worden van de vermoedelijke verwachting van een gemiddeld geïnformeerde, omzichtige en oplettende gewone belegger, de maatman-belegger, tot wie de mededeling zich richt (vgl. HR 30 mei 2008, LJN BD2820)*"). Comp. with the U.S., where the concept of "reasonable shareholder" appears in connection with the materiality requirement at the level of liability issues under the US Securities Act and the US Securities Exchange Act; see, for instance, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (where the Supreme Court decided that information is considered material where there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision, i.e., the influence of information on the market price or value of the issuer's securities is decisive, taking into account all information made available to the investor); see generally, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 959 et seq.

[772] See Part II:Chapter III:II.C in Chapter Corporate Governance and Part III:Chapter I:II.A below.

through intermediation and investment advice could mitigate flaws in unsophisticated retail investor decision-making and in information deficiencies on markets. Although I appreciate that there are costs associated with this policy and that these costs have to be borne by end-investors,[773] I believe that benefits to end-investors and the economy as a whole would exceed these costs.

My suggestion matters given the regulatory recommendations that I draw.

The rest of this chapter is organised as follows.

Section II develops the arguments behind my policy choice of targeting more sophisticated actors. It also defines more precisely who are meant by "more sophisticated actors". It makes a distinction between so-called "informed traders" and "information traders".

Section III sets out the regulatory implications derived from my position:

The first ones duly take into account the *costs' concerns of issuers*. I build in my costs-related recommendations some measures to protect unsophisticated retail investors so that they are not *de facto* excluded from participating in financial markets. Indeed, the purpose here is not to prohibit access to financial markets to unsophisticated retail investors but merely to *discourage* them from *directly* investing.

The second set of regulatory implications concerns the relationship between investment firms, including collective investment schemes, and their end-investors. This relationship becomes crucial as under my scheme unsophisticated retail investors are encouraged to either seek professional financial advice from, or to invest through, investment firms. To the extent it is not already the case under current status, this relationship therefore deserves full consideration of the regulator as an alternative to the EU issuer-disclosure regime to provide a means to build effective investor protection. In that context, some issues under MiFID and UCITS regulations are very briefly discussed.[774]

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[773] Among these costs are the fees to be paid to the intermediaries or advisers (see on this the concerns expressed by the UK FSA in the "retail distribution review" (the so-called RDR) (UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010) and the risk of liability on the part of intermediaries and advisers.

[774] I am aware that MiFID does not apply to pension funds and insurance companies, although these are also very popular institutional investors through which retail investors invest. However, given

Finally, I recommend further work in some areas to complement the new focus of the EU issuer-disclosure regime on more sophisticated actors, with a view to ensure unsophisticated retail investor protection. In that respect, there should be proper regulation of analysts, as "market gatekeepers", proper enforcement of existing regulation, accurate financial education (to the extent necessary from a costs-benefits perspective), promotion of behavioural research and the involvement of retail investors in the law-making process (to the extent necessary from a costs-benefits perspective).

Section IV concludes.

II. More Sophisticated Actors

A. The Importance of More Sophisticated Actors

1. *Qualitative importance of more sophisticated actors: positive impact on market efficiency and corporate governance*

I argued in Part II that, if it cannot effectively and efficiently be used to protect unsophisticated retail investors, the EU issuer-disclosure regime is nevertheless useful to promote market efficiency and corporate governance.

In order to effectively achieve market efficiency and corporate governance, the EU issuer-disclosure regime should be addressed to more sophisticated actors.[775]

More in particular, more sophisticated actors contribute to *market efficiency* either by trading on the information or by issuing comments on stocks or corporate activities on the basis of this information. The latter contribute to the investment decision of investors.

It should be reminded that the ECMH does not depend on each individual considering each piece of information: if "enough" market participants consider each

the fact that MiFID was recently adopted, with much foss around it and that it should be reviewed in the course of 2011 and given the fact that the 2007-2008 financial crisis mainly hit credit institutions, including the ones subject to MiFID, I thought that it would make sense to select only MiFID-related issues in the context of this dissertation.

[775] See, interestingly, article 21(1) of Council Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities (stating that an annual financial statement, for instance, is meaningful to a "financially literate" investor).

item of (material) information, the information can be incorporated in security prices.[776] As there is an increased chance of information to be incorporated in stock prices if made available to more sophisticated actors because these market participants are more likely to use it rationally,[777] there is a social interest to direct information to them.

More sophisticated actors are also the ones who are more likely to promote *corporate governance*. Where they act as "shareholders",[778] they have the incentives to vote and monitor and to do so in an informed manner. Where they act as gatekeepers without acquiring securities, their reports and recommendations have the potential to play an important pressure to improve corporate governance.

2. Quantitative importance of institutional investors in the E.U.

The European market is not retail in nature.[779] It is a truly institution-oriented system. This means that "to the extent that individuals and households invest in equity securities at all, it is through intermediaries."[780] This means as well that unsophisticated retail investors often request professional advice.[781]

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[776] See Part II:Chapter II:II in Chapter Market Efficiency.

[777] See Part III:Chapter I:II.C.3 below.

[778] See note 586 and accompanying text.

[779] See Part II:Chapter III:II.C.2 in Chapter Corporate Governance.

[780] DONALD C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Virginia Law Review 1025, (2009). at 42. See also the French AMF, Economic and Financial Newsletter, Spring 2009, at 9 (showing that direct and indirect participation of French households in financial markets (listed shares, participation in UCITS, and listed securities other than shares) is rather low when compared to other elements of the French financial portfolio, i.e., deposits, cash and life insurance).

[781] See UK FSA, Building Financial Capability in the UK: the Role of Advice (2004), at 1 (arguing, as part of its development of a retail market strategy, that while information can be used by confident consumers "many people will continue to find financial services bewildering and will want some customised help to identify their financial needs and so make better decisions"); Explanatory Memorandum to the MiFID Proposal, at 30 (across the E.U., the investment advice industry is becoming an "increasingly important financial business in its own right with over 4,000 independent financial advisers in the UK, over 7,000 in Italy and larger numbers in Germany"); Charlie McCreevy, Opening Remarks, Open Hearing on Retail Investment Products, Speech/08/393, 15 July 2008, at 3 ("[i]nvestment products are frequently sold on the basis of advice from financial intermediaries"); see also BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007. See statistics of the European Federation of Financial Advisers and Financial Intermediaries (FECIF) on its web-site. See, interestingly, article 4.1 of Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing-up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (mentioning that "listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors *and their investment advisers* to make an informed assessment of the assets and liabilities,

The U.S. present a similar situation, although only since recently.

In 1950, more than 90% of US equity was owned directly by households. By 2007, the figure had dropped to less than 30%.[782] At the same time, the percentage of US equity owned by institutions had risen from less than 10% to 73.4% of the market value of outstanding equity securities in 2006.[783] In conclusion, "[i]f we take into consideration that institutions account for more than a proportional share of trading, we can assert that almost all of the daily trading in the U.S. stock is done by institutions."[784]

This does not mean however that individual and household direct investments have declined in absolute numbers in the U.S. In fact, from 1965 to 2006, the value of equity securities owned by households increased from approximately USD616 billion to USD5.5 trillion.[785] But this means that direct investments by individuals have decreased. There is a preference to invest in a mutual fund, an employer-established pension fund or an insurance product, to make retirement plan elections or to defer to account management by a brokerage firm or investment adviser, rather than directly investing in capital markets. Besides, the capitalised amount spent on investment advice (retail and institutional) is estimated as at least 10% of the entire current market capitalisation.[786]

3. Other aspects of the importance of more sophisticated actors

Directing the EU issuer-disclosure regime to more sophisticated actors provides an *alternative to more far-reaching solutions*:

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financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities" as if each one had an investment adviser (emphasis added)).

[782] Professor Donald Langevoort speaks about the "institutionalization of the securities market" or "institutionalized marketplace". See DONALD C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Virginia Law Review 1025, (2009).

[783] See Securities Industry and Financial Markets Association Fact Book 2007, at 65.

[784] LUIGI ZINGALES, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, (2009). at 13. See also JILL E. FISCH, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wisconsin Law Review 333, (2009). at 335 (speaking of "deretailization of the securities markets").

[785] See Securities Industry and Financial Markets Association Fact Book 2007, at 65.

[786] See KENNETH FRENCH, *Presidential Address: The Cost of Active Investing*, 63 J. Fin. 1537, (2008).

Prohibiting direct access to equity markets to unsophisticated retail investors, as suggested by some academics,[787] would be a too drastic and too paternalistic option.[788] It would be unappealing for political and economic reasons.[789]

I am not either in favour of devising any broad regulatory strategy to keep retail investors out of the securities markets, whatever the individual- or market-protection reasons may be. For instance, I do not support imposing new taxes on securities trading.[790]

I do not favour a solution which would restrict unsophisticated retail investors to low-risk collective investment schemes or simple products.[791] This being said, I believe that there should be increased protection when more complex products are being offered

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[787] See, for instance, HOWELL E. JACKSON, *To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 Journal of Corporation Law 101, (2003)., at 674; STEPHEN J. CHOI, *Regulating Investors Not Issuers: A Market-Based Proposal*, Calif. L. Rev. 279, (2000). (although not arguing that individual investors distort stock prices, proposing an investor classification scheme (based on informational resources and market knowledge, as displayed on a licensing exam) that would prohibit direct investment in securities markets by unsophisticated investors; further arguing that (1) the recent proliferation, and then consolidation, of private trading platforms, which are open only to large institutional investors trading securities issued privately through Rule 144A offerings, and (2) the existence of alternative trading systems (so-called "dark pools"), designed to provide additional liquidity for institutional investors trading in public securities, demonstrate that market participants are willing to trade in an environment that excludes individual investors); DONALD C. LANGEVOORT, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Northwestern University Law Review 135, (2002). (suggesting that behavioural literature, if accurate, invites regulation that privileges the savvy and treats unsophisticated traders as economic undesirables); LYNN A. STOUT, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Virginia Law Review 611, (1995)., at 618 (criticising regulatory policies which encourage direct and excessive trading as a beneficial activity). See also PAUL MAHONEY, *Is there a Cure for "Excessive" Trading?*, 81 Virginia Law Review 813, (1995)., at 728 (noting that individual investors should be protected from themselves and excluded from the market, given that they are systematically prejudiced by their use of the freedom to trade; but examining why limiting market access is not an entirely desirable solution).

[788] *Accord* LUIGI ZINGALES, The Future of Securities Regulation, 47 Journal of Accounting Research 391, (2009)., at 28.

[789] For the economic and political reasons to promote retail investors' participation in financial markets, see Part II:Chapter I:II in Chapter Investor Protection.

[790] See for support of a tax on securities trading, such as a Tobin tax, JOSEPH STIGLITZ, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 Journal of Financial Services Research 10, (1989).; LYNN A. STOUT, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Virginia Law Review 611, (1995)., at 699-702; JOHN MAYNARD KEYNES, The General Theory of Employment Interest and Money (Macmillan Cambridge University Press. 1936). (likening stock markets to casinos and suggesting that a stock transfer tax might "mitigat[e] the predominance of speculation over enterprise in the United States"). See for criticisms against imposition of a tax on securities trading, *inter alia*, HARALD HAU, *The Role of Transaction Costs for Financial Volatility: Evidence from the Paris Bourse*, 4 Journal of the European Economic Association 862, (2006). See for an account of recent discussions relating to the introduction of a Tobin tax, FT.com, Tobin or not Tobin, 8 November 2009 and the discussions in the European Parliament relating to the introduction of a "financial transaction tax".

[791] See, *inter alia*, STEPHEN J. CHOI, *Regulating Investors Not Issuers: A Market-Based Proposal*, Calif. L. Rev. 279, (2000)., at 279, 300-02.

or traded to retail investors, in form of a special authorisation for instance to be delivered on a case by case basis at the level of the relationship between retail investors and their intermediaries.

Besides, my position *dismisses more costly and hazardous solutions*, like a tier-disclosure system distinguishing among addressees based on their presumed financial literacy. Indeed, financial literacy is always difficult to assess with any certainty.

In addition, and as further developed below, the presumption of operating in a market of more sophisticated actors *allows* persons responsible of the drafting of disclosure *more flexibility*, reducing their compliance costs.[792]

Furthermore, next to a cost-saving rationale, if the benchmark for persons responsible of the drafting of disclosure is "more sophisticated actors", *communication to the market should be improved* and consequently market efficiency and corporate governance should be enhanced. Indeed, for instance, the most informative message to the ones impacting market efficiency and corporate governance could be a highly technical discussion that includes a lot of terms of art of the industry, complicated sentence structures and numerous caveats in statements. But if the benchmark to be taken into account by the drafters of that statement to make that statement not misleading and to make it understandable is unsophisticated retail investors, this threshold could get in the way of more sophisticated investors as the numerous disclaimers, that the responsible drafters would have to insert to be sure that unsophisticated investors know about the various ways the statement could go wrong, could cloud the communication to more sophisticated actors and therefore negatively impact market efficiency and corporate governance.

This should also *affect how courts decide on lawsuits* filed for alleged failure to comply with the EU issuer-disclosure regime. Indeed, if the benchmark for persons responsible of the drafting of disclosure becomes more sophisticated actors, this could impact the judicial assessment whether a particular statement was misleading or not. A

[792] See Part III:Chapter I:III.B below.

particular statement might be misleading for the unsophisticated retail investor although it is literally true. With more sophisticated actors as relevant audience, if a statement is literally true, courts should take it for its literal truth and not consider it ambiguous. With increased sophistication of recipients, any perceived trend toward issuers being considered insurers of investors' investments should be reduced and securities regulation should be less treated as a consumer protection law.[793]

Lastly, my suggestion is less innovating than it may appear, although I appreciate that it could seem conceptually difficult to accept as one might be afraid that retail investors would be offered less protection:

The idea to relax protection for unsophisticated retail investors through disclosure is already behind a number of reforms which seem to take into account the important presence of more sophisticated actors. This could be illustrated by the increased emphasis on best practices and "comply or explain" rules that let issuers to experiment with different approaches to corporate governance and disclosure without one-size-fits-all requirements.[794]

B. A More Precise Definition of More Sophisticated Actors: "Informed Traders" and "Information Traders"

1. Preliminary remark

I suggest that the EU issuer-disclosure regime be addressed to two categories of more sophisticated actors: more sophisticated investors, who I call "informed traders", and other financial markets' professionals, who I call "information traders".

2. Informed traders

"Informed traders" are actors who invest and trade on the basis of information.

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[793] *Accord* ZOHAR GOSHEN, et al., *The Essential Role of Securities Regulation*, 55 Duke L. J. 711, (2006)., at 3. See also Part II:Chapter I:V.C in Chapter Investor Protection.

[794] See, for instance, corporate governance statement in the annual report pursuant to article 46(a) of the Fourth Company Law Directive, as amended by Directive 2006/46/EC.

Building on the definition of "qualified investors" under the Prospectus Directive[795] and of "professional clients" under MiFID,[796] informed traders include (i) legal entities which are authorised or regulated to operate in the financial markets, including credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity dealers, as well as entities not so authorised or regulated whose corporate purpose is solely to invest in securities; (ii) national and regional governments, central banks, international and supranational institutions such as the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organisations; (iii) other legal entities which do not qualify as SMEs under the Prospectus Directive; and also (iv) SMEs and natural persons who directly invest on capital markets either because they do not invest through a professional investor or because they do not request from professionals investment advice or portfolio management services. Support for the extension of informed traders to the latter sub-category can be found in the MiFID which subjects investment firms which provide execution-only services to lighter conduct of business rules.[797]

Some may have difficulty with the idea of using in part the definition developed for the purposes of an exemption from the requirement to produce a prospectus[798] as the basis for a regime determining the mandatory contents of a prospectus. They argue that there would be scope for conceptual muddle. However, I believe that two issues ought to be distinguished here: the publication requirement and the audience of disclosure. On the one hand, there is the publication requirement and its exemptions, more in particular the exemption based on the qualification of the addressees. So-called "qualified investors" are supposed to fend for themselves and therefore offers exclusively made to them are assimilated to private placements and not subject to any formal procedure of

[795] Note that the European Commission has recently suggested to change the definition of "qualified investors" in article 2.1(e) of the Prospectus Directive to make this concept similar to the concept of "professional clients" under the MiFID. See EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009).

[796] See Annex II of MiFID (a "professional client" is "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs.").

[797] See article 19.6 of MiFID.

[798] I.e., article 2.1(e) of the Prospectus Directive.

approval, publication and dissemination of information.[799] Nevertheless, it is very likely that qualified investors will nevertheless ask the issuer for some sort of disclosure documents, although not mandatorily subject to any formal procedure. By contrast, the approval, publication and dissemination procedure further to the Prospectus Directive is justified in case of so-called "public offerings", as the investment products being offered could be purchased by (unsophisticated) retail investors.[800] And, for this reason, it makes sense for supervisory authorities, in charge of the enforcement of the procedure, to control that the financial intermediaries and advisers, *who invest other people's money or impact the investment decisions of other people*, are provided with correct and not misleading information, duly published and disseminated. On the other hand, there is the audience to whom disclosure made in the context of an offer to the public is directed. In that respect, I suggest that the yardstick be higher than lower, i.e., that the benchmark to be taken into account by drafters be at the rather high level of sophistication of so-called more sophisticated actors, for all the reasons explained above.

Annex II of MiFID sets out identification criteria for persons who are not automatically considered as professional clients but who may be treated as such upon request. These include private individual investors. Investment firms must assess the experience, expertise and knowledge of these people. The frequency of financial transactions made by those persons, the size of their financial instruments' portfolio and their financial knowledge are the *de minimis* identification criteria for this fitness test. I do not suggest to insert these criteria in the definition of "informed traders".

More generally, I do not rely on proxies in determining whether or not an investor falls into this category. This category includes a broad range of investors, from individuals with whatever educational and business experience to professional money

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[799] See also articles 27 through 33 of MiFID (providing for a clients' categorisation which affects how much information is to be provided by the intermediary: the less sophisticated will receive the more protection through information). See in the U.S., SEC v. Ralston Purina Co., 200 F.2d 85, 93 (8th Cir. 1952) and 345 U.S. at 127 (the Supreme Court establishing that "a transaction not involving any public offering" is "[a]n offering to those who are shown to be able to fend for themselves…"). See subsequent US SEC definition of "accredited investor" (see note 136 above and accompanying text).

[800] And this could, under my suggestion, happen in two ways: either by direct investments or (and I would like the regulator to encourage this second path) by indirect investments, i.e., through an intermediary or on the basis of a professional advice.

managers and everything in between. Their shared feature is that they are either large retail investors[801] or institutional investors or are to be treated as such for my purposes because they did not think it necessary to request professional advice or portfolio management services or to pool their investments through an institutional investor.[802] The *caveat emptor* should apply.[803]

By covering (allegedly) sophisticated individuals as well as companies and institutional investors, this definition reflects the reality of European capital markets. Indeed, (1) many wealthy individuals invest in European stock markets as many companies are owned by families;[804] (2) many large companies in Continental Europe are owned by other companies;[805] (3) an increasing stake of large Continental European firms is bought by institutional investors, like pension funds, mutual funds or insurance companies;[806] and (4) the unsophisticated retail investor appears to participate in European financial markets based on professional advice.[807]

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[801] See Part II:Chapter III:II.E.3.b.ii in Chapter Corporate Governance.

[802] Note that retail investors may be sophisticated: see, JOSHUA D. COVAL, et al., Can Individual Investors Beat the Market? (2005). (documenting that skillful individual investors exploit market inefficiencies to earn abnormal profits, above and beyond any profits available from well-known strategies based upon size, value, or momentum).

[803] See section 5(2)(d) of the UK Financial Services and Markets Act 2000 (providing that, in setting standards of consumer protection, the UK FSA shall take into account "the general principle that consumers should take responsibility for their decisions").

[804] See CHRISTOPH VAN DER ELST, Shareholder Mobility in Five European Countries (2008). (for France, Spain, Italy, Belgium and the U.K.); for Germany, see TOM KIRCHMAIER, et al., Who Governs? Corporate Ownership and Control Structures in Europe (2004).; see also CHRISTOPH VAN DER ELST, et al., Onderzoeksrapport ten behoeve van de SER Commissie Evenwicht Ondernemingsbestuur - Een overzicht van juridische en economische dimensies van de kwetsbaarheid van Nederlandse beursvennootschappen (24 October 2007).; for the Netherlands, see FEDERATION OF EUROPEAN SECURITIES EXCHANGES, Share Ownership Structure in Europe (2007).

[805] Idem.

[806] See European Central Bank, Structural Issues Report, Corporate Finance in the Euro Area, May 2007, at 67 et seq. Participation of private financial companies is particularly high in the U.K. compared to other Member States (see FEDERATION OF EUROPEAN SECURITIES EXCHANGES, Share Ownership Structure in Europe (2007).). See also, CHRISTOPH VAN DER ELST, Shareholder Mobility in Five European Countries (2008).

[807] See Part III:Chapter I:II.A.2 above.

3. *Information traders*

"Information traders" are actors who are giving investment advice or commenting on stock or corporate developments.[808] Information traders are "market gatekeepers", i.e., agents who ensure compliance of issuers with applicable rules by reviewing disclosures.

One might question why the scope of the information required for the purposes of investment decisions should be determined by reference to categories of persons other than investors, like so-called "information traders". I believe that this is not contrary to the Prospectus Directive.[809] I do not see the reason why the information necessary to make an informed assessment of the issuer should be restricted to the persons making the investment decisions and not extended to the categories of people contributing, by their advice or reports, to these investment decisions.

This category includes securities analysts,[810] financial media,[811] corporate and securities regulation lawyers,[812] and auditors.[813] I do not consider credit rating agencies

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808 See also BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001)., at 787 (referring to "reputational intermediaries" (accounting firms, investment banking firms, law firms and stock exchanges)).

809 Article 5.1 of the Prospectus Directive provides that "[…] the prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities."

810 For contributions that show that analysts promote market efficiency, by impacting price accuracy, see Do European Brokers Add Any Value through Recommendations? , pt. (2009). (analysts' share tips can help beat most mutual funds); BENJAMIN C. AYERS, et al., *Evidence That Analyst Following and Institutional Ownership Accelerate the Pricing of Future Earnings*, 8 Rev. Acct. Stud. 47, (2003). (finding evidence that the stock prices of corporations that receive increased analyst coverage reflect future earnings earlier than neglected firms); RICHARD FRANKEL, et al., *Characteristics of a Firm's Information Environment and the Information Asymmetry Between Insiders and Outsiders*, J. Acct. & Econ. 229, (2004)., at 232 (noting that outside investors in firms with greater analyst coverage face less information asymmetries). But see OYA ALTINKILIC, et al., *On the Information Role of Stock Recommendation Revisions*, Journal of Accounting & Economics (JAE), Forthcoming, (2009). (finding that analysts' tips do not move price). For studies showing that analysts contribute to increased market efficiency by impacting liquidity, see DARREN T. ROULSTONE, *Analyst Following and Market Liquidity*, 20 Contemp. Acct. Res. 551, (2003). (arguing that since analysts provide public information, increased analysts' coverage has a positive association with liquidity). For studies arguing that analysts impact corporate governance, see JOHN A. DOUKAS, *Security Analysis, Agency Costs, and Company Characteristics*, 56 Fin. Anal. J. 54, (2000). (analyst coverage can reduce agency costs associated with dispersed share ownership which separates ownership from control). See for the latest regulatory developments at European level, the relevant web-pages of the European Commission web-site. Comp. with the US regime concerning analysts under SOx.

811 See MICHAEL BORDEN, The Role of Financial Journalists in Corporate Governance (2006).; see also MICHAEL KLAUSNER, *The Limits of Company law in Promoting Good Corporate Governance*, *in* Restoring Trust in American Business, (J.W. Lorsch, et al. eds., 2005)., at 97-8. Journalists are not regulated in European securities regulation.

as their opinion refers to the risk related to debt instruments and this dissertation is only concerned with equity.[814]

Each has a particular position that, at least in theory, enables it to produce more information than currently available in the market. This reduces information asymmetry between a company and its investors, provided of course that the position of information traders is free of any conflict of interests. Issuer-disclosure provides feedstock for further investigation and analysis and reduces search and verification costs. These costs reductions increase the activity of information traders, generating additional information. In the cases of the media and, to some extent, analysts, this information is made public. The rest of the information generated by analysts is given confidentially to traders, who combine it with information they generate themselves, to trade in ways that move price. The resulting movement in price is, of course, public and constitutes new information in and of itself.

C. Possible Objections and Related Responses

1. What about engagement by unsophisticated retail investors?

It could be argued that if the EU issuer-disclosure regime is targeted at more sophisticated actors, unsophisticated retail investors will not be in a position to exercise their voting rights and their monitoring of management or the controlling party. In other

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[812] See JOHN C. COFFEE, The Attorney as Gatekeeper: An Agenda for the SEC (2003).; FRED C. ZACHARIAS, *Lawyers as Gatekeepers*, 41 San Diego Law Review, (2004). Lawyers are not regulated in European securities regulation but might be regulated under the laws of European jurisdictions whereas they are regulated under state laws in the U.S.

[813] See Daouk Battacharya and Michael Welker, The World Price of Earnings Opacity, Working Paper 2002, at 16 (finding that the number of auditors a country has (scaled by population) affects the opacity of disclosure in that country. An increase in the number of auditors in a country decreases the earnings opacity of firms' disclosures); MERRITT B. FOX, *Corporate Governance: Gatekeeper Failures: Why Important, What to Do?*, 106 Mich. L. Rev. 1089, (2008)., at 1093-94 (arguing that when auditors fail, they undermine their capacity to reduce information asymmetries. This reduction, and the accompanying decline in the accuracy of the issuer's share price as a predictor of future cash flows, undermine the effectiveness of the whole panoply of devices that create the structure of incentives that encourages managers to make share-value-maximizing decisions). They are regulated under, *inter alia*, Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. Comp. with the US regime under SOx and state laws.

[814] See for their regulation in the E.U., Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJEU, 17 November 2009, L302/1. Comp. with US Rating Agency Reform Act of 2006 under which the US SEC has real supervisory powers over credit rating agencies and H.R. 3890 (the Accountability and Transparency in Rating Agencies Act) passed by the House Financial Services Committee in October 2009, see also Pub. Law No. 109-291.

words, they will not be able to be committed shareholders in a position to exercise the necessary influence and check they are allegedly expected to do further to Chapter Corporate Governance.[815]

However, the exact discussion under Part II should be recalled here. As a general matter, unsophisticated retail investors should not be relied upon to impact corporate decisions or to exercise proper supervision of management or of the controlling party because of, *inter alia*, their limited ability relating to corporate affairs and the collective action problems they face as small investors.[816]

If *unsophisticated retail investors* nevertheless have the will to exercise their "responsibilities" as shareholders, which of course is to be encouraged, it should be stressed that they *are not disempowered* by my policy suggestion:

They can make sure their voting and monitoring powers are duly exercised by the institutional investor through which they might have invested.[817]

They can also rely on shareholders' associations and proxy voting firms to help them exercise their voting powers.

It should be noted in that respect that proper regulation of those shareholders' associations and proxy voting firms becomes paramount and should be investigated by European instances to avoid abuses.[818] Indeed, there is evidence that some proxy advisory firms have an inherent conflict of interests in the voting process because they also provide related consulting services, like corporate governance ratings, corporate governance advice, and other research services, in addition to providing voting recommendations on proposals submitted at shareholders' meetings. This situation raises an important concern as proxy advisory firms are not subject to any required

[815] See Part II:Chapter III:II.E.2 in Chapter Corporate Governance.

[816] See Part II:Chapter I:IV.B.2 in Chapter Investor Protection and Part II:Chapter III:II.E.3.b.ii in Chapter Corporate Governance.

[817] Recall here the discussion relating to measures to promote engagement by institutional investors, see Part II:Chapter III:II.E.3.b.iii in Chapter Corporate Governance. And more importantly, see Part III:Chapter I:III.C below.

[818] *Accord* OECD, Corporate Governance and the Financial Crisis – Conclusions and emerging good practices to enhance implementation of the Principles.

disclosure or oversight regarding their ability to control or influence the outcome of a vote.[819] Besides, it should be avoided that proxy advisors merely tick the box and develop a one-size-fits-all approach to complex corporate decisions because it could be counter-productive. Furthermore, it is a highly concentrated industry which would gain from more competition.[820]

Provided that there is accurate regulation to deal with any concern relating to shareholders' associations and proxy voting firms, the costs borne by unsophisticated retail investors of requesting these associations and firms' services seem to be less than the costs for unsophisticated retail investors of digging into long and complex disclosure documents in order to find the relevant information to exercise vote or monitor the management or the controlling shareholder. And the benefits on the ballot or on supervision of corporate affairs seem more certain than without that pulling of shareholders' action.

2. *What about equal treatment of shareholders?*

It could also be argued that the principle of equal treatment of shareholders, provided that this principle exists under European law, is at risk under my suggestion: unsophisticated retail investors are presumably not put in the same position as more sophisticated investors in terms of relevant investment information.[821]

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[819] See in the U.S., US SEC efforts in that respect, summarised on the web-site of Shareholder Communications Coalition. See also Millstein Center Policy Briefing n° 3, Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry, March 2009.

[820] Note, for instance, that RiskMetrics Group acquired in November 2009 KLD Research & Analytics, Inc., a leader in environmental, social and governance research and indexes for institutional investors. This followed the purchase by RiskMetrics Group of Innovest in February 2009.

[821] For arguable bases of a principle of equal treatment of shareholders, see, *inter alia*, article 4 of the Shareholders Rights Directive ("[t]he company shall ensure equal treatment for all shareholders who are in the same position with regard to participation and the exercise of voting rights in the general meeting."); article 17.1 of the Transparency Directive ("[t]he issuer of shares admitted to trading on a regulated market shall ensure equal treatment for all holders of shares who are in the same position."); article 3.1 a) of the Take-Over Directive ("[f]or the purpose of implementing this Directive, Member States shall ensure that the following principles are complied with: (a) all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected"). See for the question of the existence of this principle in the take-over context, the Opinion of Advocate General Mrs Verica Trstenjak delivered on 30 June 2009 (Case C-101/08, Audiolux SA and Others) (holding that a principle of equal treatment should not be acknowledged as a general principle of law considering the fact that the equal treatment of shareholders has no constitutional value neither according to the European Union's legal system nor the Member States' legal system) and the European Court of Justice decision, (Fourth Chamber), Judgment of 15 October 2009 (reference for a preliminary ruling from the *Cour de cassation* (Luxembourg)) , OJ C 297, 5 December 2009 (holding that community law does not include any *general*

However, all investors, be they more or less sophisticated, receive the same information under my suggestion. No information is concealed from unsophisticated retail investors. My suggestion only aims at re-focussing the benchmark of addressees who should be taken into account when drafting disclosure.

Furthermore, as already explained, the European system in place is not totally coherent in its approach and does already contain some contradictions which do not put all investors on an equal foot.[822]

Lastly, as my suggestion could be perceived as having the undesirable consequence of rendering access to financial markets difficult for unsophisticated retail investors, I provide below some safeguards in that respect, including an increased focus on the proper regulation of the relationship between investors and investment firms and of market gatekeepers, and investment analyst in particular; on proper enforcement of existing rules; on financial education; on behavioural researches and on retail investors' involvement in the law-making process.

3. *What about cognitive bias, agency problems and inadequate risk-management of more sophisticated actors?*

As *expertise has a price*, thereby increasing the costs of investment, there must be clear benefits to unsophisticated retail investors for investing through professional intermediaries or seeking professional advice.

In that respect, it could be pointed to the fact that more sophisticated actors could also be subject to cognitive bias,[823] agency problems and inadequate risk-management

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principle of law under which minority shareholders are protected by an obligation on the dominant shareholder, when acquiring or exercising control of a company, to offer to buy their shares under the same conditions as those agreed when a shareholding conferring or strengthening the control of the dominant shareholder was acquired).

822 See Part II:Chapter I:I in Chapter Investor Protection. For instance, the Prospectus Directive allows the prospectus to be written in a language different than the summary prospectus. And this language could be a language that some investors do not understand.

823 See the works of behavioural finance relating to emotions, biases and heuristics of institutional investors, including, ROGER LOWENSTEIN, When Genius Failed: The Rise and Fall of Long-Term Capital Management (Random House Trade Paperbacks. 2000). at 75; MICHAEL HAIGH, et al., *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. Fin. 523, (2004). (professional traders show more myopic aversion than control group); TROY A. PAREDES, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L. Quarterly 417,

policy. They could be liable to make or advise irrational investment and trading decisions. To the extent this is the case, this should be a concern where they invest other people's money or advise other investors.

However, regarding cognitive bias, most studies show that financial intermediaries/advisers are on average *more rational* than unsophisticated retail investors.[824] Studies also show that informed traders are able to beat the market.[825]

To the extent it is not the case, employees should be trained to over-come their incompetence.[826] This training should be supported by the firms who employ them.

(2003). and references therein cited at note 170 and accompanying text; John Plender, Error-Laden Machine, Financial Times, 3 March 2009, at 8 (suggesting that institutional investors have been victim of "disaster myopia" during the current financial crisis); GUILLERMO BAQUERO, et al., Do Sophisticated Investors Believe in the Law of Small Numbers? (2007).; DONALD C. LANGEVOORT, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stock-brokers and Sophisticated Customers*, 84 Calif. L. Rev. 627, (1996). (discussing why more sophisticated investors may make bad investment decisions); JAMES A. FANTO, *Braking the Merger Momentum: Reforming Company law Governing Mega-mergers*, 49 Buff. L. Rev. 249, (2001)., at 288-89 (attributing many merger decisions to a combination of excess optimism and the availability heuristic).

[824] *Accord* GREGORY LA BLANC, et al., *In Praise of Investor Irrationality*, *in* The Law and Economics of Irrational Behavior, (Francesco Parisi, et al. eds., 2005)., note 161 (stating that most behavioural finance academics would agree that professional investors are less prone to irrationality than non-professionals); ANDREW JACKSON, The Aggregate Behaviour of Individual Investors (2003). (showing that individual investors are more likely than institutional investors to make irrational or imprudent investment decisions); PAUL GOMPERS, et al., *Institutional Investors and Equity Prices*, 116 Q.J. Econ. 229, (2001).; JOHN NOFSINGER, et al., *Herding and Feedback Trading by Institutional and Individual Investors*, 54 J. Fin. 2263, (1999).; MARK KELMAN, *Law and Behavioral Science: Conceptual Overviews*, 97 Nwstrn. L.Rev. 1347, (2003). (noting that "violations of rationality precepts seem to disappear rather quickly when people have an opportunity to make decisions again, [especially] … when those who will have the chance to repeat the decisionmaking process are rewarded if they behave the way rational choice theorists believe that normative decisionmakers should behave, and are penalized if they do not."); JOHN A. LIST, *Does Market Experience Eliminate Market Anomalies*, 118 Q.J.Econ. 41, (2003). (running an experimental evidence showing that experience significantly eliminates the endowment effect).

[825] For studies on the greater expertise of "informed traders", see Georgette Jasen, Investment Dartboard: Luck Out: Stock Experts Top the Darts, Wall Street Journal, 9 October 1996, at C1 and Georgette Jasen, Putting Away the Darts After 14 Years: The Wall Street Journal's Dartboard Ends Its Run, Wall St. J., Apr. 18, 2002, at CI (in 1988, the journal staff invited professional money managers to select the stocks they thought would do best in the next 6 months. Then the staff picked their own, by throwing darts on the page from the stock quote section. In the first round, the winner of the contest was the darts. However, over a period of fourteen years, with the involvement of more than 200 investment professionals, after 142 contests, the pros won by earning an average 10.2% investment gain per six month period, while the darts managed only 3.5% average gain); LAURENT BARRAS, et al., *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas*, Journal of Finance, Forthcoming, (2009). (suggesting that about 24% of funds have negative alpha (poor stock picking ability), while the other 76% have a positive alpha. *However*, for all but a tiny fraction of these, the positive return is less than fees and expenses, often by a significant amount. I see in this an explanation of the popularity of index funds. See however in that respect my opinion under Part II:Chapter III:II.E.3.b.iii in Chapter Corporate Governance).

If the educational efforts are unsuccessful or cost-inefficient to be pursued, those concerned should be prohibited from exercising their job of investing/advising other people's money by providing for proper internal disciplining regime and overall public and private liability regime.[827]

Regarding agency problems, if it is true that investment firms "will not maximise returns to their investors if their personal incentives point in a different direction and market-place discipline is weak",[828] this should be dealt with by appropriate regulation and due enforcement.[829]

Regarding the lack of proper risk-management regulation or the lack of proper supervision of the risks in financial transactions, here again, appropriate regulation should allow to avoid the system being used to the detriment of end-investors.[830]

In sum, I believe that if sound regulation and proper enforcement are in place, incompetence, conflicts of interests and lack of proper risk management can be avoided. Therefore, the specific existing regulatory provisions should be assessed to examine to what extent there is room for change.

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[826] See the general requirement to have skilled staff in investment firms, *inter alia*, article 13.2 of MiFID and article 5.1(d) of MiFID Implementing Directive. See also the "retail distribution review" (the so-called RDR) by the UK FSA and the UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010. See Part III:Chapter I:III.C below.

[827] See the general requirement to have compliance functions, risk management functions, internal audit, responsibility of senior management and complaints handling procedures under, *inter alia*, article 13.2 of MiFID and articles 6 to 10 of MiFID Implementing Directive. See also the "retail distribution review" (the so-called RDR) by the UK FSA and the UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010. See as well the works of the European Commission on Packaged Retail Investment Products (so-called PRIPs).

[828] DONALD C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Virginia Law Review 1025, (2009)., at 32.

[829] See generally on conflicts of interest, including inducements policy, *inter alia*, articles 13 and 18 of MiFID; articles 21, 22, 23 and 26 of MiFID Implementing Directive and articles 12.1 and 14.2(c) of UCITS IV. See also the various codes of conduct and best practices applicable to financial intermediaries/advisers, including IOSCO's guidance for investment advisers on due diligence good practices regarding investments in structured finance instruments by collective investment schemes offered to retail investors (August 2009).

[830] See, *inter alia*, article 7 of MiFID Implementing Directive; the proposals to amend the Capital Requirements Directive; the legislative proposals of September 2009 regarding the creation of European supervisory authorities following the de Larosière Report of March 2009; and the Member States' initiatives (for instance, see the Belgian Lamfalussy Committee Report).

III. Regulatory Consequences

A. Preliminary Remark

I examine below the following legal consequences from the new focus on more sophisticated actors:

- cost-efficient regulatory implications in terms of content, language, dissemination and storage of disclosed documents;
- an increased focus on the relationship between investors and investment firms in order not to *de facto* dissuade unsophisticated retail investors from investing at all in financial markets. In this context, a close examination of MiFID is paramount. However, as the time for a full examination is not ripe, given the short period since implementation in Member States,[831] a thorough analysis is not warranted in this dissertation. This being said, I make some specific remarks in connection with retail investor protection;
- an increased focus on indirect investments by retail investors in financial markets, as the indirect implication of my policy suggestion leads to discourage retail investors who do not fall under the definition of informed traders to directly invest in equity issuers. In this context, packaged retail investment products should be considered.[832] As packaged retail investment products are broader than the limited scope of this dissertation in terms of issuers and securities covered, an exhaustive analysis of the work already initiated by the European Commission in their respect is not warranted here.[833] I therefore

[831] MiFID should have been implemented in Member States by 31 January 2007. However, this deadline of transposition was not complied with by any Member State. See the European Commission web-site for implementation state of play of FSAP directives.

[832] For a definition of packaged retail investment products, see EUROPEAN COMMISSION, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council Packaged Retail Investment Products Impact Assessment (2009).

[833] See the relevant web-pages on the European Commission web-site in that respect. The European Commission should come out with legislative proposals to increase investor protection. The goal would be to have a consistent regime with respect to pre-contractual disclosure rules and selling rules for the entire range of packaged retail investment products in order to ease comparison and to ultimately boost retail cross-border investments.

make only some general comments regarding one, i.e., UCITS, as UCITS seem to enjoy a great popularity;

- increased need for proper enforcement of existing rules, for proper regulation of market gatekeepers and for a proper understanding of retail investors' behaviours as well as retail investors' education and retail investors' involvement in the law-making process.

B. Cost-Efficient Regulatory Implications

1. Preliminary remark

If the issuer focusses on more sophisticated actors when drafting disclosure, straightforward disclosure costs should presumably come down to some extent. This could be eased by the specific measures developed below.

The cost-efficient suggestions I make, although they might seem minor, could contribute to the target set by the European Commission to reduce administrative costs of issuers, i.e., costs linked to legal obligations to provide information either to public or private parties. These costs should be reduced by 25% by 2012. This reduction is expected to lead to an increase in the level of GDP of about 1.5% or around €150 billion.[834]

I suggest elsewhere in this dissertation additional regulatory reforms which also allow for costs reductions. They would not be sensible if more sophisticated actors were not playing an important role in financial markets. Yet, they also flow from the recognition that financial markets are efficient with respect to well-established issuers. Therefore, they are not treated here but in Chapter Disclosure of Well-Established Companies in Efficient Markets.[835]

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[834] See the relevant web-pages of the European Commission in that respect.

[835] See Part III:Chapter II:II.B.2 and Part III:Chapter II:II.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets (relating to company registration and one main disclosure document).

2. *Content of issuer-disclosure*

a. Reconsideration of the summary prospectus and advertisements

How could summary prospectuses[836] be effective to meet their expected goal of unsophisticated retail investor protection if prospectuses of which they are an abbreviated form do not themselves protect unsophisticated retail investors?

Well, I am of the opinion that they are not.

In its advice relating to the Key Investor Information under UCITS IV, CESR concludes that the low levels of investment knowledge and financial capability of unsophisticated retail investors reinforce the need for clear and simple disclosures (and the importance of efforts to enhance unsophisticated retail investors' ability to understand financial information). In that respect, CESR supports the introduction of a Key Information Document to protect unsophisticated retail investors.[837]

If I share CESR's observations of market realities, i.e., that unsophisticated retail investors have limited investment knowledge and financial capability, I cannot agree with the justification for its regulatory recommendation to introduce a Key Information Document, i.e., unsophisticated retail investor protection.[838]

Summary notes[839] do not either protect unsophisticated retail investors.

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[836] See article 5.2 of the Prospectus Directive (requiring summary prospectus).

[837] See CESR, CESR's Technical Advice at Level 2 on the Format and Content of Key Information Document Disclosures for UCITS, CESR/09-552, 8 July 2009, at 13 et seq.

[838] Note the suggested change of wording in the European Parliament's view of the amendment to article 5.2, alinea 1 suggested by the European Commission, see EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010). ("in order to *enable* investors to take informed investment decisions" would become "in order to *aid* investors when considering whether to invest in such securities" (emphasis added)). Comp. with the US SEC disclosure document release No. 33-8861 (14 December 2007) which provides mutual funds the option of sending investors a summary prospectus instead of the statutory prospectus. And see, for an assessment, JOHN BESHEARS, et al., How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices? (2008). (finding that providing summary prospectus does not meaningfully alter the investors investment choices and therefore does not improve portfolio quality).

[839] See article 5.3 of the Prospectus Directive.

Besides, summary notes are redundant: securities notes suffice in case of a prospectus consisting of a registration document provided that the section relating to risks factors is extended to risks specific to the issuer.

Therefore, I plead for the suppression of summary notes, if the EU-flavoured shelf registration system is maintained.[840]

However, contrary to summary notes, summary prospectuses are not redundant.

If one cannot say, without running contrary to market realities, that summary prospectuses protect unsophisticated retail investors, it should be admitted that summary prospectuses are useful to the extent they ease potential investors' search for the most important pieces of information that will determine their potential interest in the offering.[841] They could enable prospective investors, be they (unsophisticated) retail or professional investors, to avoid to read through the (currently dozens and sometimes hundreds pages long) prospectuses without knowing the main characteristics and risks of the issue.[842]

Therefore, I do not suggest to suppress them.

Considerable strain has been placed on the summary prospectus under the Prospectus Directive as it was to perform multiple functions, none of which had been adequately tested.

They are not an investor protection technique.[843]

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[840] See Part III:Chapter II:II.B.2.d in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[841] *Accord* EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)., amendment to recital 10 of the Prospectus Directive ("[the summary prospectus] should focus on essential elements that investors need in order to be able to decide which offers of securities to consider further").

[842] "Prospectus" should be understood as "registration prospectus" or "short form offering prospectus" further to Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[843] See IFF Research and YouGov, UCITS Disclosure Testing Research Report, June 2009. See also LACHLAN BURN, *KISS, but tell all: short-form disclosure for retail investors*, 5 Capital Markets Law Journal 141, (2010). (asking the question whether disclosure, however short and simple, is the right consumer protection tool in financial markets).

They cannot be seen as containing sufficient information to enable investors to take investment decisions on an informed basis.[844]

And they cannot be seen as a means to deliver regulatory information to host supervisory authorities in support of the prospectus passport.

I consider that summary prospectuses do not serve any other function than promoting offerings.[845] They are *marketing tools* although they should not be considered as "advertisements" under the meaning of the Prospectus Directive.[846]

My suggestion to retain summary prospectuses takes into account the interests of unsophisticated retail investors in particular.

The provision of a summary prospectus should contribute to keep unsophisticated retail investors interested in equity markets. Indeed, these documents should be considered as the only way for unsophisticated retail investors in particular to easily grasp the main features of an offering or listed securities in order to make their own opinion on them. On their basis, unsophisticated retail investors could decide whether to directly invest in financial markets,[847] or to request professional advice or to invest through an institutional investor, with all related regulatory implications especially with respect to the liability issues.[848]

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[844] See however the wording of article 78.2 of UCITS IV ("Key investor information shall include appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.") and EUROPEAN COMMISSION, Update on Commission Work on Packaged Retail Investment Products 16 December 2009 (2009)., where it is said that stakeholders have confirmed that the benchmark for harmonisation of pre-contractual disclosures would be the key information document under UCITS IV. See also amendment to article 5.2, alinea 1 of the Prospectus Directive, in EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). (providing that summaries should enable investors to take investment decisions on an informed basis).

[845] "Summary prospectus" should be understood as "summary registration prospectus" or "summary short form offering prospectus" further to Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[846] See article 15 of the Prospectus Directive.

[847] In which case they should read the full prospectus, as the only document on which an investment decision can be based.

[848] See LACHLAN BURN, *KISS, but tell all: short-form disclosure for retail investors*, 5 Capital Markets Law Journal 141, (2010). (referring to the "quick read" (useful to both intermediaries and retail investors) and to the "check on the intermediary" (enabling retail investors to check what they are being said by the intermediary with another source) functions of summary prospectuses).

Summary prospectuses should only set out the main features of the offering, i.e., its essential characteristics and risks.[849] I believe that the content of summary prospectuses should be inspired, but only where appropriate,[850] by the works done in connection with the Key Investor Information in the context of UCITS IV and with packaged retail investment products.[851] This should strive for consistency across the different regulations applicable to broadly commercially comparable (retail) products.[852]

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[849] See article 5.2 of the Prospectus Directive. But see also Annex I to the Prospectus Directive and article 24 of the Prospectus Regulation which provide for guidance with respect to the content and format of summary prospectus. One could legitimately question whether all items in the indicative Annex I of the Prospectus Directive are relevant to retail investors and are appropriate to enable them to make an investment decision (for instance, information on research and development, patents and licences). See the suggested content of the key information document which would replace the summary prospectus in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)., suggested amendment to article 5.2, alinea 1 of the Prospectus Directive.

[850] See LACHLAN BURN, *KISS, but tell all: short-form disclosure for retail investors*, 5 Capital Markets Law Journal 141, (2010). (raising the question about how far harmonised disclosure can go across the investment spectrum, given the characteristics of the different products (UCITS products, non-UCITS products (structured corporate note and vanilla corporate bond or share)).

[851] See UK Shareholders Association, Dutch AFM and Fin-Use answers to the consultation on the review of the Prospectus Directive (see the European Commission web-site in that respect). See also EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)., suggested amendment to article 5.2, alinea 1, of the Prospectus Directive (justifying its suggested amendment as follows: "[…] instead of introducing some key information elements in the summary, the summary should be replaced by a key information document. The detailed content and format shall be determined at level two, but shall incorporate to a large part the information in the current summary note. Advice by the new European Securities and Markets Authority on the level two measures should duly consider the developments in the PRIPs debate. The concept of comparability across investment products is best dealt with during the course of the PRIPs initiative as a horizontal measure and this should hence be addressed in such a manner in due course").

[852] See Joint Response by the UK HM Treasury and the FSA to the European Commission consultation on the review of the Prospectus Directive; EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)., suggested amendment to recital (10) of the Prospectus Directive. See also recital (59) of UCITS IV ("[t]he nature of the information to be found in the key investor information should be fully harmonised so as to ensure adequate investor protection and comparability"); articles 78.3 and 78.7 of UCITS IV. See also EUROPEAN COMMISSION, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council Packaged Retail Investment Products

This consistency should ensure comparability of products with similar characteristics albeit their different legal form which may compete for the same retail savings.

To avoid confusion for investors as to the level of incompleteness inherent in summary prospectuses and in addition to what is already provided in the Prospectus Directive,[853] it should be clearly stated that the document is a "summary prospectus".[854]

The summary prospectus should be drafted in an harmonised easy-to-read format, i.e., with tabular presentation and section headings, which would allow for easy comparison with other comparable investment products.[855]

There should not be any formal requirement in connection with a maximum length.[856] This kind of requirement is not useful considering the experience since the entry into force of the Prospectus Directive.[857] Despite regulatory requirements under the Prospectus Directive,[858] summaries have so far been lengthy, have included more than the essential characteristics and risks and were written in technical language. I trust that the above-mentioned recommendations relating to the content and the format of summary prospectuses will be sufficient to ensure short and easy-to-understand summary prospectuses while at the same time providing meaningful information to investors. To deal more specifically with the problem of the use of professional jargon, the regulator could get inspired by the results of the work done by CESR in the context

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Impact Assessment (2009). See also the works done at CESR in connection with Key Investor Information under UCITS IV.

[853] See article 5.2 of the Prospectus Directive.

[854] Comp. with article 15.3 of the Prospectus Directive in connection with advertisements. Comp. as well with article 78.1 of UCITS IV.

[855] *Accord* European Parliament's point of view on European Commission's suggested amendment to article 5.2, alinea 1 of the Prospectus Directive (suggesting a common format), in EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). Comp. with article 78.7(c) of UCITS IV.

[856] See however recital (21) of the Prospectus Directive (the summary should not normally exceed 2,500 words). *Accord* with my suggestion, recital (10) of EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009).; *EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007).*, at 10; White & Case answer to the consultation on the review of the Prospectus Directive. But see CESR's recommendation that the key information document under UCITS IV be limited to two sides of A4 (CESR/08-087).

[857] See, for instance, the summary prospectus in the first major securities offering in the U.K. to adopt the tri-partite format for prospectuses introduced by article 5.3 of the Prospectus Directive (Standard Life): the summary was 13-pages long.

[858] See recital (21) and article 5.2 of the Prospectus Directive.

of UCITS IV to provide a common glossary of terms which could be made available to the public.[859]

Lastly, liability should only be attached to misleading, inaccurate or inconsistent information contained in the summary prospectus,[860] when read together with the prospectus. Unlike it has been suggested by the European Commission, there should not be liability if the summary prospectus "does not provide key information enabling investors to take informed investment decisions and to compare the securities with other investment products.".[861] Indeed, I do not see how the summary prospectus could be seen as being of and by itself an investment document. Moreover, the last part of the sentence relating to comparison with "other investment products" raises questions. The comparability with other investment products seems to be primarily relevant when dealing with certificates and other structured securities that may have a similar risk profile as investment funds. It may be less relevant in the case of shares or equity-linked securities. In addition, when taken together with the abolition of the current 2,500 word limit it seems the suggestion in the European Commission's proposal could well lead to extremely detailed and extensive summaries which could come to resemble prospectuses in their own right. While an issuer might be quite relaxed about liability for a summary under the current regime, if this proposal were to be enacted issuers would not want to take the risk of omitting any information that could be key information, namely, information necessary to take investment decisions on an informed basis. It is hard to see how lengthy and detailed summaries would enhance the protection of investors and they would only increase the administrative burdens on issuers (and competent authorities who have to review them). Besides, the "easy access" to the essential prospectus information as referred to in Recital 21 of the Prospectus

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[859] See CESR, CESR's Technical Advice at Level 2 on the Format and Content of Key Information Document Disclosures for UCITS, CESR/09-552, 8 July 2009.

[860] See article 6.2, alinea 2 , of the Prospectus Directive.

[861] Recital (10) and articles 5(b) and 6 of EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). See, to support my opinion, the suggestion to suppress the reference to this liability in the European Parliament's view relating to the European Commission's suggested amendment to article 6.2, alinea 2, of the Prospectus Directive, in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)..

Directive would then be questioned. Also, with regard to the fact that host member states may require the summary being translated into their official language, the passporting of prospectuses would become more burdensome.

Advertisements should enjoy the same partial liability shield and contain the same cautionary language as provided for summary prospectuses.[862]

b. Suppression of cross-reference list

The cross-reference list required under the Prospectus Directive is superfluous as explained below in the discussion relating to the use of the web-site of the issuer.[863] Therefore, it should be deleted.

3. Extended use of English

a. The current regime

The Prospectus Directive allows home Member States, in case of a national offer or international offer including the home Member State, to impose a language different than the one "customary in the sphere of international finance". Only in the case of a cross-border offer exclusively outside the home Member State is the issuer allowed to publish the prospectus only in the language customary in the sphere of international finance.[864]

Although the European Commission has not made explicit that English is to be understood as the language customary in the sphere of international finance,[865] this formula is likely to lead to the English language in practice. For instance, the financial press which enjoys an international authority, including The Financial Times or the

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[862] See article 5.2 (b) of the Prospectus Directive.
[863] See article 11.2 of the Prospectus Directive and see Part III:Chapter I:III.B.4 below.
[864] See article 19 of the Prospectus Directive.
[865] All to the contrary, the European Commission emphasised the fact that other languages can be used as long as they are customary in the sphere of international finance. See European Commission, Prospectus Transposition Meeting Minutes 26 January 2005; EUROPEAN COMMISSION, Synthesis of the Comments on the Third Consultation Document of the Internal Market and Services Directorate-General: "Fostering an Appropriate Regime for Shareholders' Rights" (2007)., at 5.

Wall Street Journal, is written in English.[866] Nevertheless, an explicit recognition of English as the language referred to by the expression "language customary in the sphere of international finance" would be welcome to avoid different interpretations by Member States.[867]

In other words, under the current regime, the use of English as exclusive language for the drafting of the prospectus and as widely-recognised customary language in the sphere of international finance is permitted only in a purely international transaction, excluding the home Member State. But when the home Member State is targeted, the latter may impose its local language: translation requirements may therefore be imposed where the language required by the home authority differs from the issuer's choice.

The Transparency Directive has a similar language policy with respect to so-called "regulated information", which includes periodic reporting. It takes as benchmark the location of the regulated market where the securities are admitted to trading .[868]

The translation regime of the Prospectus Directive and the Transparency Directive is complex. But, if it is generally regarded as successful in reducing the costs of translation and in supporting the prospectus passport, is it effective for the growth of capital markets by promoting participation? In other words, in what respects would it make a significant difference if there was a provision which imposed one single language for disclosure?

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[866] See DOROTHÉE FISCHER-APPELT, *Implementation of the Transparency Directive— room for variations across the EEA*, 2 Capital Market Law Journal 133, (2007). (arguing that language customary to the sphere of international finance should be interpreted as referring to English).

[867] See, *inter alia*, PR4.1.5A of the UK UKLA Prospectus Rules ("[t]he FSA will consider a language to be customary in the sphere of international finance if documents in that language are accepted for scrutiny and filing in at least the international capital markets in each of the following: (1) Europe; (2) Asia; and (3) the Americas"); the notes on the Dutch Act on Financial Supervision (*wet financiële toezicht*) (stating that usually with this phrase English will be meant; but adding that it can however not be ruled out that under certain circumstances French or German also could be seen as a language customary in the sphere of international finance); section 19 of the German securities prospectus act (*Wertpapierprospektgesetz*) (using the expression "language customary in the sphere of international finance". While the German Finance Committee says that no other language than English could be covered by this expression, this narrow interpretation is criticised by academic literature. Some argue that a language that is customarily spoken in transnational transactions in the respective countries can also be covered).

[868] See, *inter alia*, articles 20.1, 20.2 and 20.3 of the Transparency Directive.

It seems that translation costs form a relatively small part of overall costs of issuers going public or already listed. Some authors conclude that they should no longer be a significant issue.[869]

Besides, it is generally considered that the language regime which is for its most part governed by issuer's choice is supporting the growth of European capital markets.[870] Issuers are said to be able to use a language which enables them to collect the most: depending on their perception of market demand, they are said to be able to either use English or bear the costs of translation in the language(s) used by the investors they try to target. It is believed that the current regime does not impede the market to solve the issue itself.

However, imposing one single language under all circumstances would certainly *reduce time-consuming and intensive cross-checking as well as verification exercises*, which are all part of the translation process and are needed to counter the risk of inaccuracies creeping into disclosure via the translation process.

But more importantly, it would bring *additional advantages in terms of comparisons between issuers and investment products* and avoid distortions, transactions being domiciled in Member States with a more friendly language regime.

To take these concerns into account while at the same time avoiding inflexible rules that cannot adapt to market demand, I suggest a different language regime.

This being said, I am well aware of the Member States' likely sensitivity when it comes to language issues and the absence of reference to the English language as language customary in the field of international finance could be seen in that respect as being constructive ambiguity. But my suggestion could be seen as only implying to extend what already exists in some Member States to all Member States.

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[869] See CENTRE FOR STRATEGY & EVALUATION SERVICES LLP, Framework Contract for Projects relating to Evaluation and Impact Assessment Activities of Directorate General for Internal Market and Services - Study on the Impact of the Prospectus Regime on EU Financial Markets - Final Report (June 2008)., at 53 et seq.

[870] See EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 22 (describing the language regime as "one of the core success factors" of the Prospectus Directive).

b. The suggested regime

i International offerings, including or not the home Member State, or issuers listed (solely or not) in host-Member-State-regulated market

In an international context and for the reasons developed below, I suggest to suppress issuer's choice and to *require disclosure to be written in English*, whether or not the home Member State is tapped.[871] Any translation in local language (of the home Member State or the host Member State(s)) should be left to the discretion of the issuer, depending on its perception of market expectation.[872]

In the "sphere of international finance", as this expression is used in the Prospectus Directive and in the Transparency Directive, one can safely assume that English is widely spoken and understood by those who play an important role therein, i.e., more sophisticated actors.

By contrast, unsophisticated retail investors cannot be expected to have a good knowledge of English. But this should not be a concern as most unsophisticated retail investors are usually not interested in participating in an international offering outside the home Member State due to a strong and well-documented home bias.[873] And even when they are interested in an international offering, including or not the home Member State, they usually indirectly participate through a financial adviser/intermediary and in any case usually do not read the related disclosure.[874] The language of disclosure in an international context, including or not the home Member State, should therefore not be imposed having unsophisticated retail investors in mind.

Requiring prospectuses and periodic reports to be drafted *at least* in English in an international context presents the following advantages:

[871] *Accord* CESR, Languages accepted for the purpose of the scrutiny of the Prospectus and requirements of translation of the Summary, CESR 09-133, February 2009 (out of 28 Member States, 20 seem to accept English as prospectus language where they are the home competent authority whatever the circumstances). Note that, in the context of funds, to promote the marketing of French funds abroad, the French AMF General Regulation allows prospectuses and other fund documents to be written in a language customary in the field of finance.

[872] Comp. with company law matters, in Part II:Chapter III:II.E.3.d.ii in Chapter Corporate Governance.

[873] See note 882 below and accompanying text.

[874] See Part III:Chapter I:II.A.2 above.

It solves the problem of comparability between data. There is no doubt that comparison between investment products is paramount for investor protection purposes. Having documents drafted in the same language, i.e., English, is the pre-requisite for the creation of something similar to the US Interactive Data Electronic Applications (IDEA) for European-wide information dissemination to allow easy comparisons.[875]

Furthermore, it contributes to ease the implementation of the new electronic platform called eXtensible Business Reporting Language (hereafter XBRL).[876] XBRL attaches standardised electronic tags to elements of information on financial statements. The tagged data can then be pulled out of the comprehensive electronic disclosures, allowing investors to draw out the information they are interested in examining on a selective basis. It also allows software programmes to calculate ratios and perform other analyses without having to re-input financial data, providing enhanced access to information for analysts and investment firms. Even though, according to some commentators, the objective of XBRL is to "level the playing field for tens of millions of average investors",[877] I rather believe that it will concretely allow more sophisticated actors to search information more efficiently and more effectively.

In addition, it makes sense if one considers my suggestion developed below of having search facilities of national storage mechanisms at least available in English.[878]

Translation in local language(s) relevant to the specific transaction is still possible. However, it is not made mandatory: it is left to the issuer's discretion. Consequently, issuers will have to make their own assessment of the necessity to provide for translations in local language. They are likely to bear the additional costs of

[875] IDEA is the expected successor of EDGAR. See US SEC web-site ("[i]nstead of sifting through one form at a time in EDGAR and then re-keyboarding the information to analyze it, investors will be able to utilize interactive data to instantly search and collate information to generate reports and analysis from thousands of companies and forms through IDEA").

[876] See generally the XBRL web-site. See in the U.S., information on advances in XBRL on the US SEC web-site; see also EDGAR Release 9.17 for latest revisions to EDGAR Filer Manual relating to XBRL. In the E.U., the European Parliament has requested the European Commission to come up with a road map for introducing XBRL reporting in the E.U. (European Parliament resolution of 21 May 2008 on a simplified business environment for companies in the areas of company law, accounting and auditing (2007/2254(INI)); see also EDDY WYMEERSCH, The Use of XBRL in the European Financial Markets (2008).

[877] Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n., Opening Remarks to the Practicing Law Institute's SEC Speaks Series (Mar. 3, 2006).

[878] See Part III:Chapter I:III.B.4.d.iii below.

translation if, for instance, for whatever reason, the home bias of targeted (unsophisticated retail) investors in host Member States is less than in the usual case.

It cannot be argued against my suggestion that the competent authority of the home Member State would have difficulties in performing its approval procedure if the documents submitted to it are in English.

In fact, competent supervisory authorities are already provided with English-written prospectuses under the current regime.[879]

Besides, this counter-argument would cast doubts on the competence of the authority, which already takes part in international and European fora where English is the communication language, like CESR.

This being said, there is a perceived feeling that some European supervisory authorities are less adequately staffed than others to be working in international financial contexts. However, this is not a reason to dismiss my policy suggestion. There should be efforts to level the playing field in terms of competence of supervisory authorities. This is what CESR already tries to do. If these efforts do not prove successful, the rules determining the home Member State should be reconsidered with a view to have only truly competent supervisory authorities in charge.

To be sure, it could be that the national law of Member States will need to be changed further to this suggested scheme. This will be the case if the national law requires that documents drafted in compliance with securities laws be disseminated at least in the local language. But, although this could give rise to a heated debate as it touches protectionist sensibilities, these difficulties should be surmounted.[880]

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[879] See article 19.2, alinea 2 of the Prospectus Directive.

[880] See as illustrative example of the complexities of the language regime in some Member States, the case of Belgium. See in that respect, CLARISSE LEWALLE, et al., *L'emploi des langues en Belgique en matière de prospectus : évolutions après la directive 2003/71/CE et la loi du 16 juin 2006*, 4 Droit bancaire et financier, (2007).

ii National offerings or issuers solely listed on home-Member-State-regulated market

Unsophisticated retail investors have a strong home bias: they are most of the time more interested in offerings and in securities of companies listed in their own jurisdiction.[881] Therefore, it can safely be assumed that public offerings solely in home Member States have a retail nature.

However, for the reasons given above, which refer to the institution orientation of European markets and to the lack of time and competence of unsophisticated retail investors to read and understand disclosure, I do not plead for disclosure to be written in the official language(s) of the home Member State even when only the home Member State is concerned by the offering or the listing.

I therefore make no exception to the requirement to have disclosure drafted at least in English.

iii No translation required except for summary prospectus, summary periodic report and advertisement

I explained above the reasons why unsophisticated retail investors should not be banned from financial markets.[882] This being said, some ancillary measures are needed to concretely avoid that unsophisticated retail investors be indirectly excluded from financial markets.

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[881] *Accord* EUROPEAN COMMISSION, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council Packaged Retail Investment Products Impact Assessment (2009).; BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007; CENTRE FOR STRATEGY & EVALUATION SERVICES LLP, Framework Contract for Projects relating to Evaluation and Impact Assessment Activities of Directorate General for Internal Market and Services - Study on the Impact of the Prospectus Regime on EU Financial Markets - Final Report (June 2008)., at 18; EUROPEAN COMMISSION, European Financial Integration Report (Commission Staff Working Document) (2007)., at 9; Green Paper on Retail Financial Services in the Single Market, 2007, COM(2007)226, at 6 (noting that, notwithstanding the growth of the provision of cross-border retail financial services, most consumers opt for products distributed locally through branches, subsidiaries and intermediaries). See also for case studies in the US market, GUR HUBERMAN, *Familiarity Breeds Investment*, 14 Review of Financial Studies 659, (2001).; BONG-CHAN KHO, et al., Financial Globalization, Governance, and the Evolution of the Home Bias (2007).

[882] See Part II:Chapter I:II in Chapter Investor Protection.

Among these measures, I suggest to add a disclosure requirement in the form of a *summary periodic report*.[883] This would reflect market practice from issuers' side[884] and market demand from investors' side. The same recommendations as to the content and the format of the summary prospectus above would apply to the summary periodic report.

Besides, I suggest that summary prospectuses, summary periodic reports and advertisements be made accessible in the official language(s) of every Member State where retail investors are targeted, if English is not an official language.[885]

As already suggested,[886] if, as a general rule, unsophisticated retail investors do not read the information made available to them, this does not presumably apply to the information contained in summary prospectuses,[887] summary periodic reports and advertisements.[888]

And it cannot be expected from all unsophisticated retail investors to know English fluently enough to understand a summary prospectus, a summary periodic report or an advertisement.[889]

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[883] However, there would not be any summary periodic report if the regulatory suggestion I make to suppress the separate drafting of periodic reports is followed by the European regulator. See Part III:Chapter II:II.D.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[884] Comp. with the practice of "Letters from the CEO".

[885] See article 19 of the Prospectus Directive (providing that the competent authority of each host Member State *may* require that the summary be translated into its official language(s)). See also EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009)., at 5 (the European Commission considered, at the request of the High Level Group of Independent Stakeholders on Administrative Burdens, suppressing the obligation to translate the summary prospectus. But, for reasons of investor protection and investor confidence, it decided not to). See however, the solution suggested by Austria, the Netherlands and Luxembourg which supervisory authorities do not require a translation of the summary into local language if the prospectus is published in English (CESR, Languages accepted for the purpose of the scrutiny of the Prospectus and requirements of translation of the Summary, CESR 09-133, February 2009). See as well article 94.1(b) of UCITS IV (providing that Key Investor Information could not be translated in local language and could be disseminated in English if English is a language approved by the competent authorities of the host member state).

[886] See Part III:Chapter I:III.B.2.a above.

[887] To take into account the suggestions made in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets, all references to "summary prospectus" here should be understood as references to "summary registration prospectus" and "summary short-form offering document".

[888] See EILIS FERRAN, *Cross-Border Offers of Securities in the EU: The Standard Life Flotation*, 4 ECFR 461, (2007). (predicting that summary plus advertisements approach adopted by the flotation of Standard Life plc on the London Stock Exchange for its equity offering in which the prospectus passport route was used would become the new standard practice in the London market for retail-oriented offers).

[889] See also the other measures I recommend in connection with content and format of the summary prospectus, Part III:Chapter I:III.B.2.a above.

4. *Mandated use of issuer's web-site and regulated information service providers*

a. Preliminary remark

The European Commission allows the issuer to publish prospectuses in an electronic form to make it available to the public.[890] Besides, it seems to encourage the use of the Internet where the Prospectus Directive provides for the *possibility* for the home Member State to require issuers who make prospectuses available in a newspaper or in a printed form also to publish it on their web-site.[891]

The Transparency Directive requires the information to be disseminated to the public throughout the E.U. on the basis of a communication to the media and provides that an indication in this communication on which web-site financial reports are available suffices.[892] Some Member States have implemented this provision by requesting some kind of paper-based publication of regulated information (or of information on the "regulated information"), while it is permitted in all but one Member States.[893]

b. Suggested modifications to current regime

I agree with the current system provided for by the Prospectus Directive as it gives the issuer the option to choose its publication media, i.e., paper-based or Internet-based.

However, I would suggest the following modifications:

Under current status, publication on the issuer's web-site cannot be used in practice, as it is linked to the simultaneous publication on the web-sites of all involved financial intermediaries and agents, which technically and logistically is not

[890] See article 14.2, alinea 1, (c), (d) and (e) of the Prospectus Directive.

[891] See article 14.2, alinea 2 of the Prospectus Directive. See also article 14.2, alinea 1, (c), (d) and (e) of the Prospectus Directive.

[892] See article 21.1 of the Transparency Directive and article 12.3 of the Transparency Implementing Directive.

[893] See, for instance, the Belgian CBFA (requiring the annual report to be made available in the form of a brochure). See for the other Member States, CESR, Summary of responses to Questionnaire on Transposition of the Transparency Directive, CESR/08-514b, September 2008, Questions 122-124; see also EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008)., annex 5.

achievable.[894] I would therefore suggest to give the option to issuers to either place the prospectus on their web-site or on the web-site of their financial intermediaries, as the case may be.[895]

In addition, together with other commentators,[896] I would suggest to suppress the requirement to deliver to persons requesting it a paper copy of the prospectus free of charge when the prospectus has been made available in electronic form.[897] This could be made optional at the discretion of issuers.

Besides, I would make mandatory the current possibility provided for by the Prospectus Directive for the home Member State to require issuers who make prospectuses available in a newspaper or in a printed form also to publish it on their web-site.[898]

I also agree with the regime provided for by the Transparency Directive, but only to the extent it calls for the use of "regulated information service providers".[899]

Regulated information service providers take into account the wider capital markets-related reasons for requiring wide dissemination to the market generally and easy access to published information, for which individual company web-sites are not

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[894] See article 14.2 (c) of the Prospectus Directive.

[895] *Accord* suggested amendment to article 14.2 (c) under the EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010).

[896] *Accord* HIGH LEVEL GROUP OF INDEPENDENT STAKEHOLDERS ON ADMINISTRATIVE BURDENS, Opinion of the High Level Group, subject: Stakeholders' suggestions ('offline-consultation') (2008). (advising the European Commission to consider abolishing the obligation to deliver a paper copy of the prospectus).

[897] See the current version of article 14.7 of the Prospectus Directive.

[898] *Accord* article 13(b) of COUNCIL OF THE EUROPEAN UNION, Proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market - Presidency compromise (2009)., amending article 14.2(c) of the Prospectus Directive (Member States shall require issuers or the persons responsible for drawing up a prospectus which publish their prospectus in accordance with (a) or (b) to also publish their prospectus electronically in accordance with (c)).

[899] Comp. with the U.K. See for details of the UK regime, the relevant pages on the web-site of the UK FSA.

well-suited.[900] They are news wires which offer issuers a choice of input mechanisms, charging structures and distribution networks. The minimum standards with which they have to comply should be harmonised at European level, particularly for security, timely processing, distribution and ease of use. Depending on the services offered, these regulated information service providers should deliver issuers' press releases of regulated information directly into the editorial systems at newspapers, wire services, disclosure services, trades, television or other media, leading financial systems, portals and web-sites, industry and consumer systems and major databases and make them available via RSS feeds. In that respect, and contrary to the lower requirement under the Transparency Directive,[901] I consider that full text disclosure provides the required level of ease of access to regulated information, including periodic reports, to the extent that these are maintained.[902]

In my opinion, next to relying on regulated information service providers, the system provided for by the Transparency Directive should rely on the issuer's web-site to a greater extent than is currently the case,[903] especially as individual web-sites of issuers seem to be important in a corporate governance context where the shareholders of a particular company wish to have information relating to that particular company. As already said, in the current form of the Transparency Directive, Member States may still impose paper-based dissemination due to the minimum harmonisation character of the Transparency Directive.[904] I would suggest the Transparency Directive to

[900] See for positions supporting mine, NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 972 (considering that the requirement under article 6(1) of the MAD that all inside information be made available at a minimum on the issuer's web-site provides a very shaky basis for effective pan-European disclosure of sensitive information); German Submission concerning Article 17 of the Proposal for a Directive on Transparency Requirements, Position Paper, 10 October 2003, on file with author (where Germany considers that the media for dissemination and for storage purposes should be different as web-sites result in the lowest degree of information dissemination but in the highest degree in terms of storage). Comp. with the US SEC in SEC, Securities Exchange Act Release 43, 154, 15 (not considering web-site disclosure alone to be sufficient to meet the obligations imposed on issuers under Regulation Fair Disclosure which prohibits selective disclosure).

[901] See article 12.3, alinea 2, of the Transparency Implementing Directive.

[902] See Part III:Chapter II:II.D.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets and my suggestion to suppress periodic reports.

[903] *Accord* MARCO BECHT, European Disclosure for the New Millenium, in Capital Markets and Company Law, (Klaus J. Hopt, et al. eds., 2003)., at 87 and at 89.

[904] See CESR, Summary of responses to Questionnaire on Transposition of the Transparency Directive, CESR/08-514b, September 2008, Questions 122-124; see also EUROPEAN COMMISSION, Commission Staff Working Document - Report on the implementation of the Directive on Takeover Bids - Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of

mandatorily provide for disclosure on the web-site of the issuer, in addition to the use of regulated information service providers, and to leave to the option of the issuer the possibility to use, on top of that, paper-based dissemination. Indeed, no other means of communication than the Internet offers benefits greater than the costs incurred.[905]

My suggestions do not involve a change of mentality and market's habits:

In the area of finance, on the one hand, most listed issuers have and maintain a web-site on which they provide increasing amounts and types of information. It is very often mandated by national legislation.[906] And one could say that it is mandated by European regulations.[907] Therefore, my suggestion should not entail heavy additional costs for issuers, be they SMEs listed on regulated markets.

On the other hand, issuers' web-sites are increasingly viewed by investors as key sources of information about the company. Most market participants use them to retrieve information they are looking for.[908]

Any concern of web-site access for retail investors is outdated:[909] it is widely showed that today most adults, including of course more sophisticated actors, are familiar with the Internet.[910]

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transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008)., annex 5.

905 This proposal could extend beyond securities regulation into company law. See, to support this view, Corporate Governance - The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange, Recommendation 10.3 ("[t]he company should dedicate a specific section of its website to its shareholders, on which they should be able to find *inter alia* the provisional timetable of meetings and periodic information, convocations to Annual General Meetings, the conditions of access and terms of voting for shareholders, downloadable registration and proxy forms, and any relevant documentation for Annual General Meetings of shareholders. Guideline: Wherever possible, the company should give shareholders the option to raise issues via the company's website.").

906 See, for instance, article 14 of the Belgian Royal Decree of 14 November 2007; article 5:25m, part 3 of the Dutch act on financial supervision (*wet financiële toezicht*). Comp. with the U.S. where there is no requirement for issuers to have a web-site under federal law although there is a requirement for companies listed on the New York Stock Exchange to establish and maintain their own web-site, unless certain exceptions apply (NYSE Listed Company Manual, Section 303A.14).

907 See recital (6) of the Shareholders Rights Directive which presupposes that all listed companies already have a web-site. The Shareholders Rights Directive seems to have introduced European listed companies to the Internet age. *Accord* DIRK A. ZETZSCHE, Virtual Shareholder Meetings and the European Shareholder Rights Directive - Challenges and Opportunities (2007).

908 *Accord* MAZARS, Transparency Directive Assessment Report (2009)., at 164.

909 *Contra* EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009)., at 4 (explaining that the European Commission considered, at the request of the High Level Group of Independent Stakeholders on Administrative Burdens, suppressing the obligation to deliver a paper copy of the prospectus pursuant to article 14.2 of the Prospectus Directive. However, it concluded that it would "reduce the level of investor protection because of the existing digital divide, namely in cases where the

And beyond the sphere of finance, the Internet seems to replace more and more hard paper newspapers as information tool. It should be noted that in some Member States under consideration, for instance in Belgium, the national gazette is no longer printed but is only available on the Internet.[911] If official periodicals publishing important information like new regulations have adopted the Internet, there is no reason why disclosure giving market participants information about the activities of the company in which they have invested or intend to invest or about which they provide investment advice/services, could not also be published on the Internet.

My suggestions aim at pushing what can already be largely observed on the market place one step further by requiring at a minimum the use of the web-site of issuers for dissemination purposes in order to create a real market standard. This would leave the option to the issuer to use paper-based dissemination as long as it has also used Internet-based dissemination. I believe that it would allow for related costs-efficiencies while not compromising, but even increasing, investor protection.[912]

c. Advantages

Despite the possibility offered by the Prospectus Directive and the Transparency Directive to make use of the web-site of the issuer, paper-based communication means

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investor has no access to internet. The abolition of this obligation would have a negative impact in the confidence of the consumers because it would create discrimination between investors depending on whether they have internet access or not.”).

910 According to Internet World Stats, which provides statistics on the use of the Internet all over the world, the number of Internet users has grown in the E.U. by 227.3% between 2000 and 30 June 2009, to about 63.1% in 2009. Comp. with statistics of the U.S. on the Internet World Stats web-site or in the literature, including in Sandra West & Victoria Leonard-Chambers, Ownership of Mutual Funds and Use of the Internet, 2006, Investment Company Institute Research Fundamentals (Oct. 2006) (in 2006, 92% of mutual fund shareholders had Internet access); Sandra West & Victoria Leonard-Chambers, Mutual Fund Shareholders’ Use of the Internet, 2005, Investment Company Institute Research Fundamentals (Feb. 2006) (79% of all US adults had Internet access in 2005); Pew Internet & American Life Project (following an October-December 2007 survey, 75% of adults use the Internet). These statistics all support the fact that there is no more digital divide.

911 See article 3.5 of Directive 2009/101/EC of the European Parliament and of the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent, OJ L 258, 1 October 2009, at 11–19 (setting out the publication requirements in the national gazette).

912 *Accord* EUROPEAN SECURITIES MARKETS EXPERT GROUP, Position on Article 10 of the Prospectus Directive in relation to the Transparency Directive (2008).

are still used in many Member States for the purposes of dissemination of information under those directives.

This situation is problematic to the extent that their use entails additional costs for issuers and investors with no matching benefits:

Publication of announcements, prospectuses or periodic reports in newspapers or in printed form available at specific locations is *costly* (compared to the unpredictable benefits). Professional print-outs are often on fancy paper with much use of colours for marketing purposes. Those costs, first incurred by the issuers, are ultimately passed on to investors. If the concerned people had the option and not the obligation, at their discretion, to send printed copies of the prospectus or periodic reports to the investor, upon investor's request, I expect that they would stop preparing in advance costly superfluous print-outs of the documents. I expect that they would wait to see whether there is market demand for them. If this is the case, they would deliver less expensive print-outs, as they would lack the time to organise for fancy coloured ones. It would not be perceived as bad marketing on their part if they justify it as good policy to reduce costs for the benefit of investments' returns and if it becomes market standard. It should be noted that there is no reason to believe that concerned people will deny investors the provision of the prospectus or periodic reports, upon their request.

In addition, timeliness is an important feature of an effective EU issuer-disclosure regime. So are the channels used for the dissemination of the information disclosed. Indeed, prompt disclosure has a positive impact on price accuracy, liquidity and corporate governance.

Timely disclosure increases market efficiency because it allows the market to respond to statements or material changes rapidly, and alerts all market participants to developments that may influence their investment decisions/advice.

It also gives the necessary information to impact corporate governance.Whereas paper-based dissemination does not contribute to *timely accessibility* of information to all market actors in the E.U., disclosures posted on the web-site of the issuer enable issuers to make simultaneous disclosure to potentially the entire world. In this respect, Internet access contributes to an upgraded real-time disclosure system.

Disclosure on the Internet also contributes to *easy accessibility* of information to investors as it enables them to find information about a specific issuer from the same source of information, which is available around the clock and at no direct charge to investors.

In addition, Internet-based disclosure provides a system that users could *customise* to access only portions of a company disclosure to retrieve only the information relevant for them.

Furthermore, it provides a system that investors can *access at any point in the life cycle of the issuer*, whether it is making an offer of securities to the market or meeting its continuous disclosure obligations.

Besides, by providing an automatic direct link to a document incorporated by reference, without requiring any re-filing of the materials that have already been posted, the Internet approach *reduces time-consuming search costs* for users without increasing costs for issuers.

Lastly, an extended use of the Internet takes into account the *environmental concerns* that are important in any costs-benefits analysis under the better regulation policy of the E.U.[913] There is no doubt that some interested market participants will still wish to read disclosure from a paper print. However, the electronic form of disclosure will avoid systematic print-outs of the entire document by interested parties. It will permit print-outs of selected parts of special relevance to market actors.

Access to information for purposes of meeting the requirements under the EU issuer-disclosure regime should be considered as being equal to delivery of this information, provided that all legal conditions regulating access to the information have been met.[914] More precisely, there should be a "hash", or something similar, that

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[913] See the relevant pages on the European Commission web-site dedicated to the "better regulation" policy of the E.U. and especially the Impact Assessment Guidelines, 15 January 2009, SEC(2009) 92.

[914] See Part III:Chapter I:III.B.4.d below.

authenticates the document as well as the date and time of posting. The act of posting, together with the relevant hash, provided that is was made in accordance with all applicable regulations, could then constitute delivery. As long as investors have access to the information, it should not be required to be otherwise delivered. This idea is buttressed by the concept that access to information is made easy.[915]

Using at least the issuer web-site for publication purposes provides an additional reason to suppress article 10 of the Prospectus Directive which requires a document to be filed with the competent supervisory authority containing or referring to all documents made public in the preceding year.[916] There is no reason to maintain this requirement as those documents are the ones which are to be posted on the web-site of the issuer and therefore can be easily retrieved by the competent authority if needs be.[917] The suppression of the requirement for the issuer to fulfil the obligation under article 10 of the Prospectus Directive is estimated to amount to a saving of €30 million per year.[918]

d. Additional harmonising measures

i Measures relating to the web-site of issuers

The Prospectus Directive already requires to take measures to avoid targeting residents in Members States or third countries where the offer of securities to the public does not take place.[919] But for the web-based system to work properly and for a robust use by companies of their web-site, some additional precautions are required.

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[915] Comp. with the U.S., and SEC Rule *17 C.F.R. § 230.172 (2006)*; see also Securities Offering Reform, Securities Act Release No. 33-8591, *70 Fed. Reg. 44,722, 44.*783(Aug. 3, 2005). See for a comment, Bloomenthal, Securities Law Handbook, Vol. 1, Chap. 5, Part II, § 5:1 et. seq. (Thomson Reuters/West 2008).

[916] See also article 27 of the Prospectus Regulation.

[917] Note that the European Commission suggested the suppression of article 10 of the Prospectus Directive (see EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009)., at 9).

[918] See EUROPEAN COMMISSION, Commission Staff Working Document accompanying the Proposal for a Directive amending the Prospectus Directive and the Transparency Directive – Impact Assessment (2009)., at 14.

[919] See article 29.2 of the Prospectus Regulation with respect to prospectus and base prospectus (referring to the insertion of a disclaimer as to who are the addressees of the offer).

The challenge consists of balancing the goals of promoting the benefits of the Internet with the need to protect the integrity of the markets from fraud and abuse and to protect market participants.[920]

I think the best channel that should be used to implement my suggestions is a regulation, as it would bring legal certainty, contrary to initiatives at Level 3, which would arguably offer more flexibility although to the detriment of achieving harmonisation.[921]

My suggestions relating to the specificities of the issuer web-site as minimum mandatory dissemination channel are as follows:

Issuers should keep their web-site updated and accurate at all times.

Quality standards of issuers' web-sites should be provided. At a minimum, there should be security measures to maintain the integrity of the information, and to avoid manipulation or modification from unauthorised persons.[922] Upgraded quality standards could be along the lines of those set out by CESR in connection with the storage of regulated information.[923]

Issuers should make sure that market actors are easily and unambiguously directed first to their web-site and second, to the appropriate place where issuer-disclosure is posted on this web-site. To that end, issuers should be urged to seek that their company web-site appears in the first three hits suggested by the most used search tools, like Google, when typing their company name. And the company web-site must be designed to lead investors and the market efficiently to issuer-disclosure.[924] More European-level standardisation in that respect is welcome to ease the work of market

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[920] Comp. with US system, see SEC Corporate Website Guidance, Release Nos. 34-58288, IC-28351 (the "website release"), effective since 7 August 2008.

[921] For further details on the European regulation I suggest, see Part III:Chapter II:II.B.1 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[922] See, for existing provisions, recital (31) and article 29.1(2) of the Prospectus Regulation; CESR/05-407, June 2005, CESR's Final Technical Advice on Possible Implementing Measures of the Transparency Directive. Comp. with the U.S., Release Nos. 34-58288, IC-28351; File No. S7-23-08 (so-called "Website Release"); Release No. 33-7856 (Apr. 28, 2000) [65 FR 25843] (so-called "2000 Electronics Release").

[923] See CESR's Final Technical Advice on Possible Implementing Measures Concerning the Transparency Directive – Storage of Regulated Information and Filing of Regulated Information, CESR/06-292, June 2006, at 8 et seq.

[924] See existing rule under article 29.1(1) of the Prospectus Regulation with respect to prospectus and base prospectus ("the prospectus or base prospectus shall be easily accessible when entering the web-site").

participants to achieve that objective. For instance, the European regulator could provide for a European-wide title for the specific section on the homepage of the relevant web-site that directs market participants to issuer-disclosure (for instance, "Investors Relations"). By clicking on that title, users should be directed to another web-page offering several options, including "regulated markets disclosure".[925] Under this heading, there should be a choice between a certain number of preceding calendar years, including the current one.[926] Each year should include all types of disclosure required to be made by issuers (for instance, IPO and secondary offerings-related documents; periodic reports; *ad hoc* disclosure; notifications of major shareholdings; etc.) and relating to that calendar year. The disclaimer mentioned above should be posted on the web-page containing the link to the prospectus, close to this link, to make sure that it is read by addressees.

For security reasons, the relevant web-page which contains issuer-disclosure should not contain hyper-links directing to third parties' web-sites, even for information incorporated by reference.[927] The alternative is that the issuer reproduces in full text on its web-site the document to which it wanted to refer to. No liability concern should arise for the issuer to the extent the persons responsible for the third party's document are explicitly and clearly mentioned in the document itself.

However, another document of the issuer, available on the web-site of the issuer, could be referred to in a specific document through a hyper-link. This constitutes an additional advantage of using the Internet as the (issuer's) document which is cross-referred to is more easily accessible to the user.

Market participants must be able to download and print issuer-disclosure.[928] Issuer-disclosure must therefore be presented in a format readily accessible to the general public, like non-editable pdf format.

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[925] Other sections could be "other disclosure of interest to investors", "blogs and shareholder forum" etc.

[926] See Part III:Chapter I:III.B.4.d.ii below.

[927] Comp. with article 29.1(3) of the Prospectus Regulation with respect to prospectus and base prospectus ("the prospectus or base prospectus shall not contain hyper-links, with exception of links to the electronic addresses where information incorporated by reference is available").

[928] See existing requirement under article 29.1(4) of the Prospectus Regulation with respect to prospectus and base prospectus ("the investors shall have the possibility of downloading and printing the prospectus or base prospectus").

To be sure that market actors, and especially investors who have already invested, remain aware that they are expected to check the relevant web-site of the company they are interested in, there could be a default-based system where those who have disclosed their e-mail address to the issuer receive notice that new information has been posted with the appropriate web-link and, at the discretion of issuers, an option to receive paper-based disclosure.[929]

However, this solution should not result in information over-load. It should be at least organised so that it is easy for those interested to subscribe and un-subscribe from this option.

Besides, to the extent new push technologies, like RSS feeds, could enable users to receive a notice from the companies of their choice informing them that new issuer-disclosure is available and explaining how to access it automatically, these technologies should be promoted. In other words, issuers' web-sites should suggest investors to provide their e-mail address or to use RSS feeds on the specific web-page relating to "Investors Relations".

I do not believe however that other push technologies, like releases through other dissemination channels like newspapers, should be used to that purpose as costs would exceed benefits, except to the extent provided above.[930]

A last issue concerns the treatment of previously posted information on the issuer's web-site that is accessed at a later time.

If the flow of information is left the way it is under the Prospectus Directive and the Transparency Directive, there cannot be a continuous duty to update previously posted information as such updating requirement would be very costly for issuers. Therefore, I suggest that liability should only apply to statements and posted material at the time when these statements were initially made or information initially posted, unless the company affirmatively restates or reissues the statement. For investors to understand that the posted materials or statements speak as of a certain date and time, these date and time should be clearly mentioned on the posted material or statement.

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[929] For further details, see Part III:Chapter II:II.D.2 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[930] See above, the use of regulated information service providers.

If on the other hand the regulator follows my recommendation to have one main disclosure document, there will be a complementary requirement to update the information contained therein in case of material changes and in accordance with a schedule detailed by the European regulator.[931]

ii Measures relating to the preservation of information

Issuer-disclosure should remain on the issuer web-site for a period equal to the longest prescription period related to claims that could be brought on the basis of that information.[932] Besides, the issuer should have a technological system which keeps the information, without it being apparent on the web-site, for a longer period. Issuers should be responsible for preservation.

iii Measures relating to the central storage of issuer-disclosure

With respect to central storage of issuer-disclosure, the Transparency Directive provides for the designation by each Member State of at least one "officially appointed mechanism" (hereafter, OAM) for the central storage of information.[933] The OAM must meet minimum quality standards as to security, certainty as to information source, time recording, and easy access by end-users.[934] OAMs are the subject of voluntary standards under a European Commission recommendation,[935] following CESR's support of a European network model for integration based on a central application service and a central database containing a list of all issuers with links, for each issuer, to the relevant OAM.[936] Probably in the face of the many impediments related to inter-operability between national systems of Member States, CESR decided to set up the European

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[931] See Part III:Chapter II:II.D.2 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets.

[932] But see articles 4.1 and 5.1 of the Transparency Directive (providing for a 5 years minimum preservation period with respect to annual financial reports and half-yearly financial reports).

[933] On the need to have a centrally-maintained European regulatory information system to facilitate cross-border researches of company information, see the mixed views expressed under MAZARS, Transparency Directive Assessment Report (2009)., at 169.

[934] See article 21.2 of the Transparency Directive.

[935] See Commission Recommendation 2007/657/EC on the electronic network of officially appointed mechanisms for the central storage of information referred to in the Transparency Directive [2007] OJ L267/16 (hereafter the European Commission Recommendation).

[936] See CESR/06-292 (June 2006), at 11. For a discussion of CESR's reach over the storage regime, see NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 209-210.

network of national storage mechanisms using the MiFID database on shares admitted to trading on European regulated markets that it is already running on its web-site.[937]

A central storage mechanism would render the notification procedure superfluous.[938]

And, most importantly in my opinion, it would offer a tool of comparison between products available.[939] If a single location is provided on a Member State basis, the storage mechanism could be a useful step for comparison between products offered by all listed companies of a single Member State, before the creation of a European central electronic filing system, similar to IDEA in the U.S. From that angle, I view the storage mechanism envisaged by the E.U. as a useful complement for investor protection to the publication mechanism, for which the issuer web-site, combined with the use of regulated information service providers as the case may be, is the preferred tool. The next step is for CESR to launch the process of achieving the inter-operability between the various national storage mechanisms.[940]

In this context, I would suggest the following to ensure consistency and a proper balance between investor protection and market access for issuers:

There should only be one national storage mechanism per Member State and not at least one, as currently provided by the Transparency Directive.[941] I plead for the European Commission to request the suppression of all national measures which

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[937] See CESR Half-Yearly Report 2008. pt. (2008)., at 17.

[938] See article 18 of the Prospectus Directive (providing for the submission by the competent authority of the home Member State of a certificate of approval of the prospectus to the competent authority of the host Member State). *Accord* Dutch AFM's answer to the European Commission consultation on the review of the Prospectus Directive on the relevant page of the European Commission web-site.

[939] See to support that view, CESR, Summary of responses to Questionnaire on Transposition of the Transparency Directive, CESR/08-514b, September 2008 (where respondents to CESR questionnaire on the transposition of the Transparency Directive identified the lack of a central information source as a major obstacle to the operation of the Transparency Directive).

[940] Comp. with the European Commission agenda for interconnexion between trade registers (see relevant web-pages on the European Commission web-site). Further thoughts should be given to the idea of having only one web-based register/storage mechanism per Member State for filings that a "local" listed company (to be defined) would be required to make pursuant to the EU issuer-disclosure regime or to company law directives (like the Fourth and the Seventh Company Law Directives), and of inteconnecting the various national registers/storage mechanisms for easy access and comparability by investors.

[941] See article 21.2 of the Transparency Directive.

provide for filing of the regulated information with another authority than the competent supervisory authority designated by the home Member State for the securities regulation area.[942] This will avoid unnecessary filing with authorities, different in each Member State, and will provide clarity for issuers.

The competent supervisory authority should have its own web-site available at least in English[943] and accessible free of charge to all market participants.[944] This web-site should serve as storage mechanism.[945] It should be noted in that respect that the Transparency Directive already provides that all regulated information disclosed be at the same time filed with the supervisory authority of the home Member State.[946] Besides, the Prospectus Directive requires that the competent authority of the home Member State publish on its web-site over a period of 12 months all the prospectuses approved.[947]

The competent supervisory authority should be able to receive electronic filings and should not be allowed to request paper filings from issuers. It should store the information in electronic format by issuer's registered name for easy access by market participants. The format required for filing with the competent supervisory authority should be the same as the format imposed for dissemination, to avoid undue costs for issuers.

The web-site of the supervisory authority should comply with minimum quality standards of security.[948]

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[942] See in Belgium, the royal decree of 23 February 2010, designating the Belgian CBFA as OAM, as from 1st January 2011. But see the French AMF, which, as from 6 January 2009, must send issuers' regulated information to the *Direction des Journaux Officiels* for storage purposes on a dedicated web-site.

[943] See the web-site of the financial supervisory authorities of the Member States concerned by this dissertation, i.e., the UK FSA, the French AMF, the Belgian CBFA, the Dutch AFM, the Italian Consob, the German BaFin and the Spanish CNMV, each available both in local language(s) and in English, where English is not the local language.

[944] This is the case in all Member States concerned by this dissertation.

[945] Comp. with the UK GABRIEL (GAthering Better Regulatory Information ELectronically), which serves as regulatory reporting system for the collection, validation and storage of regulatory data for regulated firms and which is made available to certain companies by the UK FSA.

[946] See articles 19.1 and 21.1 of the Transparency Directive.

[947] The competent supervisory authority has however the choice to publish the prospectuses as such or a list of prospectuses approved, including, if applicable, a hyperlink to the prospectus published on the web-site of the issuer, or on the web-site of the regulated market. Besides, the obligation to store that information only lasts for 12 months. See article 14.4 of the Prospectus Directive.

[948] See CESR's Final Technical Advice on Possible Implementing Measures Concerning the Transparency Directive – Storage of Regulated Information and Filing of Regulated Information, CESR/06-292, June 2006. See also articles 5 et seq. of the European Commission Recommendation.

In addition, national storage mechanisms should make search facilities available at least in English.[949]

It should be made clear that no liability can be assumed by the supervisory authority with respect to the regulated information it hosts on its web-site. The solution to designate supervisory authority web-site as the national storage mechanism should not impede the supervisory authority's core role to check if the information was duly and accurately disseminated.

iv Measures relating to the retrieval of information

As far as retrieval of information already posted on the web-site is concerned, the system design needs to ensure easy access to a specific disclosure that was made at a specific date and time. It should allow certainty in tracking issuer-disclosure and in establishing the timing of issuer-disclosure.[950]

C. Importance of MiFID-Related Issues

1. Preliminary remark

The reader will recall that, further to my reasoning, indirect investments, i.e., on the basis of professional advice or through an institutional investor, are encouraged.

When investing through, or on the basis of the advice of, an investment firm, unsophisticated retail investors should be accurately protected. I think that proper intermediation, i.e., intermediation regulated to protect investors, can provide the necessary *confidence* to unsophisticated retail investors for them to increase their (indirect) participation in financial markets.

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[949] Comp. with article 18.2 of the European Commission Recommendation (providing that national storage mechanisms must make search facilities available in the language accepted by the competent authorities in the home Member State and, at least, in a "language customary in the sphere of international finance").

[950] See article 16 of the European Commission Recommendation in that respect. See also CESR's Final Technical Advice on Possible Implementing Measures Concerning the Transparency Directive – Storage of Regulated Information and Filing of Regulated Information, CESR/06-292, June 2006. See also the recommendations in Part III:Chapter II:II.D.2 in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets and Part III:Chapter I:III.B.4.c above.

The idea of the utilisation of investment firms and other market participants as gatekeepers was developed in the U.S. by Professor Rainier Kraakman in the 1980s.[951] It is now widely accepted in the US academic literature.[952] In Europe, in contrast, the gatekeeper theory has not been subject to extensive academic writing.[953] And on both sides of the Atlantic, the regulatory measures do not take into account the insights of the theory. The most controversial issues relate to who exactly among gatekeepers could be held liable and the standard of liability.

Proper regulation of investment firms is paramount from another point of view as well. Risks extend down the chain. Inadequate regulation can lead to economy-wide instability as investment firms have the potential through their investment policies to create instability in the securities markets.[954]

In assessing whether European legislation provides for proper rules governing the relationship between investors and investment firms with a view to maintain investor confidence in financial markets, MiFID ought to be considered.[955]

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[951] See RAINIER H. KRAAKMAN, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale L.J. 857, (1984).; RAINIER H. KRAAKMAN, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53, (1986).

[952] See, *inter alia*, BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001).; RUTHERFORD B. CAMPBELL, et al., *The Ethical Obligation of Transactional Lawyers to Act as Gatekeepers*, 56 Rutgers L. Rev. 9, (2003).; STEPHEN CHOI, *Market Lessons for Gatekeepers*, 92 Nw. U. L. Rev. 916, (1998).; STEPHEN CHOI, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. Chi. L. Rev. 567, (1997)., at 584-87; the works of Professor Coffee, including, JOHN C. COFFEE, Gatekeepers - The Professions and Corporate Governance (Oxford University Press. 2006).; JAMES D. COX, *The Oligopolistic Gatekeeper: The US Accounting Profession*, *in* After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S., (John Armour, et al. eds., 2006).; JILL E. FISCH, et al., *Is there a Role for Lawyers in Preventing Future Enrons?*, 48 Vill. L. Rev. 1097 (2003).; SEAN J. GRIFFITH, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. Pa. L. Rev. 1147 (2006).; ASSAF HAMDANI, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53, (2003).; DONALD C. LANGEVOORT, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 Law and Contemporary Problems 45, (2000).; FRANK PARTNOY, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash. U. L.Q. 491, (2001).; FRANK PARTNOY, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. Rev. 365, (2004).; HILLARY A. SALE, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. Cin. L. Rev. 139, (2004).

[953] See for a European piece of literature, Klaus J. Hopt, *Die Verantwortlichkeit der Banken bei Emissionen*, 1991, at 33-37. See as well the doctoral thesis of the same author, Klaus J. Hopt, Der Kapitalanlegerschutz im Recht der Banken. Gesellschafts-, bank- und börsenrechtliche Anforderungen an das Beratungs- und Verwaltungsverhalten der Kreditinstitute, München (Beck) 1975, 610 pages.

[954] This also applies to other institutional investor, like collective investment schemes, including UCITS.

[955] See on MiFID generally, *inter alia*, Dominique Servais, Intégration des marchés financiers, Editions de l'université de Bruxelles, Commentaire J. Mégret, 2007. See as well the work of the European

MiFID has been described by the European Commission as one of the "mainstays of investor protection".[956] The core question is whether MiFID does a good job at protecting unsophisticated retail investors who invest indirectly in financial markets.[957] Does it need to be reformed to better tackle information asymmetries between investors and investment firms and agency problems present in the relationship?

Time is still needed for MiFID to bed down, as already mentioned.[958] Consequently, it is not the place to make a full assessment of MiFID with unsophisticated retail investor protection in mind. This is left for other research.[959] This being said, some issues are worth to be mentioned:

2. Some general thoughts

Regulation in the pan-European investment services market should reflect that there are limits to disclosure as a tool for investor protection. The European regulator should consider, as essential complements to disclosure, effective rules on conflicts of interest, suitability tests, appropriateness tests and other conduct of business rules.[960] Only then,

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Commission related to Packaged Retail Investment Products (so-called PRIPs) on the European Commission web-site. See also for national regulatory measures to increase unsophisticated retail investor protection, the "retail distribution review" (the so-called RDR) by the UK FSA and the UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010 (improving clarity for consumers on advice services and tackling the potential for remuneration bias). UK firms subjected to the RDR are expected to fully implement the new rules by 31 December 2012. See also the UK FSA Hanbook Notice 98 (introducing, *inter alia*, new rules for advised sales of investments to retail clients (including (i) a new independence standard, (ii) new charging rules aimed at removing provider influence by banning commission, and (iii) disclosure requirements to provide customers greater transparency regarding the charges for advice). See also the work of the Joint Forum (the Basel Committee on Banking Supervision and the IOSCO) and the International Association of Insurance Supervisors on customer suitability in retail sales of financial products and services. And the works of IOSCO Technical Committee on point of sale disclosure.

[956] See European Commission, Explanatory Memorandum to the MiFID Proposal, COM (2002) 625, at 26.

[957] See LACHLAN BURN, *KISS, but tell all: short-form disclosure for retail investors*, 5 Capital Markets Law Journal 141, (2010). (suggesting that MiFID may need amendment to achieve a proper level of consumer protection given the deficiencies of summary prospectuses to protect retail investors).

[958] See note 832 above and accompanying text.

[959] Note in that respect article 65 of MiFID which sets out the time frame for the reviews and reports to be done to assess the effectiveness of MiFID and the need for amendments. The first reports should be issued in 2010.

[960] Recall as well the discussion in Chapter Corporate Governance starting from the premise that the deficiencies in corporate governance of firms where institutional investors invest on behalf of end-beneficiaries will be covered up and even amplified if financial intermediaries do not live up to the expectations set for them by the market. In that respect, I suggested that one should encourage active

there will be no need to restrict retail investors' choice to particular risk-controlled products and services or to manage retail investors' activity more directly.

Does MiFID strike the right balance between a more paternalistic approach and a more disclosure-based approach?

The *large disclosure component* of the conduct of business regime of articles 19(2),[961] 19(3),[962] 19(7),[963] 19(8),[964] and of the best execution requirement of articles 21(3) and 21(4) of MiFID suggests that regulation is generally targeted at protecting autonomy and choice and supporting decision-making through information. This is at variance with the well-documented evidence of difficulties of unsophisticated retail investors to make rational investment decisions and to manage disclosure efficiently, as outlined in Part II.[965] Besides, the more onerous the monitoring and reporting requirements, the greater the likelihood of costs being passed on to retail investors.

On the other hand, suitability/appropriateness/know your client requirements of articles 19(4)[966] and 19(5)[967] of MiFID are associated with a *more paternalistic and managerial approach* to unsophisticated retail investors to minimise information asymmetries in the firm-investor relationship and the behavioural defects under which investors operate.

All in all, there is limited intervention in the investor decision, save with the imposition of suitability/appropriateness controls where a high level of control passes to the investment firm. This *limited intervention* is based on the assumption of an informed

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involvement of institutional investors for the due supervision of management and the controlling parties while at the same time avoid financial intermediaries to subscribe to corporate governance principles but do nothing concretely except tick the box. See Part II:Chapter III:II.E.3.b.iii in Chapter Corporate Governance.

[961] See as well article 27 of MiFID Implementing Directive.

[962] See as well articles 29 to 33 of MiFID Implementing Directive.

[963] See as well article 39 of MiFID Implementing Directive.

[964] See as well articles 40 to 43 of MiFID Implementing Directive.

[965] *Accord* LARS KLÖHN, *Preventing Excessive Retail Investor Trading under MiFID: A Behavioural Law & Economics Perspective*, 10 EBOR 437, (2009). (arguing that MiFID does not do enough about the market failure which consists of over-confidence, over-optimism and biased self-attribution in capital markets on the part of retail investors as there is no duty to actively warn the client or stop the client from trading).

[966] See as well articles 35 and 37 of MiFID Implementing Directive.

[967] See as well articles 36 and 37 of MiFID Implementing Directive.

and rational retail investor, equipped to choose between competing products and services and to make rational investment choices.

But this is flawed if not accompanied by ancillary measures to minimise risks. These measures should include effective enforcement of the obligations of investment firms, involvement of unsophisticated retail investors in the law-making process to ensure that disclosure rules are well suited for their protection and unsophisticated retail investor education to enhance the effectiveness of disclosure.[968]

In addition, there is a concern whether MiFID is sufficient in its current drafting to promote a *coherent approach* regarding *product disclosure*.[969] There is likely a need for greater regulatory consistency across the full range of product types which present investment similarities to replace the current "regulatory patchwork". But this seems to be in the process of being taken care of by the European Commission, at least with respect to packaged retail investment products.[970]

Furthermore, more attention could be paid to the *disclosure of the level of complexity* of an investment product and the *expected liquidity* of the product sold to unsophisticated retail investors. Indeed, more complex products raise a "fair price problem" and illiquid products could be unsuitable for unsophisticated retail investors given, for instance, buyer's expected holding period. This is important if MiFID aims at maintaining investor confidence in the distributor's role of proposing only products that are appropriate to the investor's needs and circumstances.[971]

Besides, there might also be a need to address *conflicts of interest* along the whole investment chain more than what is currently provided for. MiFID arguably does not adequately address the issue of conflicts of interest as it is limited to requirements of

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[968] See Part III:Chapter I:III.E below.

[969] See article 19.3 of MiFID and article 31 of MiFID Implementing Directive.

[970] See EUROPEAN COMMISSION, Update on Commission Work on Packaged Retail Investment Products 16 December 2009 (2009).; EUROPEAN COMMISSION, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council Packaged Retail Investment Products Impact Assessment (2009).

[971] See my suggestion under Part III:Chapter I:II.A.3 above to have more complex products offered to unsophisticated retail investors subject to a stricter regime, which may include a special certification of the investment firm.

disclosure of these conflicts to the client before undertaking business on its behalf, where there is a risk of damage to the client's interests.[972] A major area of concern regarding conflicts of interest is the fact that the retail financial system is built on commission-based distributor remuneration.[973]

Lastly, some might question whether distributors subject to and complying with MiFID requirements have a sufficient *level of professionalism and competence*.[974] With respect to distribution disciplines, it is key to ensure that sales-people are appropriately trained and monitored.[975] The concern about expertise of course applies to any decision-maker in the investment chain. Each of them should be appropriately resourced and meet relevant standards of experience, skill and ethics in matters subject to some discretion, including engagement with companies or voting decisions.

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[972] See article 18.2 of MiFID. See however article 13.3 of MiFID and article 12 of MiFID Implementing Directive which require internal policy to prevent conflicts of interest; see also articles 22 and 23 of MiFID Implementing Directive which set out the content of the conflicts of interest policy and the record keeping requirements of conflicts of interest.

[973] See for an overview, CESR, Inducements: Good and Poor Practices, CESR/09-958, 22 October 2009. See also the "retail distribution review" (the so-called RDR) by the UK FSA and the UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010, at 23 et seq. (advocating a move from provider-driven sales decisions to a model in which the intermediary agrees the remuneration level with the client); see also the work of CESR in that respect, including CESR/07-228b, Inducements under MiFID.

[974] See however the requirements of article 5.1(d) of MiFID Implementing Directive (requiring firms to "employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them"). Some suggest that there be practising certificates for investment firms' employees to be organised in a way that requires those advising on more complex products to be certified to a higher level (see Robert Higginbotham, 5 steps to restoring savers' faith in risk, FT.com, 17 November 2009).

[975] See UK FSA initiatives for qualifications and ethics of investment advisers, UK FSA policy statement entitled "Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules", March 2010, at 40 et seq.; article 313-7 2bis of Book III of the General Regulation of the French AMF, to enter into force on 1 July 2010 (which provides for a system to ascertain that investment service providers have a specified minimum level of regulatory knowledge); Belgian CBFA, Communication CBFA_2009_09 of 17 February 2009. Comp. with the U.S., where brokers-dealers are registered with the US SEC and subject to strict professional and suitability standards.

D. Importance of UCITS-Related Issues

1. Preliminary remark

As already stressed, the European retail market is not so mature in the sense that there is no real active culture of pan-European retail investing.[976]

However the picture could change, and already does to some extent, when collective investment is considered.

UCITS can be viewed as an effort in developing a product that is retail-focussed and that offers many advantages to unsophisticated retail investors in particular.

As any other collective investment scheme, UCITS could deliver diversified exposure to investments to unsophisticated retail investors, by the pooling of their (limited) funds.[977] Consequently, it could contribute to fight the unsystematic risk and the home bias. This is important when one considers that lack of portfolio diversification and home bias are well-reported weaknesses in retail investors' decision-making.[978]

UCITS benefit from economies of scale by accessing many investments.

They could offer lower transaction costs, as their assets managers who buy assets in large tranches can pass on the costs reductions to UCITS unit-holders.

They offer liquidity guarantees, at least in the case of open-ended collective investment schemes which allow redemption upon request by investors at a price related to the net asset value of the fund.

And they could mitigate, through the intermediation they offer, the defects in investors decision-making and information deficiencies.

[976] See Part II:Chapter III:II.E.3.c.iiin in Chapter Corporate Governance and Part III:Chapter I:II.A in Chapter Issuer-Disclosure Addressees and Consequences; see also note 870 and accompanying text.

[977] See article 1.2(a) of UCITS IV specifying that UCITS operate on the principle of risk-spreading; see also articles 52 et seq. for the investments limits when investing in the same body.

[978] See Part II:Chapter I:V.D in Chapter Investor Protection and note 870 and accompanying text.

Besides, the strength of collective investment schemes in general is critical to the health of the European economy[979] and positively correlated with the development of equity markets across the E.U.[980]

UCITS are politically interesting in the E.U., which is more and more characterised by an ageing population in search for private retirement products. Effective private solutions are looked for to complement public pensions and to foster financial independence of European citizens. In this context, UCITS provide an established vehicle for accumulating capital throughout working life. They have been explicitly identified by the European Commission as forming part of the solution to the need to find alternatives to public pensions.[981]

Although banking deposits and insurance reserves dominate household savings in most European countries, UCITS play an important role.[982] For the last 10 years, investment funds have been on average growing faster than the banking and the capital market as a whole.[983] And equity funds are the most popular.[984] This market share is

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979 *Accord* INGO WALTER, The Global Asset Management Industry: Competitive Structure and Performance, 8 Financial Markets, Institutions, and Instruments 1, (1998)., at 72; ROSS LEVINE, *Financial Development and Economic Growth: Views and Agenda*, XXXV Journal of Economic Literature 688, (1997)., at 699; BERNARD S. BLACK, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, (2001)., at 801.

980 *Accord* European Commission, Financial Integration Monitor (2006), SEC(2006)1057, at 19-21; Asset Management Expert Group Report, Financial Services Action Plan: Progress and Prospects, 2004, at 6.

981 See European Commission, Green Paper on Financial Services (2005-2010), COM (2005) 177, at 18; European Commission, Green Paper on the Enhancement of the EU Framework for Investment Funds, 2005, COM(2005)314, at 3; Interim Report of the Financial Services Committee Subgroup on the implications of ageing populations for financial markets, FSC 4180/06, October 2006. See as well, Memorandum from the UK FSA, Treasury Committee Inquiry Into Restoring Confidence in Long Term Savings (FSA Treasury Evidence).

982 See European Commission Green Paper on the enhancement of the EU Framework for Investment Funds, COM (2005) 314, at 12 (reporting for 2005 that more than 20% of the adult European population has invested in UCITS); Commission Staff Working Document accompanying Proposal for a Directive of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) – *Impact Assessment of the Legislative Proposal Amending the UCITS DIRECTIVE*, SEC(2008) 2263 (reporting that their average share in European household assets amounts to 11.5%); French AMF, Economic and Financial Newsletter, Spring 2008 (showing that, in terms of preference, insurance comes first, then bank deposits, then UCITS).

983 See CESR, Annual Report (2006), at 17 (reporting for 2006 that the E.U. had one of the most developed fund-managed industries in the world, with total assets under management at more than €7 trillion, or around 14.4% of the world's funds under management); European Commission, Financial Integration Monitor (2006), SEC(2006)1057 (reporting that assets under management represent 50% of European GDP); Asset Management Expert Group Report, Financial Services action Plan: Progress and Prospects, 2004, at 18 (reporting that UCITS funds amount to almost 80% of the total funds market);

expected to increase in the future, at least after the current financial crisis, for the reasons outlined in the preceding paragraphs.[985] UCITS funds are said to have established a global reputation with the UCITS replacing US mutual funds as the leading international fund investment.[986]

2. Some general thoughts

But UCITS, as any other investment, also present risks. Special attention should be paid in future research to their regulation with a view to protect especially unsophisticated retail investors.

For instance, there should be proper regulation to avoid conflicts of interest and corporate governance risks, particularly with respect to the independence and monitoring of the fund manager, and to avoid liquidity and redemption risks faced by unsophisticated retail investors.

The European Commission is in constant dialogue with CESR on the effectiveness and adequacy of the provisions on eligible assets and investment limits, in particular in the context of the recent market turmoil. However, first lessons drawn from the crisis suggest that at first stage there is a need to focus more on risk management processes rather than eligible assets and investment limits.[987]

Issuer-disclosure under the Prospectus Directive and the Transparency Directive serve the primary function of supporting market efficiency and effective corporate governance. By contrast, I believe that disclosure in the UCITS context aims at protecting unsophisticated retail investors. Fund disclosure should therefore take

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White Paper on Enhancing the Single Market Framework for Investment Funds (2007) (SEC (2006) 1451) (reporting the breakdown of the funds industry as UCITS (74%), non-UCITS (20%), private equity (2%) and hedge funds (4%)); BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007, at 55 (reporting aggregate investments of €1,971 billion at the end of 2005); French AMF, Economic and Financial Newsletter, Spring 2009 (for data on UCITS as at spring 2009, i.e., taking the financial crisis into account).

[984] See EFAMA International Statistical Release (2008).

[985] See Asset Management Expert Group Report, Financial Services action Plan: Progress and Prospects, 2004, at 8 (expecting European growth rates to outstrip US rates between 2004 and 2014); White Paper on Enhancing the Single Market Framework for Investment Funds (2007) (SEC (2006) 1451), at 2 (predicting growth rates of around 10% annually until 2010).

[986] See Asset Management Expert Group Report, Financial Services action Plan: Progress and Prospects, 2004, at 9.

[987] See in that respect, the efforts by CESR, CESR, Risk Management Principles for UCITS, February 2009, CESR 09/178.

particular account of the decision-making process, the relevance, comprehensibility and timeliness of disclosure and the ability of individuals to use the information. In this context, worth to be noted is the attempt of the UCITS disclosure reform to design a disclosure regime based on an analysis of investor practices and competences.[988] The Key Investor Information, based on Level 1 and Level 2 measures, should replace the simplified prospectus which failed to deliver basic information on the UCITS product and risks and to support competent and informed decision-making. The problem with the simplified prospectus reflected one of the most serious failures of the FSAP, i.e., its construction of a disclosure regime which has not been informed by large-scale studies on investor behaviour and competence and the risks of cross-border investing in particular. The European Commission, assisted by CESR, made considerable efforts to engage a wide range of stakeholders, and particularly retail investors, in the redesign of the simplified prospectus and to ensure transparency. For the first time, the European Commission seemed to recognise that there is a need for greater evidence on investor decision-making patterns to inform regulation.[989] It remains to be seen whether the new disclosure design will meet its objective.

Marketing communications should as well be brought more in line with marketing rules under MiFID.[990]

E. Some Ancillary Measures to Increase Retail Investor Protection

1. Preliminary remark

"In a world where people can bet other people's money, and many institutions are too big or too interconnected to fail, investment decisions potentially become everyone's problem".[991]

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[988] See the special web-pages dedicated to Key Investor Information on the European Commission web-site, and especially the UCITS Disclosure Testing Research Report of July 2009.

[989] See Part II:Chapter I:IV.B.3.b in Chapter Investor Protection.

[990] Comp. article 77 of UCITS IV with article 19.2 of MiFID and articles 27 and 30 et seq. of MiFID Implementing Directive. But this could be thought in the context of the works done with respect to Packaged Retail Investment Products (so-called PRIPs). See notes 833 and 834 above and accompanying text.

[991] CLAIRE A. HILL, *Why Did Anyone Listen to the Rating Agencies After Enron?*, Journal of Business and Technology Law, (2009)., at 294.

Therefore, I believe that in the present-day context, and given my suggestion to direct issuer-disclosure to more sophisticated actors and to promote *indirect* participation of unsophisticated retail investors in financial markets, there is an increased need to accurately regulate more sophisticated actors involved in securities markets and seek proper enforcement of their obligations. The discussion relating to agency relationships within the firm should be recalled here, as well as the discussion relating to institutional and large retail shareholders' duties.[992] The discussion relating to MiFID and UCITS IV should also be referred to. In addition to issues already tackled, I discuss below the case of the investment adviser.

Besides, the need for providing unsophisticated retail investors with proper financial education, for involving them in the law-making process and for understanding how specific regulation can impact them should also be correctly assessed with a view to increase investor protection for them to ultimately take "better" investment decisions.

2. *Proper regulation of financial advisers*

The rules under MiFID, which apply to investment research, the rules under the MAD, which apply to all producers of "recommendations", and the rules under the directive on investment recommendations,[993] should be assessed to ensure that they properly address conflicts-of-interest risk.[994]

In so doing, one should bear in mind that stringent conflicts-of-interest rules run various risks in the European context where there is no cult devoted to "star analysts", unlike in the U.S., and where institutional investors, who should be better equipped to decode investment research, dominate the market. The imposition of onerous and costly regulation on analysts which form part of a multi-service firm might result in an investment firm not following smaller companies where trading activities in the

[992] See Part II:Chapter III:II.E.3.b.iii in Chapter Corporate Governance.

[993] See European Commission Directive 2003/125/EC [2003] OJ L339/73 (hereafter the Investment Recommendations Directive). See also the web-pages of the European Commission web-site dedicated to financial analysts, including references to European Commission's communications in that respect.

[994] See for a detailed analysis, NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 648 et seq.

securities do not justify the costs of coverage. This could be a concern in the E.U., where there is no strong independent research industry.[995]

Applicable rules should also be assessed to ensure they address the other risks generated by investment analysts, like competence and professional and ethical standards.

3. Proper enforcement of existing regulations

I suggest elsewhere in this dissertation a more ambitious harmonisation of the liability associated with the EU issuer-disclosure regime's violations than the one already existing under the Prospectus Directive, the Transparency Directive and the MAD with a view to achieve the policy objectives one assigns to private enforcement.[996]

4. Proper education of unsophisticated retail investors

As evidence shows, retail investors with less education are more likely to invest inefficiently, earning only a small reward for the risk they take.[997]

Investor education programmes could be seen as feasible minimally intrusive efforts to correct some problems, even more so in a context of increasing complexity of investment products.[998] They would rest on the premise that an educated investor need not rely on her intuition for a sense of how the market functions, thereby reducing the role that any misleading heuristic would play. It is assumed that with appropriate education, unsophisticated retail investors could learn to mitigate the impact of their cognitive bias in their investment decision-making process.[999] It is also thought that

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[995] *Accord* Elisabetta Cervone, EU Conduct of Business Rules and the Liberalization Ethos: The Challenging Case of Investment Research, EBLR, 2005, 421, 452-453.

[996] See Part II:Chapter III:II.E.3.d.iii in Chapter Corporate Governance and Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in an Efficient Market.

[997] See Households, Institutions, and Financial Markets pt. (2007).

[998] *Accord* NIAMH MOLONEY, Building a Retail Investment Culture through Law: The 2004 Markets in Financial Instruments Directive, 6 European Business Organisation Law Review 341, (2005).

[999] *Accord* RICHARD A. POSNER, *Rational Choice, Behavioral Economics, and the Law*, 50 Stanford Law Review 1551, (1998)., at 1551; ROBERTA ROMANO, *A Comment on Information Overload, Cognitive Illusions, and Their Implications for Public Policy*, 59 S. Cal. L. Rev. 313, (1986)., at 316-17 and at 324-27 (suggesting that the behavioural literature may support the view that repeated learning opportunities and expertise make cognitive illusions less likely to affect actual decisions).

education initiatives could make investors aware of the potential for conflicts of interest by investment research and financial analysts.[1000]

As suggested above, reforms designed to remedy cognitive errors might also target the behaviour of brokers and firms who sell securities to individual investors, in order to ensure that institutional investment decisions are somehow free of cognitive error.[1001]

In recent years, financial education became a priority on the political agenda of regulators. Initiatives at the national level have started to emerge,[1002] supported by international organisations[1003] as well as European regulators.[1004] This could be explained by the move toward self-supported pensions and the need for savers to take control over their financial future. It has also something to do with the integrated strategy for the retail markets and is believed to be linked to stock market growth.[1005] It

[1000] See European Commission, Communication on Investment Research and Financial Analysts, 2006, COM(2006)789, at 7.

[1001] See Part III:Chapter I:II.C.3 above.

[1002] See, most recently, further to the UK "Financial Services Bill", introduced in Parliament on 19 November 2009, the establishment of a new independent consumer financial education body by the UK FSA, to increase financial education and awareness among consumers. The new body should roll out a national Money Guidance service from 2010 (currently being joint-piloted by the UK FSA and the UK Treasury) that should deliver "accessible, impartial financial guidance"; see also other Member States' supervisory authorities' initiatives. For a review of the financial literacy schemes in operation across the Member States, see M. Habschick, B. Seidl and J. Evers (2007), Survey of Financial Literacy Schemes in the EU 27 (VT Markt/2006/26H – Final Report).

[1003] See, *inter alia*, OECD, Improving Financial Information, 2005; OECD, Recommendation of good practices on financial education relating to private pensions, March 2008; IOSCO, Discussion Paper on the Role of Investor Education in the Effective Regulation of CIS and CIS Operators (2001).

[1004] See European Parliament resolution of 18 November 2008 on protecting the consumer: improving consumer education and awareness of credit and finance, 18 November 2008; European Commission, Communication from the Commission – Financial Education, COM(2007)808, 18 December 2007; European Commission, Commission Decision of 30 April 2008 setting up a group of experts on financial education, 2008/365/EC, OJEU, L 125/36, 9 May 2008; CESR/07-225, CESR's Report on the supervisory functioning of the Prospectus Directive and Regulation, June 2007, at 18; European Parliament, Committee on Economic and Monetary Affairs, The Future of Hedge Funds and Derivatives, Purvis Report, January 2004, A5-0476/2003 (calling for education measures with respect to high risk investments). Comp. with the U.S., where the Federal Department of Labour is responsible of advancing public knowledge of savings and investments, while the US SEC has carried out extensive investor-education initiatives (see generally, JAMES FANTO, *We're All Capitalists Now: the Importance, Nature, Provision and Regulation of Investor Education*, 49 Case Western Reserve L.R. 105, (1998).).

[1005] See LUIGI GUISO, et al., *Trusting the Stock Market*, 63 Journal of Finance 2557, (2008). (concluding from their study of the effect of trust that "if it is a policy goal to promote wider stock markets", better education about the stock market can reduce the negative effects of a lack of trust).

is said that "[f]inancial literacy is a necessary condition for financial market efficiency."[1006]

Of course, as pointed out by Professor Moloney, there is always a risk to engaging with retail investors' education. If the regulator is overly aggressive in stressing the risks of investments, unsophisticated retail investors may disappear from the market. And if the regulator produces detailed advice on savings and investment strategies, it may develop a risk of potential liability to investors. Consequently, there should be a balanced and neutral approach to support financial literacy and informed decision-making.[1007]

Besides, there are concerns about the limited capabilities of financial education to make unsophisticated retail investors' decisions more rational.[1008] Some undesirable phenomena might persist. It is thus likely to be costs-effective only to a certain extent as costs could very quickly exceed benefits. For example, framing effects, regret aversion, and the artificial segregation of accounts might depend on emotional reactions, rather than cognitive misunderstanding. Likewise, over-confidence effects might arise from motivated inference processes, rather than from the cold cognitive process.[1009]

[1006] OECD, Financial Literacy and Consumer Protection: Overlooked Aspects of the Crisis, OECD Reecommendation on Good Practices on Financial Education and Awareness relating to Credit, June 2009, at 8. It follows by saying that "[a]s such it is only one part of an effective policy response to empowering consumers in the financial marketplace. It does not substitute for financial consumer protection and regulatory frameworks."

[1007] See NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008)., at 643. For a similar point in the US context, see DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003)., at 6-7.

[1008] See, for instance, BMEConsulting, The EU Market for Consumer Long-Term Retail Savings Vehicles – Comparative Analysis of Products, Market Structures, Costs, Distribution Systems and Consumer Saving Patterns, 15 November 2007 ("[m]any consumers suffer from hyperbolic discounting where, by prioritising the present over the future, they do not fully recognise the importance of long-term saving. Many save too little as a result. The ability of the available resources made in investor education and advice to address this problem is in some doubt. In many cases, the information available to consumers is provided in ways that makes it difficult for them to translate into concrete indicators of future living standards. Overall, the countries with the most ample long-term retail savings reserves are ones that effectively compel consumers to put aside a given proportion of their income."); OECD, Examining Consumer Policy: A Report on Consumer Information Campaigns Concerning Scams, 2005, at 18 (pointing to the limited evidence of the success of education and awareness campaigns concerning scams). See also STEPHEN J. CHOI, *A Framework for the Regulation of Securities Market Intermediaries*, Berkeley Bus. L.J. 45, (2004)., at 68 (stressing that deeply-rooted behavioural biases may be resistant to education efforts); OMRI BEN-SHAHAR, et al., The Failure of Mandated Disclosure (2010).

[1009] See GREGORY LA BLANC, et al., *In Praise of Investor Irrationality*, *in* The Law and Economics of Irrational Behavior, (Francesco Parisi, et al. eds., 2005).

I tend to concur with the sceptics about the limited results that could be achieved through proper unsophisticated retail investor education agenda. Even more so if education programmes consist of long documents, that are as much unlikely to be read by addressees as are disclosure documents. Yet, this does not mean that there is no value at all in running financial education programmes targeted at unsophisticated retail investors. Unsophisticated retail investors could at a minimum be taught:

- to pay attention to the need to properly diversify the risks inherent in their investment decision and to fight their home bias;
- to seek professional advice where this would proof necessary for their own sake;
- that issuer-disclosure is not addressed to unsophisticated retail investors specifically and therefore is not likely to be thoroughly understood by them without assistance of a professional, given their presumed level of financial literacy.

I believe that the European Commission should come up with a recommendation that would include the objectives of a national education programme and the principles on which it should be based.

5. Promotion of behavioural research

Researches in psychological and behavioural factors affecting retail investors' financial decisions should be promoted.

These could inform the better regulation programme of the European Commission.[1010] They would allow the regulator to assess what type of disclosure is necessary, including its specific provider, content, format and dissemination means, from an unsophisticated retail investors' perspective.

[1010] See note 914 and accompanying text.

6. *Involvement of unsophisticated retail investors in the law-making process*

If unsophisticated retail investors are not to be *de facto* excluded from investing in financial markets, it is important to take their views and likely behaviours into account when drafting or assessing the regulations which are expected to protect their interests.

There seems to be a political intent at European level to increase consultation initiatives of retail investors.[1011]

However, although laudable in its principle, the way consultation is currently being performed might not justify the costs these initiatives entail.[1012] The problem lies with a lack of resources, knowledge and expertise of unsophisticated retail investors and the associations representing them.[1013]

Retail investors' associations, to the extent they exist in the area concerned by the consultation, are not well-funded. The funding issue is essential as limited funding restricts their scope of intervention. Because they are working on limited budgets, their staff is limited in terms of number and competence. This in turn results in retail investors' associations to have to make a choice between the files to address, leaving some requests for consultation from European instances unanswered. And the limited time frame they are being provided to answer the calls for consultation, although totally justified to avoid to slow down too much the law-making procedures, does not permit them to "compete" with the professionalism and rapidity of the answers from well-organised and well-funded large sectors' associations. Contrary to institutional and corporate investors, retail investors cannot realistically be asked to contribute to the funding of retail investors' associations, as they are too diffuse and have largely different investments' expectations.

[1011] See EUROPEAN COMMISSION, White Paper - Financial Services Policy 2005-2010 (2005).; Inter-Institutional Monitoring Group, Final Report Monitoring the Lamfalussy Process, 15 October 2007. See for a US author advocating the same, MARK J. ROE, *Legal Origins and Modern Stock Markets*, 120 Harvard Law Review 460, (2006).

[1012] See NIAMH MOLONEY, *Effective Policy Design for the Retail Investment Services Market*, *in* Investor Protection in Europe - Corporate Law Making, the MiFID and Beyond, (Guido A. Ferrarini, et al. eds., 2006)., at 437 (citing illustrations of low participation of retail investors in law-making process).

[1013] *Accord* ROBIN JARVIS, *Financial Services Policy: A Consumer and Small Business Perspective*, 1 Euredia, (2006)., at 5. See however, the recent creation of the European Investor Working Group and its report, Restoring Investor Confidence in European Capital Markets, issued on 23 February 2010. This being said, in my opinion, this report does not really present anything new.

If European instances are serious about providing retail investors a means to have their voice heard prior to drafting a regulation which is of interest to them, they should seek to have them properly funded, through public sources. To be sure, this funding should not jeopardise their independence as this would risk to reduce their usefulness.[1014]

IV. Conclusions

In Chapter Investor Protection, I stressed that financial markets could provide an important alternative funding for retirement needs at a time where governments withdraw from the provision of pensions money.[1015]

Yet, it is said that an important part of the population does not provide for retirement. In the U.K., it is estimated that it amounts to half of the population. One reason might be that future retired persons may lack confidence in financial markets.

As confidence depends on investor protection, one needs to determine what really makes for investor protection. In that respect, I argued in Chapter Investor Protection that the EU issuer-disclosure regime could not provide the necessary protection unsophisticated retail investors seek on financial market.

It flows from Part II that the EU issuer-disclosure regime is at best useless, at worst counter-productive for unsophisticated retail investors' protection.

I suggested in this chapter Issuer-Disclosure Addressees and Consequences that, as best expressed by a US legal author, the focus should be shifted "from the protection of unsophisticated investors *vis-à-vis* the underwriting of securities to the investment in mutual funds, pension funds, and other forms of asset management."[1016] The presence of (or increase in) institutional ownership and the (still increasing) recourse to financial intermediaries in the European Union give additional reasons to have an EU issuer-

[1014] See the perceived limited impact of FIN USE, set up by the European Commission in 2003 as an expert forum to examine financial services policies from the user/demand side perspective and made up of experts from backgrounds in consumer and small business, which independence is questioned.

[1015] See Part II:Chapter I:II.B in Chapter Investor Protection.

[1016] LUIGI ZINGALES, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, (2009)., at 2.

disclosure regime not aimed at the protection of unsophisticated retail investors in financial markets.

In this context, I suggested that issuer-disclosure be drafted with more sophisticated actors in mind.

This shift, which should explicitly be made clear by the European regulator, should *dissuade* unsophisticated retail investors from directly participating in financial markets or at least it should convince them to be more cautious when they do.[1017]

Financial markets are a risky business, as most dramatically showed by the 2007-2008 financial crisis. One could win millions but also lose more than what was invested. This is a rule applicable to any investor. However, more sophisticated actors are most of the time more preserved from irrational decision-taking. Therefore, unsophisticated retail investors should be encouraged to invest based on their advice or through them.[1018]

I first defined more precisely who are these "more sophisticated actors". Broadly stated, they are large retail investors and institutional investors, as well as any unsophisticated retail investor who decided not to seek professional advice or not to invest through a professional investor. They also include professionals whose job is to provide advice/opinions in whatever form relating to financial investments.

I then explained the cost-efficient regulatory implications of this change in the targeted audience of the EU issuer-disclosure regime. They relate to the use of English as communication language and to the use of the Internet for dissemination and storage purposes. Assuming that issuer-disclosure is meant to be read by more sophisticated actors leads to costs reductions that are ultimately reflected in end-investors' investments returns.

[1017] See Knowledge@Wharton, Finance and Investment, The Impact of High-frequency Trading: Manipulation, Distortion or a Better-functioning Market?, October 2009, and the quote of Professor Marshall Blume stating "[i]n my mind, the mutual fund investor should be protected at the expense of individuals who are trading on their own accounts".

[1018] *Accord* HOWELL E. JACKSON, To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns, 28 Journal of Corporation Law 101, (2003). (arguing that the regulator should not encourage direct investments by individual investors as there is evidence that they do not fare well with equity investments; encouraging investments through mutual funds).

It could be interesting to analyse to what extent the cost-efficient regulatory implications I identified could apply to other (corporate) disclosures to investors made by an issuer whose financial instruments are admitted to trading on a regulated market or for which a request for admission to trading on such a market has been made. This would present the advantage of having a totally coherent European disclosure regime for listed companies under the various disclosure obligations pursuant to securities regulation directives and company law directives.[1019] This is left for other analysis.

However, the goal of my scheme is *not to weaken the position of unsophisticated retail investors in financial markets*.

In order to avoid this result, I stated the importance to assess whether investor protection is adequately, i.e., effectively and efficiently, addressed in MiFID. I made some general comments and drew the attention to some areas for future research to examine whether unsophisticated retail investors are adequately protected by MiFID regulations in their relationship with investment firms subject to MiFID.

I also stressed that investments through collective investment schemes, and in particular UCITS, should be promoted as they offer a nice substitute for pensions and many other advantages, like solving the diversification and home bias problems. Therefore, an assessment of their regulation should also be performed in order to consider whether unsophisticated retail investor protection is adequately met.

Lastly, I drew the attention to ancillary measures which could be implemented to protect unsophisticated retail investors, *provided however* that they are legitimised by proper impact assessments. I briefly discussed in that respect the alleged importance of accurate regulation of financial advisers, as gatekeepers, who intervene in the decision-making of unsophisticated retail investors, proper enforcement of existing regulation, proper financial education, adequate involvement of the end-users in the law-making process and the importance of behavioural researches.

[1019] Consider for instance, as illustration of the current inconsistent regime, the requirement under company law that disclosure be made in the official language(s) at the place of incorporation whereas securities regulations provide for different language regimes, according to which the language of the home Member State is not always the sole language provided for the documents to be made public.

Chapter II: Issuer-Disclosure of Well-Established Companies in Efficient Markets

I. Introduction

In this chapter, I draw further regulatory implications from the identification of market efficiency and corporate governance as sole immediate objectives of issuer-disclosure.[1020] They flow from the contention that the social value of the EU issuer-disclosure regime is substantially identical on primary and secondary markets, i.e., whether or not the issuer is offering equity at the time of disclosure. Indeed, if the EU issuer-disclosure regime is aimed at improving market efficiency and corporate governance equally on primary and on secondary markets, this means that the level of disclosure, its quality and the strength of the incentives to disclose should be the same on primary and secondary markets.

This argument was developed in the U.S. by Professor Fox.[1021] As regulations and the overall situation of corporate and financial markets are different in Europe compared to the U.S. in many respects, I thought it could be interesting to determine to what extent the reasoning of Professor Fox is applicable to the European context. I am greatly indebted to Professor Fox who inspired the thoughts of this chapter.

Unlike those of Chapter Issuer-Disclosure Addressees, the regulatory suggestions of this chapter do not necessarily lead to cost reductions. Some might, like the requirement to publish a full-fledged prospectus for secondary offerings only for large issues or the suppression to subject to approval rights issues to existing shareholders. Some might not, like the suggestion to subject secondary market disclosure to an independent third party review or to introduce an integrated disclosure regime which would strengthen disclosure rules on secondary markets. Some might, but only to some extent, like the suggested harmonised civil liability regime.

[1020] See for the concept of "immediate" objectives, Part I:IV in General Introduction. See for other regulatory implications, Chapter Issuer-Disclosure Addressees and Consequences.

[1021] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).; MERRITT B. FOX, *Rethinking Disclosure Liability in the Modern Era* 75 Wash. U. L. Rev. 903, (1997).

As its title may suggest, this chapter is restricted to "well-established companies", i.e., issuers who are familiar with capital market transactions because they regularly access capital markets. *SMEs are thus excluded* from the scope of this chapter.

Indeed, it is politically difficult to define an SME.[1022]

Besides, it is also difficult to set the appropriate level of disclosure for them as lighter touch as well as heavier touch have their drawbacks.[1023] One opinion is to consider that there are other ways to promote SMEs listed on a regulated market than a cut on disclosure requirements, like taxation or employment measures. Another opinion is to provide for mini-prospectuses for SMEs or other similar measures relating to disclosure requirements to ease SMEs' access to regulated markets.[1024]

Moreover, on the one hand, SMEs generally have a limited follow-up among more sophisticated actors, including analysts and the media. As a result, less information is produced about these firms, verification of information is more costly and net returns available to information traders and other more sophisticated actors are lower. The market for SMEs is consequently less efficient in terms of price accuracy and liquidity as disclosure works less well. It is likely that their secondary market price will not be an accurate determinant of the primary market price of a further secondary

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[1022] See the compromise reached in article 2.1(f) of the Prospectus Directive. See also the suggested insertion of a definition for "companies with reduced market capitalisation", in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010). (""company with reduced market capitalisation" means a company listed on a regulated market and having had an average market capitalisation of less than EUR 100 000 000 on the basis of year-end quotes during the previous three calendar years.").

[1023] See article 7.2(e) of the Prospectus Directive (providing that account shall be taken of the size of the issuer when drafting the prospectus). However, the Prospectus Regulation has not provided for any special treatment concerning SMEs that are not considered as start-ups (see, for start-ups, article 23.1, alinea 1 of the Prospectus Regulation). Comp. with the US regulations, see, *inter alia*, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007).

[1024] See the amendment to article 7.2(e) suggested by the European Commission, in EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). (suggesting a "proportionate disclosure regime" to adapt information to the size of issuers, notably companies with reduced market capitalisation, when they do not fall under a prospectus exemption); EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 181 et seq; STEPHANE ROUSSEAU, *The Future of Capital Formation for Small and Medium-sized Entreprises: Rethinking Initial Public Offering Regulation after the Restructuring of Canadian Stock Exchanges*, 34 Revue Juridique Thémis 661, (2000).

public offering. And, on the other hand, SMEs face different cost constraints than large companies.

For all these reasons, a separate analysis is required to determine to what extent a change to existing European regulations is warranted in their respect.

By contrast, well-established companies are well followed-up by more sophisticated actors and have a reporting history. As a result, much information about them is available in the market and their market is efficient, at least under normal market conditions. Their secondary market price is consequently likely to be an accurate determinant of the market price of a further secondary public offering.[1025]

This chapter does *not* consider changing the EU issuer-disclosure regime associated with an IPO:

At first sight, IPOs are a very different situation than secondary public offerings because there is no established efficient market for the issuer's securities and because the placement of a large number of shares all at once into un-established markets requires high powered salesmanship.[1026] The issuer seems to have a far greater incentive to deceive when it is selling stocks and receives the proceeds in a primary offering than any time thereafter. Consistent with this reasoning, I suggest below to impose the IPO-related EU issuer-disclosure regime on an issuer issuing on the secondary market an amount of stock equal to some substantial portion of its already outstanding shares.[1027]

The rest of this chapter is organised as follows:

Section II examines to what extent the content, level and format of disclosure should be the same on primary and on secondary markets. Section III analyses to what

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[1025] *Accord* EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 7 (arguing for a differentiation between issuers in terms of disclosure requirements to make it easier for blue chips to issue new securities).

[1026] See for a similar reasoning in the context of the liability regime, *inter alia*, STÉPHANE ROUSSEAU, et al., *L'environnement législatif québécois au regard du projet d'adoption d'un régime statutaire de responsabilité civile dans le contexte du marché secondaire de valeurs mobilières*, 59 Revue du Barreau 627, (1999)., at 635; DONALD C. LANGEVOORT, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 Law and Contemporary Problems 45, (2000)., at 68.

[1027] See Part III:Chapter II:II.B.2.b (exception to company registration for large issue) and Part III:Chapter II:IV.D.6 (no presumption of causal link) below.

extent the same quality should be required for disclosure at the time of a public offering and after the issue. Section IV discusses whether civil liability should be structured in such a way that possible responsible persons have equally strong incentives to comply with disclosure regulation whether or not the firm is publicly offering equity at the time. Section V concludes.

II. Content, Level and Format of Disclosure

A. Preliminary Remark

The opinion that issuers should disclose the same level of information whether or not they offer securities at the time finds a large echo in the U.S. This is related to the movement over the last 30 years away from a transaction-based system of disclosure regulation toward a system of company registration, where new issues of securities do not require a prospectus to be approved by the US SEC and to be made available to the public as long as all necessary information is already available on the market through on-going disclosure requirements.[1028]

The US system of company registration rests on the premise that the market is "informationally efficient" with respect to the data contained in the disclosure documents of well-established companies.[1029] According to the ECMH, as soon as the dissemination of disclosure further to the first offering document and subsequent periodic reports and *ad hoc* disclosures occurs, the well-established issuer's securities price fully reflects the information as if everyone knows it. Providing investors with information contained in a secondary offering prospectus does not influence the price at which subsequent shares of the same issuer can be sold. In other words, according to the

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[1028] The origins of the company registration concept are to be found in the article by MILTON COHEN, "*Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340, (1966)., at 1341-42 (discussing the overlap of disclosures required under the US Securities Act and the US Securities Exchange Act).

[1029] The US SEC premised its action on the belief that "investors are protected by the market's analysis of information about certain companies which is widely available, both from the Commission's files and other sources, and that such analysis is reflected in the price of the securities offered" (US SEC Securities Act Release No. 6235, 45 Fed. Reg. 63, 693, 63, 698 (1980) reprinted in Fed. Sec. L. Rep. (CCH) Spec. Rep. No. 875, second extra ed., at 28 (10 Sept. 1980)). See also US SEC Release No. 33-6499 (1983) para IV (B) (1) ("[the relevant forms] recognise the applicability of the efficient market theory to those companies which provide a steady stream of high quality corporate information to the marketplace and whose information is broadly disseminated", i.e., "well-known seasoned issuers" and "seasoned issuers" (see definitions in note 1013 and accompanying text).

ECMH, for an established issuer whose shares trade in a thick and efficient market, the information contained in the first offering document and subsequent periodic reports and *ad hoc* disclosures is already reflected in the prevailing secondary market price at the time of the new secondary offering. The price of the shares in the new offering is determined primarily by this secondary market price and no supplementary information is useful in that respect.

As preliminary step to the company registration system, the US SEC introduced an *integrated disclosure system*, on the basis of so-called Regulation S-K, by which it integrated the overlapping and sometimes inconsistent disclosure standards under the US Securities Act and the US Securities Exchange Act to permit large issuers to refer to previously-filed information when publicly offering securities.[1030] Under the US regime, periodic reporting is incorporated by reference to the registration statement of the issuer making a public offer.[1031]

[1030] Regulation S-K serves as the basis for coordinating disclosure under both the US Securities Act registration requirements for new offerings and the US Exchange Act periodic disclosure requirements by having the requirements for each incorporate by reference questions set out in a single regulation. See for a description and comments on the integrated disclosure regime in the U.S., *inter alia*, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 136 et seq.; JEFFREY N. GORDON, et al., *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L.Rev. 761, (1985)., at 762 and 810 as well as note 131 and accompanying text.

[1031] A reporting company may incorporate by reference on Form S-3 or S-8, and sometimes on Form S-4 or on Form S-1. Form S-3 (F-3 for foreign issuers) is the short-form registration statement which allows maximum use of incorporations by reference of previously filed US Securities Exchange Act periodic reports (company specific information) and generally does not require information contained in those reports to be reiterated in the prospectus and delivered to investors. It is to be used by companies widely followed by analysts and the financial press, i.e., companies which provide a steady stream of high quality corporate information to the market-place and whose corporate information is broadly disseminated (so-called “well-known seasoned issuers” and “seasoned issuers”). Form S-1, on the other hand, requires full disclosure of both company-specific and transaction-specific information and does not permit incorporation by reference, except under certain circumstances set out in Form S-1, General Instruction VII. It is available to “unseasoned issuers” and “non-reporting issuers”, i.e., companies which have been subject to the US Securities Exchange Act reporting requirements for less than 3 years or not subject at all to them yet. See generally, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007). Note that there is not usually incorporation by reference in reverse, i.e., in the periodic disclosure documents from the US Securities Act registration statement. However, the company may in fact use much of the same disclosure in the periodic reports if there has been a recent US Securities Act registration statement. The company often may use the same material in the periodic reports but usually there is not formal incorporation by reference. US SEC Rule 12b-23 under the US Securities Exchange Act allows for incorporation into an US Securities Exchange Act report if the registrant attaches the material as an exhibit to the US Securities Exchange Act document, which is not overly helpful. The same rule has certain exceptions from the requirement to attach the material as an exhibit.

As part of its company registration system, the US regulator also developed over time an exhaustive *shelf-registration system* permitting large issuers to benefit from short market windows by using a single registration statement which identifies the classes of securities being registered (equity and debt) and the aggregate expected proceeds from all future sales.[1032]

By contrast, the E.U. does not have a well-developed company registration system.[1033] The European securities regulation only contains the basics of a company registration system by allowing some incorporation by reference[1034] and by providing a European-flavoured shelf-registration.[1035]

Given the developments in Part II concluding that the immediate objectives of the EU issuer-disclosure regime on primary and secondary markets are the promotion of market efficiency and corporate governance, the question I address here is whether a move to more "company registration" should be promoted in the E.U. with respect to well-established companies in efficient markets and, if yes, how exactly.

[1032] The shelf-registration system was introduced in the U.S. in 1983, and further amended essentially in 1993 and 2005. US SEC Rule 415 under the Securities Act permits, for offerings eligible to be registered on Form S-3 (large US issuers) or Form F-3 (large foreign issuers) and for traditional shelf-offerings, i.e., where the time of actual sale could not be known at the time of filing, a single registration statement which identifies the classes of securities being registered (equity and debt) and the aggregate expected proceeds from all sales. The 2005 US Securities Act reform introduced even easier access to the capital markets via shelf-registrations for a new category of large issuers, i.e., well-known seasoned issuers, allowing automatic effectiveness of shelf-registrations filed by such issuers for unspecified amounts of securities of different types of securities without any US SEC review. Updates to a registration statement are necessary every three years only and issuers pay as needed for takedowns (so-called automatic shelf-registration). See generally, Louis Loss, Joel Seligman and Troy Paredes, Securities Regulation, at 550 (4th ed. 2006); JOHN C. COFFEE, Enhancing Investor Protection and the Regulation of Securities Markets (2009).

[1033] See for a comparison between the European and the US systems, JEFFREY OAKES, et al., *Capital Raising: a Transatlantic Perspective*, Capital Market Law Journal, (2009).

[1034] See article 11 of the Prospectus Directive and article 28 of the Prospectus Regulation.

[1035] See articles 5.3 and 9.4 of the Prospectus Directive (providing for prospectuses consisting of a registration document, "which shall contain the information relating to the issuer", and which shall be valid for up to 12 months, provided that it has been properly updated, a securities note, which "shall contain the information concerning the securities", and a summary). See the amendment suggested by the European Commission in EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). (suggesting extending the validity of the registration document to 24 months).

B. Content of Disclosure

1. European integrated disclosure system

The information required to be disclosed at the time of a public offering and at any time thereafter should be aligned to be virtually identical. However, each of the Prospectus Directive and the Transparency Directive has its own requirements and its own definitions with little standardisation. There is no full co-ordination between the two directives with respect to the content of documents approved or filed with the competent supervisory authority. This causes practical problems, costly overlaps, duplicative and inconsistent disclosures.[1036]

I suggest to introduce in the E.U. a well-functioning integrated disclosure system, i.e., a system that applies similar disclosure requirements to offering documents and subsequent disclosure. This integrated disclosure is the necessary prerequisite of a company registration system.

For instance, the content requirements for the management report in the annual financial report should be as onerous as those relating to an operating and financial review (hereafter OFR) which must be included in a prospectus for a share offering. The

[1036] For a critic of the lack of a coherent regime under the FSAP directives, including the Prospectus Directive, the Transparency Directive and the MAD, see the works of the Financial Markets Law Committee. See also the call of the International Bar Association to streamline the current version of the Prospectus Regulation to reconsider for instance the requirement that financial information that is not prepared on an on-going basis by a listed issuer be included in a prospectus according to the Prospectus Regulation. See also in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010)., the opinion of the committee on legal affairs, estimating that the suppression of the rules which entail double transparency obligations would lead to cost reductions for companies of €30 million per year. See also ROBERTA S. KARMEL, *Reform of Public Company Disclosure in Europe*, 26 University of Pennsylvania JIEL 393, (2005). (noting that the E.U. has repeated the mistake made by the US SEC in not adopting a fully integrated regime at the outset of the federal securities regulation programme. This mistake has necessitated a series of reforms in the U.S.). Comp. with the U.S., and the missed opportunity of the US SEC to move to an extensive company registration system, with the abandonment of the regulatory modifications further to the Wallman Report which explored what an extensive company registration system would look like and recommended a voluntary pilot program. See US SEC, Report of the Advisory Committee on the Capital Formation and Regulatory Processes, Fed. Sec. L. Rep. (CCH) No. 1726; the SEC's initial response, in November 1998, in the "Aircraft Carrier" proposal; and US SEC Release No. 33-7606 (Nov. 3, 1998) which was then abandoned.

OFR can be compared to the management discussion and analysis of financial condition and results of operations (hereafter MD&A) required by regulation of the US SEC for publicly traded US companies.[1037] The present situation where the information required under the Transparency Directive is less demanding than the information required under the Prospectus Directive with respect to, respectively, the management report and the OFR, does not make sense if one considers that the objectives of the management report are the same as the objectives of the OFR. Moreover, this is not convenient as companies under the current system usually use annual financial reports as basis for any subsequent share offering prospectus. It requires companies to add to disclosures used in management reports when planning a share offering, except to the extent they voluntarily put a more comprehensive management report into their annual financial reports and except to the extent Member States have imposed super-equivalent requirements for a management report. Besides, periodic reporting required by the Transparency Directive under the current regime lags behind the standard required for international securities offerings and European share offerings.

I suggest the enactment of an entirely new regulation for disclosure of issuers listed on a regulated market whose equity securities are heavily traded (hereafter the European Regulation). It could be something similar to US Regulation S-K, which, as already said, prescribes a single standard set of instructions for filing forms under the US Securities Act and the US Securities Exchange Act.[1038]

Annex I (Minimum Disclosure Requirements for the Share Registration Document) and Annex III (Minimum Disclosure Requirements for the Share Securities Note) to the Prospectus Regulation as well as the disclosure requirements under the

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[1037] Comp. article 4.2(b) of the Transparency Directive and article 46 of the Fourth Company Law Directive or, for companies required to prepare consolidated accounts, article 36 of the Seventh Company Law Directive (content of the management report of the annual financial report) with, on the one hand Item 9 of Annex 1 to the Prospectus Regulation (OFR) and, on the other hand, Regulation S-K, Item 303 of the US SEC (MD&A). The US MD&A report requires extensive discussion of "known trends or uncertainties" that might have a favorable or unfavorable impact on future financial performance. US regulation also encourages (but does not require) the preparation of forward-looking financial projections under the auspices of a safe-harbour rule designed to protect against law suits (see Rule 175 and Section 27 A of US Securities Act; Section 21E of US Securities Exchange Act). For another example, comp. Item 19 of Annex I to the Prospectus Regulation (related parties transaction in a share offering prospectus) with article 5.4 of the Transparency Directive and article 4 of the Transparency Implementing Directive dealing with related parties transactions to be disclosed in the interim management report.

[1038] See note 1031 above and accompanying text.

Transparency Directive, the Transparency Implementing Directive, the Fourth and the Seventh Company Law Directives to the extent concerned by periodic reports, and the disclosure requirements under the MAD, to the extent concerned by disclosure of inside information,[1039] should be considered for purposes of the European Regulation.

The European Regulation should at a minimum provide the information relating to a public offering and any time thereafter, i.e., continuing disclosure.

The European regulator could go one step further than US Regulation S-K and provide all disclosure-related matters relating to a public offering or any time thereafter, like dissemination, including the use of an issuer's web-site, storage, language, including the more general use of English, and liability issues, while Regulation S-K only deals with disclosure.[1040]

The European Regulation should, in those respects only, replace what is currently provided under the above-mentioned regulations.

The European Regulation would allow for the obvious advantage of consistency among the various disclosure rules.[1041]

2. *European company registration system*

a. Preliminary remark

The system under the Prospectus Directive is a system of regulatory disclosure entirely based on transactions: each new issue requires a new approval procedure of a new offering document.

The system of company registration I envisage requires a well-functioning integrated disclosure system as provided above. It draws on the US experience: it is built on similar assumptions, i.e., it invokes market efficiency as a metric, and offers comparable advantages, as developed below. It does not suggest a US-flavoured shelf-

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[1039] Note that, interestingly, the obligation under article 6(1) of the MAD was originally designed to form part of the Transparency Directive (European Commission, Towards an EU Regime on Transparency Obligations of Issuers Whose Securities are Admitted to Trading on a Regulated Market (the Transparency Report), MARKT/11/.07.2001.

[1040] See US Regulation C for many but not all matters.

[1041] Note that, in case the recommendations provided in this chapter find a positive echo with the European regulator, the changes to existing regulations suggested further to the regulatory implication developed in Chapter Issuer-Disclosure Addressees and Consequences should be adapted to be consistent with this chapter.

registration system as it contends that European financial markets do not justify this system.

b. Features of the European company registration system

Under my scheme of company registration, a large established issuer registers once when it decides to go public for the first time by submitting to the competent supervisory authority a *registration prospectus* for approval. This registration prospectus thus replaces the current prospectus under the Prospectus Directive.

The registration prospectus contains what is required under the European Regulation. It complies with language requirements and is disseminated and stored in the way suggested in Chapter Issuer-Disclosure Addressees and Consequences.[1042]

The registration prospectus is accompanied by a *summary registration prospectus* complying with the suggestions made in Chapter Issuer-Disclosure Addressees and Consequences.[1043] It should be recalled that this summary registration prospectus constitutes the main marketing tool, together with the summary offering prospectus referred to below.

After the IPO, this large, established, publicly traded issuer provides continuing information pursuant to a *duty to update* information contained in the registration prospectus and summary registration prospectus. As further developed below, this consists of complying with current MAD disclosure requirements and the schedule of disclosure to be set out by the European Commission for periodic updates of the registration prospectus with previously disclosed MAD information and information not subject to MAD disclosure, like financial statements and (interim) management report in compliance with applicable regulations, including the Fourth and the Seventh Company Law Directives.[1044] The issuer's web-site has flashing tags drawing market actors' attention to the new postings further to the MAD or to the updating requirement.

[1042] See Part III:Chapter I:III.B in Chapter Issuer-Disclosure Addressees and Consequences.
[1043] See Part III:Chapter I:III.B.2.a in Chapter Issuer-Disclosure Addressees and Consequences.
[1044] See Part III:Chapter II:II.D.1 below.

Market actors are kept informed of the new postings by an opt-in system of electronic communication of new postings.[1045]

Under this suggested scheme, the issuer is able to offer subsequent shares with the only requirement to submit to the competent supervisory authority a *short-form offering prospectus* which allows to incorporate by reference the up-to-date information contained in the registration prospectus. The only information that must actually be set out in full text in the short-form offering prospectus is information relating to the specific issue, including the use of its proceeds, and a description of any material change since the last update of the registration prospectus, including, in particular, the economic and financial position of the issuer and its prospects as seen by management.[1046] Annex III of the Prospectus Regulation could serve as basis (Minimum Disclosure Requirements for the Share Securities Note). The short-form offering prospectus is disseminated and stored in the way suggested in Chapter Issuer-Disclosure Addressees and Consequences.[1047]

To make sure that updated information which consists of incorporation by reference is properly reviewed by the competent supervisory authority without delaying the offering process, the competent supervisory authority reviews the updated information on a regular rotating basis to be further detailed by the European legislator.[1048] This review mainly focusses on the company's accounting practices in addition to the main areas of substantive disclosure, like risk factors, OFR and market risk disclosure. As showed by US experience, this should lead to reduced likelihood of triggering a review when filing a short-form offering prospectus and delaying this short-form offering prospectus being declared effective.

[1045] See for more details, Part III:Chapter II:II.D.2 below.

[1046] Comp. with the US Form S-3 short-form registration, note 1013 and accompanying text.

[1047] See Part III:Chapter I:III.B.4 in Chapter Issuer-Disclosure Addressees and Consequences.

[1048] Comp. with the U.S. where there is also a selective review process by the US SEC. The review focuses on Forms 10-K (annual reports) and sometimes on Forms 10-Q (quarterly reports), on at least a three-year rotating basis. US SEC review criteria are largely non-public. See Section 408 SOx for minimum standards for the review of Exchange Act reports. See generally, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 173.

The approval of the short-form offering prospectus relating to a secondary public offering is not necessary under some circumstances under my scheme:

- no approval at all is required where shares of the same class are offered/issued to existing shareholders by the way of a rights issue.[1049] This rests on the assumption that these investors should be familiar with and confident in the company in which they have already invested, and that the continuous disclosure regime mandated by the MAD means that sufficient information should be publicly available for secondary trading, to which the decision to participate in a rights issue materially resembles. Note that my suggestion, by requiring the short-form offering prospectus, answers some stakeholders' concerns that there be a specific document available containing information on the reasons for and details of the offer;[1050]
- where securities of the same class as the securities already traded are issued, the competent supervisory authority, at its discretion, the arguments of the

[1049] Rights issues are called *Bezugsrechtsangebot* in Germany, *bons de souscription d'actions* or *droit préférentiel de souscription* in France, *offerta in opzione* in Italy, *claim emissie* in the Netherlands, *actions de préférence* in Belgium. See EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 17 (noting that the costs and complexity of preparing a prospectus for a traditional rights issue could be extremely high). See for the costs relating to rights issues, the opinion of the committee on legal affairs in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010). (mentioning that reducing the costs associated with rights issues could lead to an economy of €80million per year).

[1050] Comp., A Report to the Chancellor of the Exchequer: by the Rights Issue Review Group, November 2008 (recommending a shortened prospectus for a rights issue); Joint Response by the UK HM Treasury and the FSA to the European Commission consultation on the review of the Prospectus Directive (same); insertion of article 7.2(g) to the Prospectus Directive, suggested by the European Commission, in EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009).(providing for a "proportionate" disclosure regime for all rights issues and not just, as currently provided, rights issues which are free of charge); EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 16-17 (idem); CENTRE FOR STRATEGY & EVALUATION SERVICES LLP, Framework Contract for Projects relating to Evaluation and Impact Assessment Activities of Directorate General for Internal Market and Services - Study on the Impact of the Prospectus Regime on EU Financial Markets - Final Report (June 2008)., at 34, with the opinion of the European Parliament, in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010). (suggesting to fully exempt rights issues from the obligation to publish a prospectus "as information is available to already existing shareholders").

issuer being heard, determines whether or not it subjects the short-form offering prospectus to any approval procedure, provided that the period for approval, if any, is kept to a minimum to allow issuers to benefit from market conditions as much as possible.[1051] Approval could be necessary where the competent supervisory authority has not made a check of the last updated information contained in the registration prospectus;

- the approval procedure is systematic only where securities other than the ones already listed are issued.

An exception to the suggested scheme of company registration should be provided for "large issues". Large issues could for instance be issues in the range of at least 30% or 40% of the outstanding shares. The issuer should in that case be treated in the same fashion as in an IPO for two reasons. First, an offering of this scale is likely to be accompanying a transformative event in the history of the firm and so the fact that the secondary market price prior to the offering was efficient provides much less assurance that the offering price will be efficient. Second, like for an IPO, significant marketing efforts will be needed to find new persons willing to hold the many new shares being offered and so, again, an efficient secondary market in the issuer's shares provides less assurance that the offering price is efficient. Therefore, an extensive prospectus with due approval might make sense in that circumstance.[1052]

The short-form offering prospectus is accompanied by a *summary offering prospectus*, for marketing purposes, which is disseminated in accordance with the suggestions in Chapter Issuer-Disclosure Addressees and Consequences.[1053] It consists of the up-to-date summary registration prospectus and additional information, specific to the issue.

[1051] Comp. with the US system of shelf-registration (see note 1033 above and accompanying text). See MERRITT B. FOX, *Rethinking Disclosure Liability in the Modern Era* 75 Wash. U. L. Rev. 903, (1997)., at 905 (observing that the US system is close to a fully-fledged company registration system with respect to large issuers where there would be no need to register the securities themselves ("[t]he step from less onerous registration to no registration is not a large one")).

[1052] See in the US context, MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at note 97 (providing for a similar exception in his suggested scheme).

[1053] See Part III:Chapter I:III.B.4 in Chapter Issuer-Disclosure Addressees and Consequences.

c. Advantages

Under my scheme of company registration, where information is adequately disseminated to the market-place and to investors through disclosure subsequent to the registration prospectus, the European disclosure regime is tailored to scale back the existing issuer-disclosure requirements to the extent that only a short-form offering prospectus is required for further issues, except for large issues.[1054]

It means that secondary public offerings issuers are not any longer burdened with time-consuming requirements that provide no significant added-value in the flow of information to investors.

It also means that competent supervisory authorities do not anymore have to approve, where they have to approve at all, lengthy documents for secondary public offerings where it is not necessary from a market's perspective. This is especially important where there is a pricing-risk associated with an extended time-scale for approval of the relevant documents.

d. No US-flavoured shelf-registration

The current European limited form of shelf-registration is what was left after negotiations following the first draft Prospectus Directive which incorporated a more ambitious shelf-registration system. Some Member States opposed a system along the US lines because they thought it would not be costs effective as only a minority of issuers would benefit from it. Besides, the US regime itself is not exempt of criticisms.[1055]

However, once the methodology of integrated disclosure is perfected, the delayed offering contemplated by shelf-registration becomes increasingly feasible. Indeed, the registration prospectus no longer goes stale to the extent it is updated with information of the kind included in the current periodic reports and *ad hoc* disclosure thus keeping the registration prospectus current.

[1054] This does not mean however that disclosure requirements are scaled back across the board as, given the developments I made in connection with an integrated disclosure system, periodic disclosure could become more demanding under my scheme than is currently the case.

[1055] See JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 146 et seq.

This being said, the European-flavoured shelf-registration regime is not often used for equity offerings compared to a prospectus consisting of one single document. It seems to be mostly useful for debt offerings. There seems to be a need for equity offerings for a glossy document as marketing tool and a perception that a single document manages the presentation better for equity issues.

More importantly, it seems that the European equity markets present different characteristics than the U.S.[1056] Equity offerings are not very frequent because of the disclosure obligations associated with equity which are arguably onerous where compared to debt issues. Besides, large equity offerings like the ones in the U.S. are not necessarily possible in the E.U. This is because companies do not generally have substantial amounts of authorised capital available and lack the general ability to proceed with an open (i.e., non-pre-emptive) offer without obtaining shareholder approval.[1057] Or because they are subject to pre-emptive rights further to European regulations.

Consequently, I do not suggest here a move to a US-flavoured shelf-registration system although it might make sense from a theoretical perspective relying on the ECMH.

C. Level of Disclosure

1. A difficult issue that calls for flexibility

The question of the optimal level of disclosure to be imposed by the regulator is a crucial one as there is no such thing as a free lunch. In other words, mandated disclosure entails costs: there are heavy drawbacks if the regulator requires a level of disclosure which is too high or too low.

From the demand side, if not enough information is required, investors will not be in a position to make informed investment decisions. Besides, market efficiency and

[1056] *Accord* the Rights Issue Review Group appointed by the UK Treasury and its reports (RIRG Report, November 2008).

[1057] Comp. with the U.S., NYSE and Nasdaq rules regarding the exceptions to shareholders' approval prior to the issuance of common stock.

corporate governance will not be enhanced. Whereas if too much information is required, there is a risk of information over-load with the consequence of bad investment decisions and less or poorer monitoring of management.[1058] By requiring an increased amount of disclosure, "[i]nvestors may be drowning in information while starving for knowledge".[1059]

From the supply side, it should be stressed that there is no private right to information in securities regulation.[1060] Issuer-disclosure is not a general principle of law. There could be justifiable (economic) reasons for issuers to withhold information from investors.[1061] If too much information is required, it imposes an unnecessary

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[1058] See generally TROY A. PAREDES, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L. Quarterly 417, (2003). See also US courts which recognised a "buried facts" doctrine under which information buried together with other information is not considered disclosed to investors or is considered to be false and misleading if its overall significance is obscured because material information is buried in a footnote or an appendix. See, *inter alia*, Kohn v. American Metal Climax Inc., 322 F. Supp. 1331, 1362 (E.D. Pa. 1970). For a European academic discussing information over-load, see NIAMH MOLONEY, EC Securities Regulation (Oxford University Press. 2002)., at 194 et seq. (commenting the previous European prospectus regulations and warning against overwhelming disclosure).

[1059] Adapting a 1930s Financial Reporting Model to the 21st Century: Hearing before the Subcomm. On Securities of the Comm. On Banking, Housing and Urban Affairs, 106th Cong., 2nd Sess., 2000.

[1060] See in that respect, recital (25) and article 8.2(b) of the Prospectus Directive (providing the possibility for sensitive information to be kept secret).

[1061] Comp. with the U.S., where, under the federal securities laws, companies have no general duty to disclose material corporate developments or other material inside information. There is no open-ended duty to disclose material information under the US SEC regulations, although the exceptions often swallow the rule. In other words, information can be held confidential, without the issuer having a duty to give an affirmative reason not to disclose, unless there is a rule or other duty which requires it to be disclosed. However, there has been a substantial extension of issues to be disclosed under the "current reports" (to be used for major new developments, on Form 8-K) (see Rel. No. 33-8089, 67 Fed. Reg. 19896 (April 12, 2002)) which led one observer to say that "adding substantially to the "8-K" list of immediately reportable events" is "a back-door way of getting roughly to the same point", i.e., real-time disclosure system (see DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003).). See also the stock exchange rules which are another source of a duty to disclose. Besides, the general rule of non-disclosure has not gone unchallenged. At least one court has implicitly recognised that corporations have an affirmative duty to disclose material, inside information. See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 519 (10th Cir.) ("[i]t is... obvious that an undue delay not in good faith, in revealing facts, can be deceptive, misleading, or a device to defraud under Rule l0b-5."), *cert denied*, 414 U.S. 874 (1973); see also SEC v. Texas Gulf Sulphur Co., 401 F.2d at 857 (management members have a duty to disclose material information before accepting a stock option); Issen v. GSC Enters., 538 F. Supp. 745, 751 (N.D. Ill. 1982) (general duty to disclose material information in annual report). Similarly, academics have argued that companies should be required to disclose all material facts. See JEFFREY D. BAUMAN, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 Geo. L.J. 935, (1979)., at 937; MILTON COHEN, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340, (1966)., at 1366; see also MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009)., at 55 (suggesting to add a further disclosure requirement: any time that an issuer offers to sell a substantial number of additional securities, it needs to disclose any material changes since its last annual report that are not disclosed in a subsequent quarterly or current report).

burden on issuers with associated costs, including loss of competitive position, and related negative consequences on the promotion of capital markets as a source of finance[1062] and on the economy as a whole. Whereas if too little information is mandated, there is a risk of inefficient resource allocation.

The question of the *mandated optimal level of disclosure* therefore involves a trade-off between investors' interests and issuers' interests.

And the perspective of the regulator should also be taken into account. On the one hand, mandatory regimes are costly to design, implement and enforce from public resources' standpoint. In addition, they present a risk of regulatory capture by those the regulator tries to regulate[1063] or by other interest groups lobbying for a more disclosure-based regime, such as lawyers, because that would increase their own profits. The regulator should therefore be very careful. On the other hand, and as already stated, they provide advantages in terms of standardisation and financial markets' integration that take a special importance in the European context where the ultimate goal is to have a single financial market.[1064]

Once again, this implies a trade-off.

The optimal level of disclosure should be one at which marginal benefits equal marginal costs. To settle the issue of the desirability of a mandatory disclosure provision, one needs to balance the benefits of a higher degree of achievement of objectives, i.e., effectiveness, and the costs that may go with this pursuit, i.e., efficiency.

This costs-benefits analysis is no easy exercise in the area of regulation.[1065] Besides, there are different optimal levels of disclosure depending on the issuer and the beneficiary.

Given the advantages of mandatory disclosure[1066] and the costs likely to be associated with any tier-disclosure regime,[1067] on the one hand, but given the difficulties

[1062] See note 17 above and accompanying text.

[1063] See on regulatory capture, GEORGE J. STIGLER, *The Theory of Economic Regulation*, 2 Bell Journal of Economics 3, (1971). (incumbent firms have an incentive to capture the regulatory process, and for instance to implement a system that inhibits, rather than promotes, competition, which in turn can create substantial indirect costs).

[1064] See Part I:VII.C in General Introduction.

[1065] See Part I:IV in General Introduction.

[1066] See Part I:VII in General Introduction.

to set in a common regulation a level of disclosure which would be optimal for each and every issuer and addressee,[1068] on the other hand, I suggest to keep a single European regulation to provide for the mandatory content of disclosure requirements, while pleading at the same time for some flexibility. This flexibility is lacking in the current version of the Prospectus Directive and the Transparency Directive.[1069] This flexibility could be reflected in a provision requiring competent supervisory authorities to take into account the specificities of the issuer when reviewing the documents submitted for their approval and to draft clear guidance in that respect to avoid legal uncertainty for issuers. In addition, the possibility for the arguments of the issuer to be heard should be provided for to work for issuer's protection.

2. *Considerations for supervisory authorities to assess the level of disclosure to be required*

The question of the optimal level of disclosure needs to be resolved with all objectives of the EU issuer-disclosure regime in mind as cutting back on a disclosure requirement might benefit one goal while harming the other.[1070] In that respect, one should recall the hierarchy among objectives set out in Part II, where it was suggested that retail investor

[1067] It should be noted that most issuers concerned by the EU issuer-disclosure regime do share the same specificities in terms of ownership and financing structure, level of development and activities. See 0 below. Besides, it should be recalled that I suggest to address the EU issuer-disclosure regime to more sophisticated actors only.

[1068] On the inadequacy of a one-size-fits-all approach in disclosure, see ROBERTA ROMANO, *The Need for Competition in International Securities Regulation*, 2 Theoretical Inquiry L. 387, (2001).; STEPHEN H. HABER, et al., On the Importance to Economic Success of Property Rights in Finance and Innovation (2008).; PAUL M. HEALY, et al., *Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature*, Journal of Accounting and Economics 405, (2001). See also Part II:Chapter III:II.B.3 in Chapter Corporate Governance.

[1069] See the limited and useless flexibility provided under article 7.2(e) of the Prospectus Directive (providing that account shall be taken by the European regulator in its drafting of the implementing regulation to the Prospectus Directive of the activities and the size of the issuer) and article 23.1, alinea 1 of the Prospectus Regulation (providing for the possibility to require additional information with respect to start-up companies). Comp. with EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009). and EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010).

[1070] *Accord* TROY A. PAREDES, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 Wash. U. L. Quarterly 417, (2003)., at 463.

protection is best achieved once corporate governance and market efficiency are promoted.

Besides, the optimal level of mandated disclosure must be assessed in light of the other market mechanisms which serve as independent sources of information on issuers, including, for instance, analysts reports.[1071] In other words, the level of development of capital markets needs to be considered as information might already be impounded into price through other information means. This pleads in favour of a less extensive disclosure regime for well-established issuers, as they are well followed by analysts and the financial media for instance.

In addition, each ownership structure and thereto related corporate governance arrangement calls for a different optimal level of disclosure.[1072] Some information is more important to provide where ownership is dispersed than where it is concentrated and one might count on the controlling shareholder to perform the necessary monitoring of management. For instance, directors' trades in firms with outside blockholders who monitor the firm may have relatively less informational value than directors' trades in widely held firms which may suffer from higher informational asymmetry. On the other hand, intra-shareholders' agreements should be disclosed with more details in a company with a dominant shareholder than in companies with fragmented shareholders where no shareholder would have the necessary influence to impact the content of the agreement to the detriment of other shareholders.

Moreover, the optimal level of disclosure to be mandated from a particular issuer also depends on its financing structure. In bank-oriented systems, information generation depends on its remaining internal to a limited number of recipients, whereas

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[1071] See in that respect the debate on the ban of insider trading. For an overview of the debate and related references, see, *inter alia*, NIAMH MOLONEY, EC Securities Regulation (Oxford University Press Second ed. 2008).; RENE M. STULZ, Securities Laws, Disclosure, and National Capital Markets in the Age of Financial Globalization (2008).; JONATHAN R. MACEY, Corporate Governance - Promises Kept, Promises Broken (Princeton University Press. 2008)., at 165 et seq. See also ZOHAR GOSHEN, et al., *The Essential Role of Securities Regulation*, 55 Duke L. J. 711, (2006). (for a view that the ban on insider trading shields "information traders" from competition by insiders and hence allows them to recoup their investment in information).

[1072] See Part II:Chapter III:II.B.3 in Chapter Corporate Governance.

in market-oriented systems information is externalised through stock prices. Hence, issuer-disclosure is less likely to be beneficial in terms of access to external finance for firms in bank-oriented systems, as it would reduce lenders' informational advantage and make them less attractive to depositors, leading to loans becoming more expensive without certainty about corresponding decreases in the cost of bonds or equity. Conversely, issuer-disclosure is less likely to be costly for investors in market-oriented systems than for controlling shareholders in bank-oriented systems, the latter generally requiring the benefit of private information as remuneration for their more demanding monitoring role.

Issuer's optimal level of disclosure may vary as well depending on its activities: new-tech companies require more confidentiality whereas it is arguably less costly for companies in more mature industries to disclose information. It may also depend on its stage of development: start-up companies require more secrecy whereas it is arguably less costly for well-established firms to disclose information. It may as well depend on its size: small and medium-sized companies arguably face heavier disclosure costs than large companies.

Lastly, it should be noted that the optimal level of disclosure should not be studied in isolation: rules need complementary enforcement to be effective. The desirability and effectiveness of particular disclosure rules depend also on the chosen enforcement mechanism, which highlights an important complementarity in the institutional framework. More generally, the company law and business practices, the so-called "internal decision structures",[1073] need to be taken into account. Thorough enforcement of the EU issuer-disclosure regime is as important as tightening up disclosure requirements.[1074]

I could have added that the level of disclosure also depends on the nature of the investors, as institutional investors are more likely to fend for themselves than retail investors, who would arguably have a greater need for disclosure, provided they are

[1073] MERRITT B. FOX, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities* 97 Michigan Law Review 696, (1998).

[1074] See Part III:Chapter I:III.E.3 in Chapter Issuer-Disclosure Addressees and Consequences.

sophisticated enough to understand it and act on the basis of it. However, given my suggestion above to address issuer-disclosure to more sophisticated actors, I do not consider this argument to be any longer relevant.

3. An assessment of the difference in the level mandated by the US securities regulation and the EU issuer-disclosure regime

I showed in Part II that disclosure has similar merits in the European context as in the US one.

This being said, different internal decision-making structures and external environment of issuers call for different optimal levels of disclosure to align controlling party's and (other) shareholders' interests and in assuring the best choice of real investment projects.[1075]

The U.S. are market- and retail-oriented.[1076] Besides, the conflicts of interest in US companies are more likely to arise between management and shareholders and are difficult to detect. For these reasons, information seems at first sight to bear particular importance in the U.S.

In contrast, there is a widespread belief that concentrated ownership structures require a lower level of disclosure - less content - because of the capability of the controlling shareholder to monitor management.[1077] Some argue as well that in countries where bank finance is more important, like in Continental Europe, public disclosure might be less important because banks have access to non-public

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[1075] See Part II:Chapter III:II.B.3 in Chapter Corporate Governance.

[1076] According to data from Morgan Stanley, Deutsche Bank, Barclays Capital, in 2004, in the U.S., USD17.8 billion were generated in equity, USD80.4 billion in bonds, USD105.9 billion in loans (hence, 48% of financing was provided by the markets).

[1077] See MERRITT B. FOX, *Required Disclosure and Corporate Governance*, 62 Law and Contemporary Problems 113, (1999)., at 125; MERRITT B. FOX, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335, (1999)., at 1406-1407; JOHN C. COFFEE, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757, (2002).

information.[1078] Lastly, it is argued that Continental European firms could bypass public markets and use private equity financing from institutional investors.[1079]

This leads some academics to conclude that the higher level of disclosure in the U.S. compared to the E.U. is justified.[1080]

I am of the opinion that this discussion of an allegedly justified higher level of disclosure in the U.S. compared to the E.U. should be conceived in the broader context of global regulatory convergence of disclosure requirements which would nuance any conclusion that big differences will remain.

D. Format of Disclosure

1. No more periodic reports but a periodic update of the registration prospectus

The market volume of secondary trading dwarfs the volume of primary market offerings.[1081]

In that context, disclosure of information to the markets on an on-going basis is crucial after a security has been listed. Disclosure of material events on an *ad hoc* basis alone is not sufficient for investors to be able to make investment decisions as, among

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1078 See MARCO BECHT, et al., *Corporate Law and Governance*, *in* Handbook of Law and Economics - II, (A. Mitchell Polinsky, et al. eds., 2007)., at 893 and references therein cited.

1079 See the numerous studies in connection with the pros and cons of private equity, including, Mike Wright, Andrew Burrows, Rod Ball, Louise Scholes, Miguel Meuleman and Kevin Amess, The Implications of Alternative Investment Vehicles for Corporate Governance: A Survey of Empirical Research – A report prepared for the Steering Group on Corporate Governance, 2007. See also the web-site of CMBOR, as centre specialised in private equity.

1080 See REINIER H. KRAAKMAN, *Disclosure and Corporate Governance: An Overview Essay*, *in* Reforming Company Law and Takeover Law in Europe, (Guido A. Ferrarini ed., 2004)., at 110 (arguing that issuer-disclosure is even more important in fragmented ownership structure where it can play an educative and a regulatory role in addition to the enforcement role it plays in a concentrated ownership structure: “[o]wnership structure is [therefore] important for specifying the character of the benefits of mandatory disclosure”); DONALD C. LANGEVOORT, *US Securities Regulations and Global Competition,* 3 Virginia Law & Business Review, (2008). (arguing that US securities regulation is different than European securities regulation because it has tried to promote the interests of retail investors (retail-driven approach) whereas regulation elsewhere has been built for institutional investors better able to fend for themselves and therefore has a lighter touch).

1081 According to Goldman Sachs, in 2003, proceeds from new issuances represented USD46.1 billion on a market of USD388 billion (i.e., a market share of 11.9%) whereas, according to Morgan Stanley, in 2004, proceeds from new issuances represented USD54.2 billion on a market of USD505 billion (i.e., a market share of 10.7%).

other things, they would lack a tool which would *aggregate information* and which would *make comparisons easier*.[1082]

But are periodic reports the right tools to meet the objectives of on-going information?

As a reminder, periodic reports include annual financial reports, half-yearly financial reports and interim management statements as provided by the Transparency Directive and the Fourth and Seventh Company Law Directives.

Annual financial reports are made out of the audited financial statements, the management report and the management certification.[1083] The annual report must also include a corporate governance statement which must contain, *inter alia*, a description of the main features of the company's internal control and risk management systems. But this is only in relation to the financial reporting process.[1084] Companies may also, where relevant, provide an analysis of environmental and social aspects necessary for an understanding of the company's development, performance and position.[1085] Any stronger requirement to report on non-financial matters was excluded.[1086] This being said, some Member States have been more ambitious in that respect and impose environmental and social reporting on listed issuers.[1087]

[1082] See in recognition of the importance of on-going disclosure, IOSCO, Principles for Periodic Disclosure by Listed Entities, July 09.

[1083] For the concept of management certification, see Part III:Chapter II:III.C.1 below.

[1084] See article 46(a)1(c) of the Fourth Company Law Directive and article 36.2(f) of the Seventh Company Law Directive.

[1085] See the wording of article 46(1)b of the Fouth Company Law Directive and article 36(1), alinea 2 of the Seventh Company Law Directive (providing that the review of the development and performance of the business and of the position of the company/undertakings included in the consolidation taken as a whole, shall include, to the extent necessary for an understanding of the development, performance or position, both financial and, "where appropriate," non-financial key performance indicators relevant to the particular business, "including information relating to environmental and employee matters"). See the Belgian transposition under article 96 of the Belgian company code.

[1086] See the last revision of the Fourth and Seventh Company Law Directives, directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending, *inter alia*, the Fourth Company Law Directive and the Seventh Company Law Directive, OJ L 224, 16 August 2006, recital (10), at 1. ("[f]urthermore, where relevant, companies may also provide an analysis of environmental and social aspects necessary for an understanding of the company's development, performance and position.").

[1087] See, for instance, article L225-102-1 of the French commercial code, introduced by article 116 of the French law on new economic regulations (*loi sur les nouvelles régulations économiques*, otherwise referred to as the *loi NRE*), as modified (see also for further details on the non-financial information to be provided, *inter alia*, Decree nr 2002-221 of 20 February 2002 (setting out the social information and the

Half-yearly financial reports are made out of condensed set of financial statements, interim management report and management certification.

And interim management statements are made out of an explanation of material events and transactions that have taken place during the relevant period; their impact on the financial position of the issuer and its controlled undertakings; and a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period.[1088]

According to the ECMH, information disclosed further to the MAD immediately gets impounded into price. To the extent information contained in the periodic reports currently provided under the Transparency Directive is disseminated after a MAD disclosure of the same information, this information is outdated on the day periodic reports are disseminated. This casts serious doubts on the extent of the usefulness of periodic reports in the investment decision-making process.

I suggest to *suppress the separate drafting, dissemination and storage of periodic reports*.

I suggest instead a *periodic update of the registration prospectus*.[1089]

It would reduce issuer's costs by avoiding the separate drafting (and dissemination, as the case may be) of periodic reports while at the same time increasing the possibilities for investors to make useful comparisons to take informed investment/trading decisions.

In sum, under my suggested scheme, the great majority of disclosure documents further to the EU issuer-disclosure regime are replaced with a single-document-driven disclosure regime subject to mandatory updating according to a schedule defined by the European regulator, next to MAD immediate disclosure requirements.[1090]

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information relating to the consequences of the activity of the company on the environment that should be contained in the annual report)).

[1088] Comp. with the U.S., where there is a requirement to file annual reports (on Form 10-K), quarterly reports (on Form 10-Q) as well as "current reports" (for major new developments, on Form 8-K).

[1089] See Part III:Chapter II:II.D.2 below.

[1090] For similar opinions in the US context, see JOSEPH A. GRUNDFEST, et al., Reinventing the Securities Disclosure Regime: Online Questionnaires as Substitutes for Form-Based Filings (2008).;

It should be noted that my suggestion does not impact the national law requirements relating to the drafting, audition, approval, filing and publication of (yearly, condensed or quarterly) financial statements. Financial statements are indeed subject to different regulations.[1091] My scheme does not impact either the national law provisions related to the drafting, approval, filing and publication of (interim) management reports.[1092]

It should be noted further that the summary registration prospectus and the summary offering prospectus become the main marketing tools under my scheme, replacing in that respect periodic reports, to the extent periodic reports could have been considered as marketing tools.

2. The suggested single-document-driven disclosure regime in practice

Under my scheme, the registration prospectus is the base disclosure document, together with any supplement thereto.

The other disclosure documents that are required to be separately drafted are:

- the summary registration prospectus, for marketing purposes,
- the short-form offering prospectus, together with any supplement thereto,
- the summary offering prospectus, for marketing purposes,
- any disclosure further to the MAD,
- (interim) management report,

JANIS SARRA, *Disclosure as a Public Policy Instrument in Global Capital Markets*, 42 Tex. Int'l L. J. 875, (2007).; DONALD LANGEVOORT, *Toward More Efficient Risk Disclosure for Technology- Enhanced Investing*, 75 Wash. U.L.Q. 753, (1997). (recommending abolishing the concept of the annual reports (on Forms 10-K) and quarterly reports (on Forms 10-Q) and instead implementing a "unitary company registration file" containing "all the material currently required under Reg. S-K [including financial statements, management compensation and conflict and pending litigation] plus" MD&A); for an earlier expression, see DONALD C. LANGEVOORT, *Information Technology and the Structure of Securities Regulation*, 96 Harv. L. Rev. 747, (1985). (arguing for strengthening of real time disclosure (urging the movement away from the 10K-10Q periodic reporting regime in favour of a continuous duty to update the issuer's electronic EDGAR file albeit with appropriate, well-defined non-disclosure privileges for sensitive information and a specific timetable for when certain kinds of hard-to-gather data needs to be refreshed).

[1091] See, *inter alia*, the Fourth and Seventh Company Law Directives in that respect.

[1092] See, *inter alia*, the Fourth and Seventh Company Law Directives as well as the Transparency Directive in that respect.

- (condensed set of) financial statements.[1093]

Once the registration prospectus is initially placed on the issuer's web-site, the issuer is required to update those items that have materially changed since the last reporting period and/or that have been subject to a MAD disclosure and/or a requirement to provide a supplement. In addition, it is required to replace the (interim) management report and the (condensed set of) financial statements with the latest version.

In so doing, and in addition to the requirements under the MAD and those relating to supplements, the issuer must comply with the specific timetable relating to the updating of data set out in the European Regulation and according to which information in the registration prospectus corresponding to current annual financial reports requirements are to be annually updated whereas information in the registration prospectus corresponding to current half-yearly financial reports requirements are to be updated half-yearly and information corresponding to interim management statements are to be updated on a quarterly basis. The OFR is to be updated on a continuous basis.[1094]

The system needs to automatically focus attention of the users on changes from prior disclosures. If the company's business does not change as of the next date on which an update is required, then no additional information is necessary: the system simply carries forward the prior disclosure with an automatically generated notation that there is no change from a prior update. If a change occurs, then the issuer amends its prior disclosures. Changes or amendments to already published materials are to be easily recognisable. The system automatically notes the fact that a change has occurred and various software tools are to be applied to highlight text that has been dropped from or added to the disclosure, like track changes.

The system is to be engineered so as to allow efficient identification of changed information. Audit trails must allow easy identification of the date and content of any

[1093] Note that I do not mention management certifications as I suggest their suppression under Part III:Chapter II:III.C.1 below.

[1094] See in the US context, with respect to MD&A (which the author would restyle into a "risk discussion and analysis"), DONALD C. LANGEVOORT, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, Vill. L.Rev. 1139, (2003)., at 20.

modification, thereby allowing users to reconstruct easily any issuer's disclosure history as well as to trace any disclosure item.

To avoid the temptation of an issuer to make cosmetic changes, the European Regulation must require disclosure in a form that minimises the amount of altered text, thereby making it even easier to track and understand the changes and updates.

There is an opt-in system where those who have disclosed their e-mail address to the issuer receive notice that new information has been posted with the appropriate web-link.[1095] The e-mail specifies whether the update is made pursuant to a requirement to make public any price sensitive information, i.e., information to be made public pursuant to the existing MAD provisions, or pursuant to a requirement to update the registration prospectus according to the schedule set out by the European Regulation, including the requirement of supplements. This allows investors to determine the importance of the update and when they should review it.

III. Quality of Disclosure

A. Preliminary Remark

Disclosure documents can serve as instruments to improve market efficiency and corporate governance only provided that they accurately reflect the corporate reality and do not mislead investors. What is important is relevant and honest information: what issuers report and how they report it. The quality of the information disclosed is paramount in those two respects.

In order to increase the *relevance* of information disclosed, it could be interesting to assess whether there is a need to introduce in European securities regulation something similar to the US "bespeaks caution doctrine", formalised in 1995 under the Private Securities Litigation Reform Act (hereafter PSLRA).

The bespeaks caution doctrine provides that when forecasts, opinions, or projections in a disclosure statement are accompanied by meaningful warnings and cautionary language, the forward-looking statements may not be misleading. The

[1095] See Part III:Chapter I:III.B.4.d.i in Chapter Issuer-Disclosure Addressees and Consequences.

substantial disclosure of specific risks may render alleged misrepresentations concerning soft information immaterial and thus non-actionable as securities fraud.

This kind of regulation could contribute to promote a more aggressive strategy than disclosure after the facts, focussing instead on disclosure of plans and intentions to engage in certain kinds of activities before they occur as it would shield companies from liability for including forward-looking statements or projections in public disclosures that do not materialise.[1096]

Summarising the evidence in the U.S., it appears that the PSLRA achieved its objective: suits for forward-looking statements have declined, the frequency of forecasting has increased, and the relative accuracy of forecasts has not been adversely affected by the protective safe harbour.[1097]

Given the limited scope of the dissertation, I do not dig further into this subject.

In addition, to promote its relevance, I believe that disclosure should reflect the "enlightened shareholder value" view.[1098] In that respect, and at the very least, I suggest that social and environmental issues be reported to take all constituencies into account to a larger extent than is currently done. Provided that periodic reports are still produced,[1099] the European regulator should choose another concept than "financial reports" to refer to them. This way, the fact that they also include information on corporate social responsibility, including social and environmental issues, would be reflected.[1100]

But this section is mainly concerned by the second aspect of the quality of information, i.e., its *accuracy*.

[1096] See ERICK D. PROHS, *Periodic Financial Reporting - A Relic of the Past?*, 27 The Journal of Corporation Law 481, (2002).

[1097] See, *inter alia*, MARILYN F. JOHNSON, et al., *The impact of the Private Securities Litigation Reform on the Disclosure of Forward Looking Information by High Technology Firms*, 39 Journal of Accounting Research 297, (2001).

[1098] For details of such concept, see Part I:VII.B in General Introduction.

[1099] See Part III:Chapter II:II.D.1 above and the suggestion to suppress them.

[1100] See in that respect, ICGN, ICGN Statement and Guidance on non-financial business reporting, 2008; FRANCESCO DENOZZA, *Nonfinancial Disclosure between "Shareholder Value" and "Socially Responsible Investing"*, *in* Investor Protection in Europe - Corporate Law Making, the MiFID and Beyond, (Francesco Ferrarini, et al. eds., 2006).

Disclosure documents could be biased by the view of the members of management who contributed to write it. Indeed, it is not rare to see that communications from companies aggressively highlight the positive news while playing down the less positive news, burying it in the small print.

Hence there could be a need to verify disclosure before it is released.

With respect to *financial information*, auditors might be required to intervene to check their quality.[1101]

With respect to *non-financial information disclosed in prospectuses*, underwriters have the duty to check their quality. This is expressly provided for by the US Securities Act, which provides for underwriters' liability in that respect in case of misleading or incorrect information unless they can successfully invoke a due diligence defense.[1102] At European level, there is no such legal basis for underwriters' potential liability and due diligence duty. However, given the widespread influence of US practice on international securities offerings, it became common standard to request underwriters' intervention for (non-financial information contained in) a prospectus relating to a primary or secondary public offering. Besides, Member States have developed liability standards through case law or otherwise.[1103]

[1101] See articles 51 and 51a of the Fourth Company Law Directive with respect to annual accounts and annual report; and article 37 of the Seventh Company Law Directive with respect to consolidated accounts and consolidated annual report.

[1102] See sections 11 and 12(a)(2) of the US Securities Act. The term "due diligence" is a term of art derived from the language of section 11 of the US Securities Act precluding liability where the underwriter reasonably believed, after "reasonable investigation", that no violation existed and the language of section 12(a)(2) precluding liability where the underwriter, having exercised "reasonable care," did not or could not have known of the violation. The adequacy of an underwriter's due diligence efforts and, in turn, its ability to establish a due diligence defense is determined by "the standard of reasonableness [that is] required of a prudent man in the management of his own property." (*Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696-98 (S.D.N.Y. 1968)).

[1103] See, for instance, article 212-16 of the General Regulation of the French AMF (referring to a certification to be provided by the underwriters "to the French AMF that they have exercised customary professional diligence and found no inaccuracies or material omissions likely to mislead investors or affect their judgement"); article 94, §9 of Italian Legislative Decree No. 58 of 24 February 1998 (the Italian Financial Services Act), as amended (providing that the intermediary responsible for placement shall be liable for false information or omissions that could influence the reasoned decisions of an investor, unless said intermediary proves that all due diligence was adopted for the purpose of guaranteeing that the information in question complied with the facts and that no information was omitted that could have altered the sense thereof). See also Belgian case law, including the Confederation Life case, Brussels Court of Appeal, 8 March 2002, Droit bancaire et financier, 2002, at 234 (finding no due diligence duty on behalf of the lead manager when preparing a Eurobond issue but a duty to ensure that the level of information communicated in the preparatory phase by the issuer is reliable and sufficient); and the Dutch Supreme Court ruling, VEB et al. v World Online, Goldman Sachs and ABN Amro, 27

With respect to *non-financial information contained in periodic reports*, neither in the U.S., nor in the E.U. is there an equivalent to the quality check provided by the underwriter in the context of a public offering.

The question addressed below is therefore whether there should be a quality check of non-financial periodic disclosure.[1104]

I discuss the US situation and the solution advanced by the US literature. The remaining question is whether it would be *cost-efficient* to have a quality check of non-financial information contained in periodic reports in the European context.

B. The Shortcomings of SOx and the Solution Suggested by US Literature

1. Shortcomings of SOx

What are the existing quality checks of secondary market disclosure provided by US securities regulation?

SOx introduces under section 302 SOx the concept of "disclosure controls and procedures".[1105] These are to be evaluated for "effectiveness" and signed off by the Chief Executive Officer and Chief Financial Officer on a quarterly basis. They cover the disclosure of (not exclusively financial) information required under the periodic reports.

Theoretical and empirical studies have generally confirmed the usefulness of section 302 SOx.[1106]

November 2009, LJN: BH2162 (finding that the lead underwriter (*syndicaatleider*) had a duty of care (*bijzondere zorgplicht*) owed to investors; this decision, although it ends part of the dispute, leaves open the actual discussion about whether damages have been sustained as a result of the unlawful acts that have been established, and if so, what damages can be awarded).

[1104] Note that I still refer to periodic reports, although I suggest their suppression above. This is because I would like that each of my regulatory implications be considered independently by the European Commission, without one triggering all the others. But of course, should the European Commission find sympathy for the suppression of periodic reports, reference to periodic reports here should be understood as reference to periodic updates of the base disclosure document. Note as well that given the time-sensitivity of disclosure of inside information, a quality check along the lines suggested below is not conceivable for disclosure under the MAD.

[1105] See section 302 SOx.

[1106] See ROBERT PRENTICE, *Sarbanes-Oxley: the Evidence regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703, (2007).

Section 302 SOx is complemented by a provision which imposes criminal liability on officers who knowingly certify an inaccurate periodic report.[1107]

It is also complemented by section 404 SOx which requires the issuer to disclose an annual "internal control report" as to the effectiveness of the internal control structure and procedures for financial reporting and its external auditor to "attest to, and report on, the assessment made by the management of the issuer".[1108]

However, as so-called "Rule 10b-5 letters" are only required in connection with a public offering,[1109] what is lacking in the US system is an independent third party review of the effectiveness of the internal control mechanisms relating to non-financial information contained in periodic reports, and more broadly, of non-financial information contained therein.

It could be helpful to have an independent check with regard to non-financial disclosures, like the MD&A, as it cannot be relied on insiders who tend to be subject to "group think" rationalising and may fear adverse consequences when blowing the whistle.[1110]

[1107] See section 906(a) SOx.

[1108] Section 404 SOx has been criticised for the costs it entails. See for a discussion of studies criticising section 404 SOx, ROBERT A. PRENTICE, et al., *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 Geo. L.J. 1843, (2007). For a view defending section 404 SOx, see ROBERT PRENTICE, *Sarbanes-Oxley: the Evidence regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703, (2007).; DONALD C. LANGEVOORT, Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's Duty of Care as Responsibility for Systems (2005).

[1109] Rule 10b-5 disclosure letter (also referred to as a Rule 10b-5 opinion) is a letter from the issuer's counsel addressed to the underwriter by which the lawyer would typically opine that, subject to various stated qualifications, on the basis of certain due diligence procedures, it has no reason to believe that an offering document contains an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Required by underwriters to meet their own due diligence duty under US law, it became common in international securities offerings' practice.

[1110] See sections 301, 806 and 1107 SOx relating to whistle blowing by employees, discussed in, *inter alia*, RICHARD MOBERLY, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, Brigham Young University Law Review, (2006). For a critical analysis of the US whistle blowing regulation, see, *inter alia*, TERRY MOREHEAD DWORKIN, *Sox and Whistle Blowing*, 105 Michigan Law Review 1757, (2007).; I. J. ALEXANDER DYCK, et al., Who Blows the Whistle on Corporate Fraud? (2007). (pointing to the lack of incentives and the inefficiency of protective measures for whistle blowers). Comp. with Member States' legislation on whistle blowing, including, *inter alia*, article 19 of French Act nr. 2007-1598 of 13 November 2007 or UK Public Interest Disclosure Act 1998 (PIDA) or the relevant section of the code of conduct imposed by the Dutch Corporate Governance Code of Dutch listed companies which contains the procedure relating to whistle blowing.

Another justification for the introduction of an independent third party control is that SOx provisions do not provide a basis for civil liability as they can only be enforced by public officials. This justification is however specific to the US context.

2. The concept of the "external certifier"

Given this shortcoming of SOx, Professor Fox suggests to have the annual financial report signed by an "external certifier" to play a similar function as the underwriter under a public offering.[1111]

Important to note is that Professor Fox' proposal is part of a fundamentally re-designed system of civil liability for established issuers on secondary markets. Under Professor Fox' scheme, new, more efficient and more effective incentives for compliance with periodic disclosure requirements would be created, including supervision by an external certifier, with a view to replace underwriters' liability at the time of a secondary public offering and fraud-on-the-market actions based on periodic disclosure violations.

C. The Shortcomings of European Regulations and a Discussion of the US Solution in the European Context

1. The shortcomings of European regulations

Do European regulations provide for a quality check of non-financial information contained in periodic reports?

The Transparency Directive requires to include a "management certification" in the annual and half-yearly financial reports, i.e., a statement made by management to the effect that, to the best of their knowledge:

- the (condensed set of) financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole; and

[1111] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).

- the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face; or
- the interim management report includes at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six months of the financial year. For issuers of shares, the interim management report shall also include major related parties transactions.[1112]

However, management certifications are not certifications issued by independent third parties. Besides, they do not constitute under the applicable national law a new basis for liability of physical persons who signed the statement, who remain liable under usual liability provisions, to the extent they are applicable in the particular case.[1113]

I suggest the suppression of management certifications. Indeed, I do not see any added value of management certifications with a view to increase investor protection. I suggest instead a proper harmonised civil liability regime for directors.[1114]

Thus, same as under US securities regulation, *there is no requirement of an independent third party review of non-financial information contained in periodic reports*. Hence there could be a role for an external certifier.

And the so-called Eighth Company Law Directive does not help in that respect as it only provides that "[t]he statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material

[1112] See articles 4.2(c) and 5.2(c) of the Transparency Directive.

[1113] This means that management certifications can be signed by one director on behalf of the company without the director incurring personal liability. Note in addition that there is no requirement for express certification in respect of interim management statements under the Transparency Directive. As with annual and half-yearly disclosures, Member States must solely ensure that the issuer or its administrative, management or supervisory body assumes responsibility for these statements and that provisions on liability apply (see article 7 of the Transparency Directive).

[1114] See Part III:Chapter II:IV.D below.

weaknesses in internal control in relation to the financial reporting process".[1115] The E.U., in a similar way as the US SEC in section 404 SOx, focusses on financial reporting only, in contrast with the approach used in other guidance on internal control which encompasses corporate governance issues.[1116]

This being said, it is interesting to note that external certifiers are not totally absent of some Member States' regulations. For instance, nominated advisers (so-called NOMAD) are required to be appointed further to the rules of the London Stock Exchange's international market for smaller growing companies, i.e., AIM.[1117] They provide a nice illustration of institutions, usually investment banks, which, among other things, perform quality check of non-financial information contained in periodic reports.[1118] But whether they should be imposed at the European level with respect to any equity issuer traded on a regulated market is another matter that I discuss below.

2. *The need for a thorough costs-benefits analysis for a definitive assessment*

Whether and to what extent an external certifier could play a role in checking the non-financial disclosure requirements contained in periodic reports is a difficult issue which needs to be adequately analysed and circumscribed to be realistic and cost-efficient.

As I am not equipped with the necessary tools to make a definitive assessment, I only discuss a few important issues that need to be addressed in any costs-benefits analysis.

[1115] See article 41.4 of directive 2006/43 of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/ 660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, JO, L 157/87, 9 June 2006 (hereafter the Eighth Company Law Directive) (referring to an external auditor report in connection with internal controls relating to financial reporting).

[1116] See, for instance, CoCo (Canada), COSO (U.S.) or Turnbull Guidance on Internal Control (U.K.).

[1117] See AIM Rules for Companies and AIM Rules for Nominated Advisors, 2007, for eligibility criteria, approval process, obligations, review and discipline of nominated advisers. See especially rule 17 providing that "[t]he nominated adviser is responsible to the Exchange for advising and guiding an AIM company on its responsibilities under the AIM Rules for Companies both in respect of its admission and its continuing obligations on an ongoing basis." And also Sched. 3, OR 2 (requiring the NOMAD to review non-routine statement put out by issuer clients before they are released).

[1118] Comp. with the sponsors, to be appointed further to the UK FSA listing rules (chapter 8) in connection with public offerings and certain transactions.

In the costs-benefits analysis, the extent to which the national supervisory authorities provide for the necessary quality check should be examined. There could be an increased need for an external certifier should the national supervisory authorities be required to check the quality of disclosure with a lesser frequency due to the move to a more company registration system.

Concerning the exact role of the external certifier, I believe that he should, at a minimum, certify in the annual financial report, subject to any corrections set out in the annual financial report, the truthfulness of non-financial information contained in the issuer's other periodic reports during the preceding year as of their respective publication dates. This is no easy task as illustrated by the difficulties to check the quality of social and environmental reports where they are produced on a voluntary basis or in compliance with national law regulation.[1119] In order to be able to certify, to the extent reasonably possible, the truthfulness and the completeness of the annual financial report and the earlier reports, the external certifier should perform an *on-going due diligence*.[1120] This would include information contained in the corporate governance statement. Indeed, the Fourth Company Law Directive, [1121] provided that it offers a clear legal basis for the auditor to check the content of the corporate governance statement included in the annual financial report, does not say anything about the extent of such check: is it limited to a mere ticking the box to check whether the content is as legally mandated or does it go further and include a quality check? Most opinions tend to agree that statutory auditors are merely required to undertake a formal verification of company compliance with thre requirement to publish a corporate governance

[1119] See the large body of literature in connection with social and environmental reports imposed by national law regulation and the control of their quality. See, *inter alia*, JACQUES IGALENS, *Comment évaluer les rapports de développement durable?*, 5 Revue française de gestion 151, (2004).

[1120] See the procedures issuers have developed which present various opportunities for continuous due diligence throughout the shelf-registration process in the U.S., including the use of a single underwriter's counsel, periodic due diligence sessions, etc, JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 147 and 148. But see JOHN C. COFFEE, Enhancing Investor Protection and the Regulation of Securities Markets (2009)., at 58 (admitting that the US SEC's hope that underwriters do "continuing due diligence" on the issuers using shelf-registration at the time they filed their periodic quarterly reports was never fully realised).

[1121] See 51(1), second alinea of the Fourth Company Law Directive referred to by article 46a.2 of directive 2006/46.

statement.[1122] However, monitoring of the accuracy of the information provided in the corporate governance statement is arguably very important considering the relatively low level of quality of the explanations for deviations of the reference corporate governance code, as recently evidenced by a European-wide study.[1123]

It should be examined whether the mission of the external certifier should go beyond the check of the quality of non-financial information contained in periodic reports, to cover the effectiveness of internal control mechanisms.[1124] Some stress the need for the regulator to develop criteria for assessing the effectiveness of internal controls and for precise guidance in the area. Indeed, the opportunity of external reporting on the effectiveness of internal control may not always be clear given the reputational risks it may cause to a company that could undermine its viability.[1125]

Concerning the specific body that should perform the mission, I believe that the external certifier should be a *financially sound institution* with a good balance of financial and non-financial expertise. It should be approved by the competent supervisory authority in order to assure its financial capability to pay penalties, if any,[1126] and its capacity to perform its mission.

[1122] See RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009).

[1123] See RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009). (finding only 39% of so-called «informative explanations" for a sample of 270 companies from 18 Member States; finding that the highest proportion of informative explanations comes from companies registered in France, the Netherlands, Sweden and the U.K.).

[1124] See on the difficulties relating to the effectiveness of internal controls, FEDERATION OF EUROPEAN ACCOUNTANTS, Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance (2003)., at 42 ("[s]uitable criteria for evaluating effectiveness which are transportable across different companies have not yet been developed. Effectiveness is a relative concept and scoring mechanisms do not yet exist which allow one company, or even one process or team in a company, to be benchmarked against another".). See section 404 SOx (defining effectiveness as "free from material misstatement". I believe that the US SEC criterion may be appropriate for the US SEC in its objective of preventing material misstatement in financial reporting while it may not be appropriate when assessing the wider aspects of internal control).

[1125] FEDERATION OF EUROPEAN ACCOUNTANTS, Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance (2003).

[1126] See Part III:Chapter II:IV.D below.

It could be the auditor, who would then become a "disclosure auditor".[1127] This seems to be the way contemplated by the European Federation of Accountants.[1128] However, I doubt that auditors would have the necessary competence to certify non-financial information. It has also been suggested that it be an outside disclosure counsel.[1129] However, I doubt that outside legal counsels would have the necessary competence to certify forward looking statements. Professor Fox suggests that it be the investment bank that acted as underwriter in the public offering as it has the ability to project future cash flows and could delegate responsibility for other parts of the work that auditors or attorneys could do better.[1130]

If the company has a controlling shareholder, I think that the external certifier should be elected by a majority of the minority to ensure its independence.

In exchange of the fulfilment of its duties, the external certifier is likely to charge a fee to the issuer. This fee should cover the opportunity cost of the personnel necessary

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[1127] See DONALD C. LANGEVOORT, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 Law and Contemporary Problems 45, (2000)., at 47, 52, 55 and 62 (while pleading for annual investigation by an external certifier with respect to the accuracy of the issuer's 10-K (annual report), considering that an expanded conception of the audit function most efficiently satisfies this need and would thus work effectively to merge the notions of due diligence and audit). With respect to auditors in the European context, note the provisions of directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending the Fourth and the Seventh Company Law Directives and repealing Council Directive 84/253/EEC, OJ L 157, 9 June 2006, in connection with the approval requirements. With respect to liability of auditors, see Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms 2008/473/EC, OJ, L 162/39, 21 June 2008.

[1128] See FEDERATION OF EUROPEAN ACCOUNTANTS, Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance (2003)., at 14 ("[t]he external auditor has a central role not only in application of accounting standards but also in the wider corporate governance system" and "[r]especting the limitations of the auditor's role resulting from the audit approach and the role of the auditor within corporate governance, FEE recommends extending the scope of the external audit to require the auditor to examine whether certain appropriate aspects of the corporate governance statement comply with the respective reporting standards. FEE encourages all parties involved in the EU corporate governance discussion to work on a EU-wide common "comply or explain" approach on this issue"). See also RISKMETRICSGROUP, et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009). (suggesting that, in order to improve the accuracy of the information, the role of the auditors could be extended to include the verification of the accuracy of certain facts disclosed in the corporate governance statement).

[1129] See JOHN C. COFFEE, JR., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company-Registration*, 52 Wash. & Lee L. Rev. 1143, (1995).; JOHN C. COFFEE, Gatekeepers - The Professions and Corporate Governance (Oxford University Press. 2006)., at 356. With respect to liability of legal counsels, note that they are usually incorporated as limited liability partnerships/companies and therefore individual members cannot lose more than they invest.

[1130] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).

to conduct the due diligence plus the expected value of the residual costs of litigation judgments and legal fees. This cost is traditionally deemed worthwhile to assure quality disclosure at the time of a public offering. I argued in Part II that high quality periodic reporting is equally socially valuable. Some say that,[1131] therefore , it is *a priori* worth the cost, especially with respect to forward-looking data which are essential for valuing the firm as a going concern, since they permit an investor to estimate future changes in a firm's cash flows.[1132] It is also believed that a competitive market could drive the costs to a reasonable amount.

IV. Civil Liability in Case of Violation of the EU Issuer-Disclosure Regime

A. Preliminary Remark

The current liability regime under the Prospectus Directive, the MAD and the Transparency Directive could be summarised as follows:

The Transparency Directive requires that responsibility lies at least with the issuer or its administrative, management or supervisory bodies.[1133] The Transparency Directive gives Member States the choice of limiting responsibility to the issuer or extending it to members of the corporate bodies. The Prospectus Directive provides for

[1131] See, in the US context, applying a similar reasoning, MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).

[1132] Comp. with the situation under section 13.2 of Annex I to the Prospectus Regulation (subjecting forward-looking statements to verification by an independent accountant or auditor). Comp. as well the Fourth and Seventh Company Law Directives (requiring the management report to contain at least a fair review of the development and performance of the issuer's business and of its position, together with a description of the principal risks and uncertainties that it faces, such that the review presents a balanced and comprehensive analysis of the development and performance of the issuer's business and of its position, consistent with the size and complexity of the business); article 5.4 of the Transparency Directive (requiring the interim management report to include a description of the principal risks and uncertainties for the remaining six months of the financial year) and the fact that forward-looking statements are not required for quarterly reports; with US Regulation S-K, Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations) and Part III:Chapter II:III.A above (relating to the bespeak caution doctrine).

[1133] See article 7 of the Transparency Directive.

similar requirements.[1134] The MAD does not specify who should be the responsible persons.[1135]

Although the rules under the EU issuer-disclosure regime do not explicitly provide that information should not be misleading (except with respect to the summary prospectus[1136] and advertisements[1137]), it is clear from the directive relating to unfair commercial practices that the liability attaches to misleading information or misleading omission, as defined in that directive.[1138]

The Prospectus Directive expressly requires Member States to underpin with civil liability under national law the declarations by the responsible persons about the accuracy and completeness of the information contained in the prospectus.[1139]

By contrast, there is no reference to "civil liability" in the Transparency Directive, nor in the MAD. The Transparency Directive refers to "appropriate liability".[1140] It could thus be possible for Member States to comply with the Transparency Directive by imposing criminal liability only.[1141] The MAD provides for Member States to ensure that there are appropriate administrative measures and sanctions, in addition to the right of Member States to impose criminal sanctions.[1142] I think that not providing a civil liability regime for breaches of issuer-disclosure requirements under the Transparency Directive and the MAD would run afoul of studies establishing the link between private

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[1134] See article 6 of the Prospectus Directive.

[1135] See article 14 of the MAD (providing that administrative measures and sanctions, next to criminal sanctions, at the Member States' discretion, should be imposed by Member States against "responsible persons" for breaches of the requirements under the MAD. These sanctions should be effective, proportionate and dissuasive).

[1136] See article 5.2(d) of the Prospectus Directive.

[1137] See article 15.3 of the Prospectus Directive.

[1138] See articles 6 and 7 of Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (hereafter the Unfair Commercial Practices Directive), JO L149/22, 11 June 2005. See for a discussion of liability of issuers under the Unfair Commercial Practices Directive, A.C.W. Pijls, Misleiding van het beleggende publiek, een oneerlijke handelspraktijk, Ondernemingsrecht 2008-9, at 342.

[1139] See article 6.2 of the Prospectus Directive.

[1140] See recital (17) of the Transparency Directive.

[1141] See EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 189.

[1142] See note 1120 and accompanying text.

enforcement and market development[1143] and would miss the two policy objectives of civil liability, i.e., deterrence and compensation.[1144]

The Prospectus Directive, the Transparency Directive and the MAD do not explicitly specify the persons to whom the responsibility is owed or who have the right to sue if the prospectus, the periodic reports or an *ad hoc* disclosure are incorrect.

In that respect however, the Transparency Implementing Directive provides that "[r]egulated information shall be disseminated in a manner ensuring that it is capable of being disseminated to as wide a public as possible […]".[1145] It could thus be possible for any potential investor to bring an action for breach of disclosure requirements under the Transparency Directive.

Under present status, civil liability relating to breaches of the EU issuer-disclosure regime remains a matter to be dealt with by the *national law of the Member States*. The result is that each Member State has its own civil liability regime.[1146] Current efforts to convergence at European level in supervisory and enforcement practices amongst national regulators, especially under the auspices of CESR, while very much laudable, are not sufficient in order to promote a level playing field across the European Union.[1147]

1143 See notes 215 and 691 above and accompanying text.

1144 See Part II:Chapter III:II.E.3.d.iiia in Chapter Corporate Governance.

1145 See article 12.2 of the Transparency Implementing Directive.

1146 See for illustrations from UK and German laws in connection with the periodic reports liability regime, DOROTHÉE FISCHER-APPELT, *Implementation of the Transparency Directive— room for variations across the EEA*, 2 Capital Market Law Journal 133, (2007).; see for a summary of French rules relating to issuer's liability, Florian Burnat, Review of Issuer Liability – Questions on Foreign Markets – Liability Arising from Inaccurate Statements made to the Market – Assessment regarding France, January 2007; see for a summary of German rules, Stefan Papst, Liability for Misstatements, February 2007. See also the Autumn 2009 issue of the European Company and Financial Law Review, with contributions on French law, Belgian law, German law, Italian law and US law with respect to shareholders' suits in general.

1147 As illustration of the lack of convergence, see CESR's reports and internal mappings which seek to inform European institutions and market participants about the different sanctions and administrative measures and approaches to apply sanctions and administrative measures across the Member States, in the area of market abuse and, with respect to supervisory powers only, in the area of prospectus. The purpose of these exercises by CESR is to ascertain whether competent authorities have equivalent supervisory powers as the capacity to act on an equal footing when performing cross-border investigatory/supervisory and sanctioning activities is considered by CESR as a precondition to a credible European supervisory system and fundamental to delivering supervisory convergence. See for a summary, CESR Half-Yearly Report 2008. pt. (2008).

Farther-reaching harmonisation of civil liability with respect to the EU issuer-disclosure regime is not on the policy agenda of the European Commission. The White Paper on Financial Services Policy 2005-2010 does not make any reference to it. And, the European Commission recently concluded that there was no need for action under the current process of review of the Prospectus Directive.[1148]

However, contrary to the European Commission's opinion, I think *there could be a case to support that the minimum harmonisation of liability issues* under the Prospectus Directive, the Transparency Directive and the MAD *is not satisfactory*.[1149]

It should be seen to what extent the lack of a common civil liability regime does not undermine the desired effects of the harmonised EU issuer-disclosure regime. Indeed, the national laws of Member States dealing with civil liability related to violations of the EU issuer-disclosure regime could *not provide the right incentives* for responsible persons to comply with it.

It should also be assessed whether different approaches taken by the Member States with respect to the liability for disclosure violations lead to differences in treatment of, and to *less predictability* for, responsible persons and investors, i.e., to *legal uncertainty* and, ultimately, to *less protection*. It should be assessed whether *investor confidence* in cross-border investment is jeopardised by undermining investor protection.

[1148] See EUROPEAN COMMISSION, Proposal for a Directive of the European Parliament and of the Council amending the Prospectus Directive and the Transparency Directive (2009).; EUROPEAN COMMISSION, Background Document - Review of Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Prospectus Directive) (2009)., at 15, point 4.7 and EUROPEAN COMMISSION, Commission Staff Working Document accompanying the Proposal for a Directive amending the Prospectus Directive and the Transparency Directive – Impact Assessment (2009). (suggesting not to harmonise civil liability under the (to be reviewed) Prospectus Directive). But see, new recital 8(b) suggested by the European Parliament, in EUROPEAN PARLIAMENT, Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (COM(2009)0491 – C7-0170/2009 – 2009/0132(COD)) Committee on Economic and Monetary Affairs Rapporteur: Wolf Klinz (2010).(asking the future European Securities and Markets Authority to compile a comparative table exhibiting the differences in national liability regimes).

[1149] See, in the context of MiFID, MICHEL TISON, *De bescherming van de belegger in het kapitaalmarktrecht: de hobbelige weg naar een Europees Ius Commune, in* Liber Amicorum André Bruyneel, (Bruylant ed., 2008).

The European Commission should also examine to what extent competition is distorted among issuers because of the lack of harmonised civil liability regime. It should assess whether there is room for *liability arbitrage* which would lead to a "race to the bottom" resulting from national authorities competing against each other in the attempt to attract business in their own jurisdiction. It should assess whether some Member States do introduce lighter regulatory regimes triggering successive rounds of lighter regulations by other Member States, resulting in regulatory laxity that would hardly protect the interests of investors.

This calls for an exhaustive *costs-benefits analysis*, for which specific tools are required.[1150] This analysis would in any case be required for an assessment of the compliance with the principles of subsidiarity and proportionality set out in article 5 of the Treaty on the Functioning of the European Union. This article provides that, even if the E.U. has competence to act, before it does, it must assess whether the objectives of the proposed action cannot be sufficiently achieved by the Member States and whether, by reason of its scale or effects, the proposed action can be better achieved by the E.U.

In my opinion, should the assessment pass the subsidiarity test, articles 50.2(g)[1151] and 114[1152] of the Treaty on the Functioning of the European Union could provide the adequate basis for the European Commission to regulate in the civil liability field.[1153] In any event, I believe that, if the European Commission feels some sympathy with my suggestions, a legal basis for harmonisation in the civil liability field relating to violations of the EU issuer-disclosure regime could eventually be found in the Treaty on

[1150] See for an example in European competition law, Commission Staff Working Document accompanying document to the White Paper on Damages Actions for Breaches of the EC Antitrust Rules – Impact Assessment, SEC(2008) 405.

[1151] See article 50.2(g) of the Treaty on the Functioning of the European Union (former article 44.2(g) TEC) (providing for the existence of European-level measures to protect shareholders and third parties interests).

[1152] See article 114 of the Treaty on the Functioning of the European Union (former article 95 TEC) (providing for the existence of European-level measures to promote the establishment and the functioning of the internal market).

[1153] Attention should however be paid to Judgment of the Court of 5 October 2000 - Federal Republic of Germany v European Parliament and Council of the European Union - Directive 98/43/EC - Advertising and sponsorship of tobacco products - Legal basis - Article 100a of the treaty (to be read, further to the Lisbon treaty, as article 114 of the Treaty on the Functioning of the European Union). - Case C-376/98, ECR I-8419, 2000 (where the Court stated that a mere finding of disparities between national laws and of the abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition are not sufficient to justify the application of article 100a of the treaty (to be read as article 114 of the Treaty on the Functioning of the European Union); harmonisation should genuinely have as its object the improvement of the conditions for the establishment and functioning of the internal market).

the Functioning of the European Union, as implicitly admitted by the European Commission in other areas.[1154]

I appreciate that *strong political divergences*, which stem from different legal and judicial systems, have always stood in the way of European harmonisation of liability issues. The civil liability regime for violations of the EU issuer-disclosure regime is no exception in that respect. At the time of negotiations of the Prospectus Directive, there was a fear that efforts to harmonise civil liability would jeopardise an agreement on the more fundamental issues. Consequently, political will to harmonise the field was lacking. Next to advertising, civil liability therefore is the only area in the Prospectus Directive where minimum harmonisation was sought.

If the costs-benefits analysis is not worth pursuing, for instance because of still existent strong political opposition or because of a failure to pass the subsidiarity test, or if a proper costs-benefits analysis leads to negative results, one could in any case get inspired for civil liability matters related to violations of issuer-disclosure by the solution promoted by the academics drafting the European Model Company Law Act.[1155] They suggest a company law paradigm to be used by Member States as supporting tool to modernise their company law without international duty. In essence, they suggest to *reform by free choice*. This could be applied to the civil liability field, arguably at lesser costs than proper harmonisation, with similar results.

In this context, and based on the thoughtful analysis performed by Professor Fox *in the specific US context*,[1156] I examine below what a *more extended European civil*

[1154] See European Commission, White Paper on Damages Actions for Breach of the EC Antitrust Rules, COM(2008) 165 final (not containing more than a passing reference to the requisite rule-making power).

[1155] See THEODOR BAUMS, et al., *The European Model Company Law Act Project in* Perspectives in Company Law and Financial Regulation - Essays in honour of Eddy Wymeersch, (Michel Tison, et al. eds., 2009).

[1156] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009). (arguing for the rejection of the traditional divide between corporate and securities regulation; placing US private securities-fraud litigation within the realm of corporate governance by characterising the objectives of securities litigation as the reduction of managerial agency costs and the improvement of corporate decision making); see also for an earlier expression of his ideas, MERRITT B. FOX, *Rethinking Disclosure Liability in the Modern Era* 75 Wash. U. L. Rev. 903, (1997). The four most important liability provisions of US securities law for the regulation of the primary and secondary market are *liability regime for misleading statements or omissions in issuer-disclosure* would look like.

A few remarks are worth to be made before I get into the core of my suggestions:

I suggest below a liability regime applicable for matters relating to breaches of the EU issuer-disclosure regime. Nonetheless, my suggested scheme could be extended to all other (company law) disclosure violations.

In addition, I do not pretend to draw a full European civil liability regime for breaches of the EU issuer-disclosure regime with all the concrete details which could impinge on other European or national law regulations. This limitation is admittedly an important caveat to my suggested scheme. For instance, I do not address safe harbours for reliance on experts' advice. Digging at length into procedural rules, although it impacts the likelihood of success of a claim, would require to have a complete picture of the current situation in all Member States. That could constitute a separate contribution by itself and falls outside the scope of this dissertation.[1157] In the same line of thoughts, I only envisage damages actions while other actions could be envisaged. I do not say anything on how to measure damages and what exactly should be indemnified (difference in market price or rescissionary damages). I do not tackle experts' liability, including lawyers, analysts, auditors and underwriters'. Nor do I discuss the distributors' liability. Lastly, where I plead for a particular constituency's liability, I do not consider the implications of my suggestion in the context of its insolvency.

The idea to have a single civil liability regime applicable to violations of disclosure requirements under the Prospectus Directive, the Transparency Directive and the MAD makes even more sense in case the European Commission decides to implement my suggestions relating to the suppression of periodic reports and the requirement to have a base disclosure document to be regularly updated. The civil liability regime could of course be part of the European Regulation. However, as each regulatory implication of this dissertation should be considered separately by European

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probably sections 11, 12(a)(1), and 12(a)(2) of the US Securities Act (15 U.S.C. §§ 77k, 77l(a) (2007)), penalising false or misleading statements in the registration statement or prospectus, or a violation of the requirement to register a security with the US SEC before it is offered or sold, and section 10(b) of the US Securities Exchange Act (15 U.S.C. § 78j(b) (2007)), which has to be read in conjunction with US Securities Exchange Act Rule 10b-5 (17 C.F.R. § 240.10b-5 (2008)), triggered by any type of fraudulent behaviour in connection with the purchase or sale of a security on the primary or secondary market.

[1157] See for an example in European competition law, Ashurst, Study on the Conditions of Claims for Damages for Infringement of EC Competition Rules, 31 August 2004.

instances, I do not envisage here the case of one base document and keep referring to the documents mandated under the current form of the Prospectus Directive, the Transparency Directive and the MAD.

Lastly, I need to take position on a fundamental prerequisite. Do I favour investors-friendly rules so that investors keep being confident in the financial markets as they feel well protected against breaches of the EU issuer-disclosure regime? Or, do I somehow privilege potentially responsible persons thereby promoting the use of capital markets as a source of finance, with all related positive effects?[1158] The suggestions I make are intended to strike the *right balance between claimants' and defendants' interests*. While a facilitation of claims inevitably weakens the position of defendants to some extent and works as incentive to comply with the disclosure regime, the legal protection of the defendants must not fall below a certain minimum level. This kind of guarantee is important to prevent abusive litigation which could impede the development of capital markets and to avoid that not too much resources in time and money are spent by the issuer in shielding against, and defending himself in case of, litigation which could be detrimental to shareholders and society as a whole.

In the remainder of this section, I suggest which court should be competent, i.e., the regime of conflicts of jurisdictions. I then consider which law should apply, i.e., the regime of conflicts of laws. Lastly, I discuss the issues to be resolved by the designated law that should be harmonised at European level, i.e., the scope of a specific harmonised civil liability regime associated with the EU issuer-disclosure regime. I suggest to harmonise who should be the possible defendants, who should pay the damages, who should be the possible claimants, to whom should damages be paid, what should be the standard of liability and who should bear the burden of proof.

[1158] The discussion under Part II:Chapter III:II.E.3.d.iiia in Chapter Corporate Governance should be recalled here (discussing the optimal level of robustness of a liability regime).

B. Conflict of Jurisdictions Rule

1. The current situation

I do not think persuasive the argument that the threat of multi-jurisdictional liability could make civil litigation a more powerful mechanism for ensuring credibility of securities law disclosures within the E.U.[1159] I consider that the costs and burdens on issuers of multi-jurisdictional litigation outweigh the potential benefit that this approach would entail.

Yet, the current situation leads to multi-jurisdictional liability.

The Brussels Regulation allocates jurisdiction on the basis of the "domicile" of the defendant.[1160] However, in tort claims, i.e., claims where a defendant's non-contractual civil liability is in question, like with respect to breaches of mandated disclosure requirements,[1161] it also provides for jurisdiction in the courts of the Member State where the harmful event occurred.[1162]

This is not satisfactory as, according to the case law of the European Court of Justice interpreting the latter provision of the Brussels Regulation, the claimant has a free choice between the courts of the jurisdiction of the Member State where the harm was directly suffered (i.e., in my opinion, the Member State of the "domicile" of the claimant, or, if different, the Member State of the trade) and the courts of the jurisdiction where the act giving rise to the harm was done (i.e., in my opinion, the Member State where the information was published). [1163] This choice stands as an alternative to the courts of the Member State of the defendant's domicile. This gives rise to additional risks for any responsible person.

[1159] See *contra* EILÍS FERRAN, Building an EU Securities Market (Cambridge University Press. 2004)., at 191.

[1160] See article 2.1 of Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ, 16 January 2001, L 12/1 (hereafter the Brussels Regulation). With respect to legal persons, see also article 60.1 of the Brussels Regulation which provides three possible solutions: the statutory seat, the place of central administration or the principal place of business of the company. See article 60.2 for further details for the case of the U.K. and Ireland.

[1161] Most jurisdictions seem to favour a tort law classification for capital market liability. See on this, Klaus J. Hopt and Hans-Christoph Voigt, *Prospekt- und Kapitalmarktinformationshaftung* (Mohr Siebeck, Tübingen 2005), at 9.

[1162] See article 5.3 of the Brussels Regulation.

[1163] See Bier v Mines de Potasse C 21/76 [1976] ECR 1735.

2. My suggestion

As envisaged under the Brussels Regulation,[1164] I plead for a specific conflict of jurisdictions rule for breaches of the European disclosure regime.

I recommend that the competent court be the court of the issuer's home Member State because of the legal certainty it brings.[1165] Besides, it would dismiss any concern about favouring the shareholders of one Member State over the shareholders of other Member States because of arguably more favourable procedural rules in a particular Member State.[1166]

I appreciate that this solution is issuers-friendly and that it could lead to arbitrage from issuers.[1167] An alternative that would be perceived as investors-friendly would be to declare competent the court of the jurisdiction of the European regulated market where the securities are listed, as this would mean that, say, a US issuer listed on a European regulated market could be sued in the E.U.[1168]

As mentioned above, I believe that a balance should be reached between investors' and issuers' interests while drawing the common civil liability regime. From that perspective, this suggestion is part of the overall balance.

[1164] See article 67 of the Brussels Regulation (providing that the "[r]egulation shall not prejudice the application of provisions governing jurisdiction and the recognition and enforcement of judgments in specific matters which are contained in Community instruments or in national legislation harmonised pursuant to such instruments").

[1165] In support of the home Member State choice of law, see FINANCIAL MARKETS LAW COMMITTEE, Issue 76 - Transparency Obligations Directive (January 2004).

[1166] Let us imagine that a company makes a misstament which is out in the market for 3 months. And, during that period, share price inflates by €10 and 100 million shares are purchased at least once. Under the civil liability regime, €1,000 million would need to be paid to purchasers in damages. The conflict rules provide that the procedural rules of the Member State of the claimant should apply. Imagine further that a purchaser of 30 million shares is in a Member State where the procedural rules provide him with a reasonable likelihood of succeeding. This means that the defendant company would end up paying a lot of money only to some shareholders and not to others. It would raise the concern of giving an "unparalelled dividend" to the lucky ones, i.e., the shareholders who happen to be domiciled in jurisdictions with favourable procedural rules, creating problems of fairness as other shareholders do not get the damages but do well pay the damages to the claimants.

[1167] Issuers could indeed decide to incorporate in a particular Member State because of, *inter alia*, the more issuers-friendly procedural rules in case of litigation against them.

[1168] See note 1181 below and accompanying text in case of multiple listings.

This being said, I believe that the courts of the jurisdiction of the regulated market should be competent if the issuer is not listed in its home Member State. In the rare cases where there are multiple European listings, it should be provided that the court will be the court (1) of the jurisdiction of the regulated market where the initial listing occurred or, in case of simultaneous listings, (2) of the regulated market which has the closest links with the investor, i.e., the one of its trade or of its domicile.

C. Conflict of Laws Rule

1. The current situation

The application of the conflict of laws rule provided under Rome II is not satisfactory with respect to the liability related to the European disclosure regime.[1169] Rome II provides for the "*lex loci damni*" to be applicable, i.e., the law where the damage occurred.[1170]

Yet, the Transparency Directive requires disclosure of "regulated information"[1171] to be made public to as wide a public as possible, meaning the entire E.U.[1172] Hence, listings on a European regulated market carry a potential risk that responsible persons

[1169] See Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II), OJ, 2007, L1999/40 (hereafter Rome II). It came into force on 11 January 2009 in Member States without any national implementing measure being required. There are exceptions to the general rule, including one where there is a "manifestly closer connection" with another country, which could be based in a pre-existing relationship or a contract between the parties to the litigation. The limits and applicability of the exceptions will require elucidation from the European Court of Justice, if the experience follows that of the similar wording in the Rome Convention on contractual obligations. It seems to be still unclear to what extent and how Rome II applies to issuer liability because of the exemptions it provides. For an assessment of the international prospectus liability after Rome II, see Jan von Hein, Die Internationale Prospekthaftung im Lichte der Rom II-Verordnung, in H. Baum and others (eds), *Deutsches, europäisches und internationales Handels-, Gesellschafts- und Kapitalmarktrecht. Beiträge für Klaus J. Hopt aus Anlass seiner Emeritierung* (de Gruyter, Berlin, 2008), at 371. Worth noting is that the British government tried to exempt the topic of issuer liability from the scope of application of Rome II during negotiations (see Council Document 7928/06 ADD 1 of 30 March 2006). It was however ultimately not successful with this request. From this, one can assume that an exclusion for capital markets liability was not intended. Consequently, despite the seemingly wide exceptions for securities and company law, the scope of application of Rome II seems to also include issuer liability.

[1170] See article 4.1 of Rome II (providing that "the law applicable to a non-contractual obligation arising out of a tort/delict shall be the law of the country in which the damage occurs irrespective of the country in which the event giving rise to the damage occurred and irrespective of the country or countries in which the indirect consequences of that event occur").

[1171] See definition of "regulated information" in article 2.1(k) of the Transparency Directive (referring to disclosure under the Transparency Directive and the MAD).

[1172] See article 12.2 of the Transparency Implementing Directive.

be held liable for breach of the obligations set out in the Transparency Directive or the MAD under the laws of several European jurisdictions, i.e., the jurisdictions where information is received.[1173] Freedom of choice provided in Rome II is not likely to help in that respect as the conditions for its application are rather restrictive.[1174]

The problem is less acute with respect to the Prospectus Directive as it broadly requires publication of the prospectus to be concentrated in the Member States where an offer is made or admission to listing is sought.[1175] However, as multiple Member States could be concerned, the risk of application of foreign liability laws will have to be taken into account by the issuer in structuring the transaction.

2. My suggestion

A way to solve the problem, for the sake of legal certainty for the persons who could be sued, is to provide a specific conflict of laws rule in financial matters, as permitted under Rome II.[1176]

Following a similar reasoning as with respect to the conflict of jurisdictions rule, I recommend the conflict of laws rule to provide for the application of the law of the home Member State because of the legal certainty it brings.[1177]

This solution was supported by the UK delegation during negotiations of the Transparency Directive.[1178] It was also suggested as amendment to the Transparency

[1173] See EILIS FERRAN, *Cross-Border Offers of Securities in the EU: The Standard Life Flotation*, 4 ECFR 461, (2007)., at 488.

[1174] See article 14 of Rome II.

[1175] See article 14 of the Prospectus Directive.

[1176] See article 27 and recital (35) of Rome II (allowing other European texts to provide other conflict of law rules relating to non-contractual obligations for particular matters).

[1177] *Accord* WOLF-GEORG RINGE, et al., The International Dimension of Issuer Liability - Liability and Choice of Law from a Transatlantic Perspective (2010).

[1178] See UK delegation, Proposal for a Directive on Transparency Requirements – UK submission concerning Article 7, 18 September 2003 (on file with author) (favouring the law of the home Member State). See also FINANCIAL MARKETS LAW COMMITTEE, Issue 76 - Transparency Obligations Directive (January 2004)., at 4 et seq. See also PAUL DAVIES, Davies Review of Issuer Liability : Final Report (2007). which concluded that this legal problem is "a complex subject" and that "British rules determining the answer are not entirely clear". The London Stock Exchange, when commenting on the Review, asked for more "clarity" for situations where such a "potential conflict of laws for regulated markets could arise". Without dwelling much on this question, the Davies Review incidentally favoured the adoption of a choice of law rule of either the issuer's registered office or the law of the jurisdiction where the issuer has its primary stock exchange listing.

Directive.[1179] Reacting on the proposed amendment, the European Commission stressed that some Member States feared this might erode investor protection throughout Europe.

The alternative solution could be the law of the jurisdiction of the European regulated market where the securities are listed.[1180] This would in addition offer the assurance that it will be a sensible law. Indeed, I believe that there will be in the near future an increasing concentration of European stock exchanges given the globalisation pressures in this area and this concentration will drive the national laws concerned by this competition to be even more sensible in balancing all affected interests.

However, once again, this refers to the right balance to be reached between investors and issuers-friendly rules. To face the criticism that my suggestion is too issuers-friendly, I urge in this dissertation for harmonisation of some principles which should give sufficient basic protection to investors on a European-wide scale.

This being said, I believe that the law of the jurisdiction of the regulated market should apply where the issuer is not listed in its home Member State. In the rare cases where there are multiple European listings, it should be provided that the law will be the law (1) of the jurisdiction of the regulated market where the initial listing occurred or, in case of simultaneous listings, (2) of the regulated market which has the closest links with the investor, i.e., the one of its trade or of its domicile.

[1179] See the proposed Amendment 81 to the Transparency Directive which was voted in the European Parliament's Economic and Monetary Affairs Committee on 17 February 2004 but was not adopted in plenary session.

[1180] In the rare cases where there are multiple European listings, it should be provided that the law will be, in order of priorities, the law (1) of the jurisdiction of the regulated market where the initial listing occurred or, in case of simultaneous listings, (2) of the regulated market which has the closest links with the issuer, i.e., the one of its "domicile", or, if the securities are not listed on the stock exchange of the jurisdiction of the issuer, (3) of the regulated market which has the closest links with the investor, i.e., the one of its trade or of its domicile.

D. Scope of the Suggested Civil Liability Regime

1. *Possible defendants*

a. The case of the issuer

The Prospectus Directive and the Transparency Directive provide for the liability of, at least, the issuer or its administrative, management or supervisory bodies. Member States could thus exonerate issuers from any liability with respect to prospectuses and periodic reports if they provide for liability of the administrative, management or supervisory bodies alone.[1181]

I do not think it would be appropriate to exonerate issuers from liability with respect to *prospectuses*.[1182] Issuers should be potentially liable when offering securities. In any case, I understand that there is wide agreement among Member States as to the possibility to make the issuer liable. They should be liable for two reasons, each referring to an objective of civil liability related to European disclosure violations:[1183]

In order to meet the *compensation goal* of civil liability, issuers should be among the defendants. Except where at the time of the suit they are insolvent, issuers are usually wealthy enough to be able to indemnify claimants.

The possibility to hold issuers accountable also contributes to meet the second objective of a civil liability scheme, i.e., *deterrence*. When offering securities to the public, issuers have a particular incentive to hide negative information in order to artificially inflate the sale price which ultimately ends up in their pockets. In this context, civil liability acts like a stick to make the issuer comply with its disclosure requirements.

I do not think it would be appropriate to exonerate issuers from liability with respect to *periodic reports and ad hoc disclosure* either. In any case, I understand that

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[1181] The same problem does not exist under the MAD as article 6.1 of the MAD provides that issuers should disclose inside information and article 14.1 of the MAD provides that Member States should provide criminal sanctions and/or administrative measures/sanctions against "responsible persons", i.e., issuers.

[1182] *Accord* EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 19.

[1183] See Part II:Chapter III:II.E.3.d.iiia in Chapter Corporate Governance.

there is wide agreement among Member States as to the possibility to make the issuer liable in those cases.

I agree with the academics raising financial centres' reputation concerns if issuers were excluded from liability in that context.[1184]

Besides, it would be contrary to the principles of civil law of most Member States, and especially the agency relationship between the company and its directors, not to hold the issuer responsible for the breach of disclosure requirements made by its directors in the course of their duty.

The purpose of imposing liability on the principal is to increase the chances that the claimant has a financially viable defendant to sue and to give the principal an incentive to control the actions of the agent. The *compensation and deterrence* rationales are thus met.

I therefore plead for the issuer to be held liable for violations of the EU issuer-disclosure regime.[1185] Any concern about over-deterrence - which could be detrimental to investors and society as a whole[1186] - should be addressed by precise formulations of the underlying disclosure obligations.

Another opinion is expressed in the US context by, *inter alia*, Professor Fox.[1187]

Professor Fox wishes to limit issuers' liability to the case they offer securities. He argues that the benefit of the misstatement or the omission in a periodic report does not accrue to the issuer contrary to what happens in the offering context but to the seller who sold at a too high price or to the buyer who bought at a too low price. In this context and considering the disclosure's objectives of improvement of corporate governance and market efficiency, the issuer is the primary victim of the violation: the company's existing shareholders are the persons damaged by the violation because of

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[1184] See PAUL DAVIES, Davies Review of Issuer Liability : Final Report (2007)., at 7-8 (arguing that "it would not be good for the reputation of the British capital markets to have them operate under a regime in which investors were not entitled to compensation for fraudulent statements made by issuers").

[1185] See however below, the possibility of issuers to recover damages paid to claimants in a recovery action against directors.

[1186] See the discussion under Part II:Chapter III:II.E.3.d.iiia in Chapter Corporate Governance.

[1187] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009). See also in the U.K., the minority view in the response of The Law Society's Committee on Company Law on Professor Paul Davies' Discussion Paper of 23 May 2007, at 11.

the resulting reduction in the value of the shares due to poor management and reduced liquidity. He concludes that it would make no sense if investors buying or selling at an unfavourable price had a cause of action against the issuer as damages would be paid for by those who are shareholders at the time the claim is awarded. Losses would be passed from one group of investors to another group, with a substantial portion dropping off as waste in the form of transactions costs, including legal fees.

The opinion expressed by Professor Fox is generally referred to as the "damage circularity problem", i.e., the fact that shareholders who continue to hold shares in the defendant after the settlement or the judgement of the case pay twice, leading to an overall net loss to these shareholders due to the non-trivial transaction costs imposed by lawyers prosecuting and defending the suits.[1188]

I tend to agree with US academics, including Professor Fox, who argue that the overall effect of a disclosure violation is a zero-sum game for diversified investors: the winners' gains equal the losers' losses. Each winner and loser is in that position by reason of chance and is just as likely to be in the opposite position as the result of disclosure violations by other issuers. For the diversified investor, and even for the non-diversified investor who buys and sells different stocks over time, the aggregate experience with disclosure violations is likely to be a wash.

But I do not share the consequences Professor Fox draws from there, *at least outside the specific circumstances of the US context*.

I ultimately think that Professor Fox' suggestion not to hold issuers responsible for misleading statements or omissions in periodic reports was primarily meant to be a response to the concerns raised by US class action damage suits based on fraud-on-the-

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[1188] See on damage circularity, JOHN C. COFFEE, Causation By Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo (2005);JOHN C. COFFEE, *Law and the Market: The Impact of Enforcement*, University of Pennsylvania Law Review, (2007).; DONALD C. LANGEVOORT, *On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, (2007)., at 633; LYNN A. STOUT, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Virginia Law Review 611, (1995). (explaining how stock trading simply transfers the benefits of ownership from one investor to another); RICHARD A. BOOTH, *The End of Securities Fraud Class Action?*, 29 Regulation 46, (2006).; MERRITT B. FOX, Fraud-on-the-Market Class Actions against Foreign Issuers (2009). The US Chamber of Commerce has used this idea of damage circularity as a key element in its recent attack on class action fraud-on-the-market litigation (see, America's Capital Markets: An Agenda for Continued Success, Equities Magazine Transatlantic Corporate Conference 2007, 28 September 2007). *Contra*, see Alice Davis Evans, Are Investors' Gains and Losses From Securities Fraud Equal Over Time? Some Preliminary Evidence, Univ. Mich. Law&Econ. Working Paper 09-002 (showing that diversified investors do suffer from securities fraud).

market theory. It is widely felt that, in the U.S., class actions under the fraud-on-the-market theory as incentive for an issuer to comply with its periodic reporting obligations come at great social expense and are also far from being totally effective, given the persistent existence of financial scandals.[1189] In this US context of rampant securities litigation that could damage the competitiveness of US capital markets,[1190] it makes total sense.

But in the European context where there is no such threat of abusive securities law class actions, I wonder what would be the real justification not to have the shareholders who are still owners after the settlement or the judgement (either because they purchased at too high price relying on the misleading information or because they sold only a part of their shares at a too low price relying on the misleading information or lack thereof) pay damages. I appreciate that these shareholders would seem to pay twice, once as damaged party who suffered a share drop or bought at too high price because of the misstatement or the omission and once as shareholder of the defendant company, if the defendant is found liable to pay damages. But the circularity claim can be rebutted on several grounds. Most importantly, I find sympathy with the arguments against damage circularity and which, in a nutshell, are based on a fight against the conception of an "innocent" shareholder and on the promotion of a "responsible" shareholder who gets the management he deserves.[1191] Moreover, the circularity argument fails to take into account the value society gains by enforcing its laws.

[1189] See JILL E. FISCH, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wisconsin Law Review 333, (2009)., at note 4 and the references therein cited and at 338 and accompanying text.

[1190] See MERRITT B. FOX, Fraud-on-the-Market Class Actions against Foreign Issuers (2009).

[1191] See LAWRENCE E. MITCHELL, The 'Innocent Shareholder': An Essay on Compensation and Deterrence in Securities Class Actions (2008).; JILL E. FISCH, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wisconsin Law Review 333, (2009). (finding a rationale for compensation by shareholders which relates to the role played by informed traders in the promotion of corporate governance).

b. The case of the directors

i Preliminary remark

Both the Prospectus Directive and the Transparency Directive provide for the possibility to hold accountable *other persons than* the issuer or its administrative, management or supervisory bodies.[1192]

However, this dissertation does not deal with the liability for misleading statements or omissions in disclosure of non-issuer defendants other than directors, like managers,[1193] accountants, underwriters (including the lead manager) or legal counsels.[1194]

Concerning auditors and misleading statements or omissions in the audited financial statements contained in disclosure, the reasons are as follows. Accountants are obviously vital gatekeepers. They too will have greater incentives to exercise care if subject to some kind of civil liability. Reputation is not always useful as signalling device.[1195] It may be appropriate to subject accountants to an approach similar to what is recommended here for directors. But the issues relating to the trade-offs between achieving any given level of care and the costs of doing so, as well as the history of the

[1192] See articles 6.1 of the Prospectus Directive and 7 of the Transparency Directive. Comp. with section 11(a) of the US Securities Act where the issuer and a list of statutorily defined potential defendants, including the directors, the underwriter and outside experts like the accountant, could be held liable if the registration statement related to a public offering contains a material misrepresentation or omission. With respect to Rule 10b-5, the possible defendants are the primary violators that engage in the fraudulent conduct (the "in connection with" requirement) (see generally Bloomenthal, Securities Law Handbook, 2008-2009 edition, Chapter 27, Parts V-VII).

[1193] Although the liability scheme that I suggest for directors could be easily extended to members of management, where, according to the national law of the Member States, these managers are subject to a similar liability regime as members of the board of directors. See for instance in Belgium, articles 527 and 528 of the Belgian company code (extending liability to members of the executive committee (*membres du comité de direction*)).

[1194] Other parties may act as gatekeepers, including securities analysts and credit rating agencies. However, responsibility of these intermediaries seems even more problematic than liability of underwriters, accountants and auditors and lawyers. See JOHN C. COFFEE, Gatekeepers - The Professions and Corporate Governance (Oxford University Press. 2006).

[1195] See CARSTEN GERNER-BEUERLE, *The Market for Securities and its Regulation Through Gatekeepers*, ECFR (forthcoming), (2009).

applicable rules of liability to date, are sufficiently different to call for a separate inquiry.[1196]

Concerning underwriters and legal counsels who performed some kind of due diligence with respect to disclosure, Member States have developed standards of liability through case law or otherwise.[1197] In the agreement between the company and themselves, their liability is most of the time explicitly excluded or limited, outside the case of fraud.[1198] Should their responsibility be engaged, there is no problem of damage circularity. As any civil liability regime framed into a European regulation would certainly lead to fee increases, a thorough costs-benefits analysis should be conducted should a market failure in the situation prevailing in Member States be proved to exist. However, my intuition is that there could be an interesting avenue to hold them accountable to a greater extent than currently provided for by national law and/or case law. This would be in investors' interest.[1199] This being said, a distinction could be made between liability at the time of the IPO and liability thereafter, i.e., at the time of a prospectus relating to a secondary public offering (be it by use of the European-flavoured shelf-registration or not) or, under the scheme under the European Regulation, an offering prospectus.[1200] I also believe that the lead underwriter should be

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[1196] See for applicable European rules, Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, OJEU, 21 June 2008, L 162/39 and the web-site of the European Commission in connection with auditors' liability.

[1197] See for underwriters' liability in connection with primary market disclosures, notes 1086 and 1087 above and accompanying text.

[1198] There is generally a provision in the agreement between the issuer and the underwriter to the effect that, in case of litigation against the underwriter, and outside the case of fraud or gross negligence, the issuer will hold the underwriter harmless. See Harold S. Bloomenthal, *Going Public Handbook*, app. 2, § 6.01 (2008-2009 ed.) (providing for a standard liability limitation clause). But see US courts which hold that indemnification agreements are, in general, not enforceable. There is considerable uncertainty as to the reach of the prohibition. Some courts restrict the rule to agreements that provide for indemnification notwithstanding intentional or reckless conduct of the claimant. Others prohibit indemnification agreements whenever the party that seeks indemnification has acted at least negligently. Moreover, the permissibility of contribution agreements is unclear, at least in case of partial settlements. Now both approaches are combined in §21D(f)(7)(B) of the US Securities Exchange Act for private class actions arising under the US Securities Exchange Act. For other actions, for instance those pursuant to section 11 of the US Securities Act (Civil Liability on Account of False Registration Statement), the controversy is still of relevance. I do not know of similar decisions in Europe. Note that in Germany indemnification agreements are considered permissible by academic literature. See references in CARSTEN GERNER-BEUERLE, *The Market for Securities and its Regulation Through Gatekeepers*, ECFR (forthcoming), (2009)., at note 337 and accompanying text.

[1199] *Accord* CARSTEN GERNER-BEUERLE, The Market for Securities and its Regulation Through Gatekeepers, ECFR (forthcoming), (2009).

[1200] See in the US context where there is an extensive shelf-registration regime which is often used, MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009). (discussing how to adapt underwriters' liability to modern practice of shelf-registration).

distinguished from the other members of the underwriting syndicate, given the different level of involvement in the drafting of the disclosure documents.

I understand that there is some controversy among Member States as to the desirability to hold directors personally accountable and no clear international trend in that respect,[1201] outside the limited circumstances of a derivative action.[1202] Some therefore suggest to leave the extension of liability to directors at the Member States' discretion.

However, I consider that having the possibility to engage directors' personal liability is justified for the reasons explained below.

This being said, a distinction could be made between inside and outside directors.[1203]

[1201] See, for instance, the UK FSMA 2000 (Liability of Issuers) Regulations 2010 which amend the regime for the liability of issuers to third parties in respect of loss suffered as a result of misleading statements or dishonest omissions in periodic information published by an issuer, or dishonest delays in publishing such information, which was made on 7 April 2010 and which comes into force on 1 October 2010. See in particular, new section 90A (dealing with the liability of issuers in connection with published information) and new Schedule 10A (liability of issuers in connection with published information) of the UK FSMA 2000. It defines the securities which are to be subject to the new liability regime and the information to which the new regime is to apply (this includes all information published by an issuer via a recognised information service, or where the availability of the information has been announced by use of such a service) and sets out the circumstances in which an issuer is liable to pay compensation for loss suffered as a result of untrue or misleading statements, or dishonest omissions by a person who has acquired, continued to hold or disposed of securities in reliance on published information (in essence, it selects a demanding fraud test for liability and it provides for liability only of the issuer, not the directors); see PAUL DAVIES, *Liability for Misstatements to the Market: Some Reflections*, 9 Journal of Corporate Law Studies 295, (2009). (insisting on the importance with respect to directors of *public* enforcement based on negligence). Comp. with Belgian law (see, *inter alia*, article 527 of the Belgian company code (liability of directors *vis-à-vis* the company for breach of agency rules), article 528 of the Belgian company code (liability of directors *vis-à-vis* company and third parties but controversy whether this could be invoked in case of breach of disclosure requirements) and article 561 of the Belgian company code (company action)); articles 225-251 of the French commercial code (holding directors liable *vis-à-vis* the company or third parties for breach of regulatory provisions). Comp. with Ontario (referring to an extensive list of potential defendants, including issuers, directors, authorising officers, controlling shareholders and experts); and U.S. (where the liability can extend to directors and other actual makers of statements as well as issuers, but not to "aiders and abettors").

[1202] See Part II:Chapter III:II.E.3.d.iiic in Chapter Corporate Governance.

[1203] See CARSTEN GERNER-BEUERLE, *The Market for Securities and its Regulation Through Gatekeepers*, ECFR (forthcoming), (2009)., at 53 (suggesting any type of negligence for executive directors and gross negligence for outside directors). It should be noted that any argument relating to the collegiality of the board to dismiss my suggestion to distinguish between inside and outside directors should be ignored as there seems to be under current national company law already distinctions between the two. See, for instance, some corporate governance codes which distinguish between executive and non-executive directors; see the various articles of the Belgian company code which do the same. Comp. with the US regime (where the liability of outside directors is determined pursuant to sections 11(f)(2)(A) of the US Securities Act, 21D(f) of the US Securities Exchange Act, 15 U.S.C. §§ 77k(f)(2)(A), 78u-4(f) (2007), i.e., it is several (not jointly and several as in section 11(f)(1) of the US Securities Act) and *ii* *Compensation rationale?*

Is directors' personal liability justified from a compensation rationale perspective?

The direct civil liability of directors will not at all meet its goal of compensation in an action brought by existing shareholders where the obligation to pay damages is shifted from directors back to the issuer, i.e., the existing shareholders, by contractual risk-shifting devices, like D&O insurance, indemnification by the company or exculpatory provisions in the articles of association.[1204]

These risk-shifting devices are widespread in the U.S. and are common in the E.U., to the extent permitted by applicable law. They offer a solution to the various costs related to directors' personal liability.[1205]

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proportionate to the percentage of responsibility of the defendant, provided that the defendant did not knowingly commit the violation). See US case law relating to the due diligence defense under section 11(b)(3) of the US Securities Act. The first important opinion concerning the due diligence defense emphasised: "[i]t is all a matter of degree." (see Escott v. BarChris Const. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968)). If a defendant is "directly concerned with writing the registration statement and assuring its accuracy, more [is] required of him in the way of reasonable investigation than [can] fairly be expected of [someone] who [has] no connection with this work." This approach has led courts to draw a distinction between corporate insiders (executive directors) and outsiders (non-executive directors and third parties, including the underwriters), imposing stringent requirements on the former and being more lenient in case of the latter (see for instance,. Feit v. Leasco, 332 F. Supp. 544, 578 (E.D.N.Y. 1971) ("[t]he liability of inside directors "approaches that of the issuer as guarantor of the accuracy of the prospectus."). However, this dichotomy does not change the fact that the "sliding scale" is gradual and that within the two groups of insiders and outsiders the standard of care continues to depend on the specific position of the defendant and his access to the issuer.

[1204] See, for instance, in the U.K.,article 233 (Provision of Insurance) of Chapter 7 (Directors' Liabilities), Part 10 (A Company's Directors) of the Companies Act 2006 ("Section 232(2) (voidness of provisions for indemnifying directors) does not prevent a company from purchasing and maintaining for a director of the company, or of an associated company, insurance against any such liability as is mentioned in that subsection."). See, in the U.S., MICHAEL KLAUSNER, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis (2009).; ASSAF HAMDANI, et al., *Rewarding Outside Directors*, 105 Mich. L. Rev. 1677, (2007). ; DONALD C. LANGEVOORT, *On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, (2007)., at 651 ("[…] nearly the entire settlement funding tends to come from the company and the insurers. Individuals are largely ignored, however culpable."). To be sure, former outside directors of WorldCom and Enron agreed to pay a total of nearly USD40 million out of their own pockets to settle class actions securities lawsuits (see for more details, BRIAN R. CHEFFINS, et al., *Outside Director Liability Across Countries*, 84 Texas Law Review 1385, (2006)., at note 4). But this was a "major departure from the norm" (BRIAN R. CHEFFINS, et al., *Outside Director Liability Across Countries*, 84 Texas Law Review 1385, (2006)., at 1385). For an analysis across countries, BRIAN R. CHEFFINS, et al., *Outside Director Liability Across Countries*, 84 Texas Law Review 1385, (2006)., at 1387 and note 13 ("[…] across countries, laws governing outside directors of public companies often lack financial "bite""; noting that this is also relevant for other directors).

[1205] See Part III:Chapter II:IV.D.1.b.iii below.

For past shareholders, who sold their shares on the basis of the information, the compensation rationale would often not be met for reasons related to the small financial capabilities of directors compared to the issuer's.

However, the lack of compensation could be less negative than it seems in the perspective to promote a "responsible" shareholder, as suggested by Professor Mitchell.[1206]

To conclude, a regime which would provide for directors' liability would not have as primary goal compensation.[1207] That is one reason why investors should also have under their national law the possibility to sue issuers simultaneously for the compensation objective to be achieved.[1208]

By contrast, the external certifier, if the suggestion to have one finds a positive echo, is a totally different case. It should be a financially sound institution.[1209] Therefore, it could be made possible in principle to get full compensation from it.

The European regulator could prohibit the issuer to indemnify the external certifier to avoid compensation being ultimately paid by existing shareholders.[1210]

D&O insurance could still be allowed as it is the external certifier who would pay for it. The insurance provider would have strong incentive to monitor the adequacy of the external certifier's due diligence practices as it is the external certifier's only function. On the other hand, the external certifier would have strong incentives to

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[1206] See note 1192 above and accompanying text. See also Part II:Chapter III:II.E.3 in Chapter Corporate Governance.

[1207] See Clifford Chance Submission to the Davies Review of Issuer Liability, 27 April 2007, at point 21 ("[g]iven the contrast between the size of claims that are likely to be brought and the probable financial position of the directors, we see the likelihood of a successful action with investors recovering adequate compensation for a fraudulent misstatement by a director to be small (beyond any available insurance cover). In most instances, a finding against a director will result in his or her bankruptcy. In practice, this is likely to mean that a director will apply the substantial part of his resources in paying the legal costs of litigation in respect of the action, leaving little, if anything, to pay compensation.").

[1208] See in that respect, Dutch Supreme Court, VEB et al. v World Online, Goldman Sachs and ABN Amro, 27 November 2009, LJN: BH2162 (holding the issuer liable on the basis of (former) article 6:194 of the Dutch civil code (misleading and comparative advertisement (*misleidende en verlegijkende reklame*)).

[1209] See Part III:Chapter II:III.B.2 above.

[1210] Unless one considers, like with the directors, that shareholders get the external certifier they deserve as they elect him.

minimise its premiums, as, although it would pass on the costs to the issuer, it has to compete with other external certifiers to get the job from the issuer.

iii Deterrence rationale?

a The theoretical point of view

Is personal liability of directors necessary to deter misleading statements and omissions? Should directors contribute personally, in the absence of deliberate fraud, in order for the deterrence policy objective of the civil liability regime to be promoted?

Within the issuer, directors are ultimately the ones who should supervise the drafting of the disclosures. Executives' decisions are influenced by the directors' oversight (as well as by shareholders' monitoring). Directors could be considered as the ones inflicting the harm on the company and its shareholders. If this reasoning is accepted, it should not be made possible to raise any argument against this principle based on the company law of agency relationships.

As further evidenced by the 2007-2008 financial crisis, neither internal control mechanisms nor whistle blowing procedures, reduce the frequency of misleading statements or omissions by directors.

Moreover, equity-based compensation or reputational concerns could not work properly as incentives to deter managers from disclosing misleading statements or making misleading omissions.[1211] Where they do, civil litigation may serve to stimulate the company to discipline directors more toughly.

[1211] For papers finding a correlation between high levels of executive compensation, financial fraud and the likelihood of a company being targeted by a securities fraud class action in the U.S., see the studies cited in RANDALL S. THOMAS, et al., *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 ECFR 165, (2009)., at 198 et seq. For the ineffectiveness of reputational concerns, see, *inter* alia, ASSAF HAMDANI, et al., *Rewarding Outside Directors*, 105 Mich. L. Rev. 1677, (2007). *Contra* BRIAN R. CHEFFINS, et al., *Outside Director Liability Across Countries*, 84 Texas Law Review 1385, (2006)., at 1389 et seq. ; see also JONATHAN M. KARPOFF, et al., *The Cost to Firms of Cooking the Books*, 43 Journal of Financial and Quantitative Analysis 581, (2008). (finding that reputational sanctions suffered by the issuer for committing fraud can be huge); and, for a similar argument putting emphasis on the combination of liability, ouster and shaming in the context of related-party transactions, ALESSIO M. PACCES, Controlling the Corporate Controller's Misbehaviour (2008).

Therefore, in case of misleading statement or omission, it could be useful, as a matter of principle, to hold directors accountable, unless the responsibility of another non-issuer defendant can be successfully invoked.[1212]

In addition, one should consider to prohibit any recourse to corporate indemnification clauses or to D&O insurance as these would jeopardise the deterrence objective of personal liability.

b And the case in practice

So much for the theory.

In practice, one should be cautious, as the policy objective is not deterrence as such but *optimal deterrence*.[1213] To achieve optimal deterrence, the costs associated with directors' personal liability need to be taken into account.

The *various costs* related to a liability regime for directors are as follows:

Directors' liability could lead to difficulties to *recruit qualified directors for affordable and reasonable "prices"*. The risk for innocent directors to face liability due to poor legal advice or errors by courts in addition to legal or factual ambiguity, for instance where it is difficult to determine if particular information is material and therefore subject to disclosure, increases such difficulties.

It could also *prompt to take risk-averse decisions*. The threat of liability without D&O insurance could lead to "extreme and undesirable caution" from directors.[1214] That in turn could lead to forego profitable opportunities due to the avoidance of legally ambiguous behaviours. And it could lead to resist taking the company public to avoid the increased risk. In other words, the threat of litigation could stimulate excessive precaution, which could be detrimental to the economy.

[1212] Appropriate safe harbours for reliance on "experts'" advice should be provided for.

[1213] Recall the discussion relating to the optimal level of deterrence and the right level of robustness of a liability regime under Part II:Chapter III:II.E.3.d.iiia in Chapter Corporate Governance. And see more specifically ASSAF HAMDANI, et al., *Rewarding Outside Directors*, 105 Mich. L. Rev. 1677, (2007).

[1214] See, for instance, PAUL DAVIES, Davies Review of Issuer Liability : Final Report (2007)., at 25 et seq.

It could lead to *information over-load*, which could be detrimental to investors as too much information would be provided by issuers by fear of a liability suit.[1215]

It could also lead to disclose commercially sensitive information that diminishes the issuer's competitive position. The threat of litigation could stimulate *excessive over-compliance costs*.

Directors could engage "in more aggressive asset protection strategies, raising the cost and risk associated with reaching those assets" further to a too robust civil liability regime.[1216]

Moreover, increasing directors' liability could make issuers "insist on very strong litigation defense, which is, at least in the first instance, at company expense", i.e., at shareholders' costs.[1217]

In order for issuers to still attract qualified directors, and not to create obstacles to ambitious, however well founded, decision-making, the European Commission could provide for *damage caps*, outside the circumstance of outright fraud, which should be related to the compensation that responsible persons receive from the company.[1218] In

[1215] See Part II:Chapter I:VI in Chapter Investor Protection (relating to information over-load and the use of disclosure documents as defence tools in case of litigation) and note 250 above and accompanying text (relating to disclaimers in disclosure documents).

[1216] See DONALD C. LANGEVOORT, *On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, (2007)., at 651 (expressing scepticism about the idea to increase directors' liability by abolishing or significantly curtailing company liability and leaving only or mainly insurance money and the non-issuer defendants personal assets on the table; predicting that it would create a "game of chicken regarding the size of corporate D&O insurance policies").

[1217] See DONALD C. LANGEVOORT, *On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, (2007)., at 651 (expressing scepticism about the idea to increase directors' liability by abolishing or significantly curtailing company liability and leaving only or mainly insurance money and the non-issuer defendants personal assets on the table; predicting that it would create a "game of chicken regarding the size of corporate D&O insurance policies"). See note 702 above and accompanying text.

[1218] See amendments to the Securities Act of Ontario in respect of civil liability for continuous disclosure (Ontario Securities Act, Part XXIII.1 (ss 138.1 – 138.14) of the Securities Act) (amending the Securities Act by providing for civil liability for secondary market disclosure violations. The amendments impose caps on damages, depending on the identity of the liable party. For a liable issuer, damages are limited to the greater of 5% of its market capitalisation or C$1 million. For a liable director or officer of a responsible issuer, damages are limited to the greater of C$25,000 or 50% of the aggregate of the director's or officer's annual compensation from the responsible issuer and its affiliates. The amended statute also provides for damages caps for other liable parties, including "influential persons", experts, and other persons making public oral statements. See Notice of Amendments to the Securities Act and Regulation, and to the Commodity Futures Act, 28 Ontario Securities Commission Bulletin 6555 (Aug. 5, 2005)).

addition, a solution to information over-load and to countless disclaimers could be to tighten the underlying disclosure obligations and, *inter alia*, the definition of materiality. Besides, supervisory authorities could be asked to check the relevance of the information provided against that materiality benchmark.

If the violation has been unambiguously corrected in the annual financial report, or publicly any time before the release of the next annual financial report, the external certifier should not be held liable. Only each of the directors who was in office at the time of publication of the earlier periodic report containing the misstatement or the omission should be liable in that case. Damages should be reduced so that they would be in proportion to the fraction of the year between the date of the earlier publication and the date of the annual financial report (or, if unambiguously corrected earlier, the date of the earlier correction). A specific standard of what constitutes due diligence with respect to the external certifiers should be drawn to make safe harbours available to them.[1219]

c Conclusion

Once again, there is a need for a costs-benefits analysis.

I think there are strong arguments on both sides.

I tend to find sympathy with the suggestion to make it possible to hold directors responsible. This being said, given the important costs associated with this suggestion, like the costs linked to attracting competent directors without paying excessive remuneration, I believe that the complementary measures, like the liability standard and the burden of proof, should be carefully considered in order to avoid over-deterrence and important litigation costs while still meeting the deterrence objective of directors' liability. The remainder of this section is deemed to draw a policy that best balances the rights of investors with incentives placed on issuers and directors.

[1219] These safe harbours could also be available to outside directors and could make reference to their reasonable reliance on an expert's advice.

2. *Contributing parties*

In order to make the threat of a civil lawsuit a useful complement to public enforcement to deter directors from making misleading statements or misleading omissions, directors should face actual diminishment in their wealth in case of disclosure violation. This way only, the deterrence objective of putting civil liability on directors would be achieved.

Therefore, issuers, who were sentenced to pay damages to the claimants, should be able to sue responsible persons through a recovery action. In drawing a recovery action provision, the European regulator should have in mind to make it the least costly possible and to alleviate any procedural obstacles.

Furthermore, the issuer should not be allowed to indemnify directors, at least perhaps beyond paying the legal fees of directors and unless one considers that shareholders get the directors they deserve. In the same line of thoughts, D&O insurance should be prohibited with respect to directors, unless one considers that shareholders get the management they deserve and therefore should bear the cost of misleading information or omission through the D&O premiums paid by the issuer, i.e., the existing shareholders. As for the external certifier, as it is the external certifier, not the issuer, who is paying the insurance and for the reasons stated above, he could be allowed to subscribe to a D&O insurance.

3. *Possible claimants*

In order to prevent abusive litigations, and given the objectives of the EU issuer-disclosure regime, I suggest to let only past and present shareholders sue, provided that they entered a trade.[1220]

[1220] Comp. the current version of section 90A of the UK FSMA (providing for statutory liability of issuers with respect to periodic reports *vis-à-vis* buyers of shares (not sellers)) with the new section 90A of the UK FSMA (which enters into force on 1 October 2010) (providing that compensation shall be paid to persons who have acquired, continued to hold or disposed of securities in reliance on published information). Comp. articles 36a and 36b of the Seventh Company Law Directive and articles 50b and 50c of the Fourth Company Law Directive (stating that liability for the drawing up of the annual accounts, annual report, and when provided separately, the corporate governance statement, in accordance with the requirements of the directives should lie collectively with the members of the administrative, management and supervisory bodies of the company "at least toward the company"); recital (2) of directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending, *inter alia*, the Fourth and the Seventh Company Law Directives, OJ L 224, 16 August 2006, at 1-7 (adding that "[t]his should not prevent Member States from going further and providing for direct responsibility toward shareholders or even other stakeholders"). Comp. with section 11 of the US Securities Act (providing that only acquirers may sue).

With respect to shareholders who have not sold their securities but would have had they known, I suggest to keep them out of the specific liability regime outlined here. They could still sue the responsible persons on the basis of the principles of the law of tort.[1221]

4. Indemnified persons

I suggest that compensation be paid to the claimant.

Some authors argue that damages should be paid to the issuer since it is the issuer who suffers the greatest loss as disclosure's primary role is to improve corporate governance and market efficiency.[1222] The company's existing shareholders are thus the ones ultimately harmed by the violation because of the resulting reduction in the value of the shares due to the misleading statement or omission. As for the persons who purchased or sold in the secondary market at an unfavourable price during the period of the violation, the overall effect of a disclosure violation is a zero-sum game, i.e., the winners' gains equal the losers' losses, as explained above.[1223]

However, in my opinion, the main flaw of this argument is that this solution would not promote investors' confidence in the market-place.

Past shareholders who sold at a too low price because of the misstatement or the omission would not have any incentive to sue in case damages are awarded to the issuer.

[1221] *Accord* PAUL DAVIES, Davies Review of Issuer Liability : Final Report (2007)., at 7-24 (considering that holders of shares who did not trade and non-acquirers who did not buy should be excluded from suing under the UK statutory liability regime. Holders of shares could still be able to sue on the basis of their common law rights); the response of The Law Society's Committee on Company Law on Professor Paul Davies' Discussion Paper of 23 May 2007, at 8 (arguing that "extending the protection to holders who do not sell would open up a body of litigants who would be encouraged to claim against the issuer against an uncertain legal framework, in particular in the context of reliance and proof of loss"). Comp. with German law (see section 44 of the stock exchange act (BörsG), Law of July 16, 2007, BGBl. [Federal Law Gazette] I, at 1330 (providing that claimant can be anyone who purchased the securities within six months from their first introduction to trading)).

[1222] See MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).; JOHN C. COFFEE, Causation By Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo (2005).; DONALD C. LANGEVOORT, *On Leaving Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, (2007)., at 633.

[1223] See Part III:Chapter II:IV.D.1.a above, in case shareholders are diversified or, where they are not diversified, they buy and sell over time.

Whereas damages that should cover the losses of current shareholders who bought at a too high price because of the misstatement or the omission would be diluted amongst all shareholders if paid to the issuer making them likely to recover only a very small part, if any, of their loss.

And if nobody sues, then how could civil liability actions be a good incentive for prompt and accurate issuer-disclosure?[1224]

5. *Liability standard*

With respect to the degree of fault required, striking the right balance between issuers' and investors' interests is, once again, at the core of the discussion.[1225] If the liability threshold is low with high penalties, this could lead to over-cautiousness from responsible persons, which could result in delays before information dissemination, disclosure of irrelevant information or over-conservative disclosure written in a language that is difficult to interpret. If the liability threshold is high with low penalties, this could run to the detriment of investor protection and investor confidence in the financial markets.

What concerns the civil liability standard at the time of a *public offer*, I suggest to apply a *negligence standard to the issuer and to the directors*.[1226] The issuer and the

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[1224] It should be recalled here that damages are paid to the issuer under a derivative action, see Part II:Chapter III:II.E.3.d.iiic in Chapter Corporate Governance.

[1225] See the plea of ESME for harmonisation of the liability standard under the Prospectus Directive (EUROPEAN SECURITIES MARKETS EXPERT GROUP, Report on the Prospectus Directive (2007)., at 19 (arguing for an amendment to the Prospectus Directive promoting an harmonised liability standard to provide issuers with legal certainty)).

[1226] See section 90 (Compensation) and schedule 10 (Compensation: Exemptions) of the UK FSMA (providing for negligence standard of care; extending liability not only to issuers but also to directors and all those who endorse the prospectus or parts of it). See also section 11(b)(3) of the US Securities Act (providing with respect to the liability at the time of the offering of non-issuer defendants, like directors, experts and underwriters, a negligence standard of care. Non-issuer defendants may escape liability if they show that they have conducted a reasonable investigation of the registration statement and, after such investigation, had reasonable ground to believe that the documents were correct and complete (the so-called due diligence defense). As regards defendants other than experts who relied on expertised portions of the registration statement (for instance, the audited accounts of the issuer), all that is necessary is that they had "no reasonable ground to believe and did not believe" that anything contained in the expert opinion was untrue. An independent investigation is not required). Comp. with section 11 of the US Securities Act (applying a strict/absolute liability standard to the issuer for primary market statutory liability) and with section 44 of the German stock exchange act (BörsG), Law of July 16, 2007, BGBl. [Federal Law Gazette] I, at 1330 (providing for a gross negligence standard of care according to which the defendant can avoid liability by showing that he was not aware of the misstatement and that his ignorance was not the result of gross negligence).

directors have indeed a stronger incentive to make misleading statements or omissions where the issuer publicly offers securities because this misleading statement or omission is likely to have a direct positive effect on the share price while the proceeds of the offering directly go into the issuer's pockets. In order to collect from the company or from the directors, the claimant must prove that there was a misleading statement of a material fact or a misleading omission of a material fact. The defendants can avoid liability by showing that they were not aware of the misstatement and that that ignorance was not the result of negligence.[1227] This standard of liability would contribute to investor protection and their confidence in financial markets.

As a general rule, it should be more difficult to prove liability in the secondary market than in the primary market in order to prevent over-deterrence and inefficient results.[1228] Therefore, for *the issuer and the directors any time after a public offer*, negligence is not warranted.[1229]

For issuers any time after the offering, he would not have an incentive not to comply as great as on primary markets.

[1227] See schedule 10 (Compensation: Exemptions – Statements believed to be true) of the UK FSMA.

[1228] This argument goes back to an article by WILLIAM BISHOP, *Economic Loss in Tort*, 2 Oxford J. Legal Stud. 1, (1982). (claiming that in cases of pure economic loss the cost to society may be less than the private economic loss suffered by the victim and that, accordingly, full liability would give an incentive to implement precautionary measures that do not minimise total social cost and that are therefore not efficient). This argument may serve as justification to adhere to the requirement of fraud/recklessness that can be found in secondary market liability provisions in the U.K. (see new schedule 10A (Liability of issuers in connection with published information), Part 2 (Liability in connection with published information), 3(2) and 3(3) of the UK FSMA, and chapter 12 (Supplementary Provisions), section 463 (Liability for false or misleading statements in reports) of the UK Companies Act 2006). Comp. with Germany (see sections 37b(2) and 37(c)(2) of the German stock exchange act (BörsG), which require intent (*Vorsatz*) or at least gross negligence (*grobe Fahrlässigkeit*) for liability for a misstatement in an *ad-hoc* announcement and negligence for liability for misstatements in periodic information. See also the application by German courts of section 826 of the German civil code which requires scienter, which has been interpreted by the courts as requiring recklessness (*dolus eventualis*)) and with the U.S. (see Rule 10b-5 as interpreted by US courts). Comp. with French law (providing for a negligence standard of care); Dutch law (providing for a negligence standard of care with respect to the issuer (article 6:162 of the Dutch civil code) but this is presumed with respect to the directors in connection with annual reports (article 2:139 of the Dutch civil code)).

[1229] It should be reminded that each of my regulatory implications should be considered separately. This being said, it should be seen whether adopting two differential liability regimes for public offerings and continuing disclosure obligations might become problematic if my suggestion related to one base disclosure document and a move to company registration is implemented. This being said, if my suggestion to have an external certifier is implemented, there is less reason not to require from issuers and directors a negligence standard on secondary markets as the liability risk could be substantially reduced by the extensive verification of the on-going disclosure requirements before they are published and by the rather standardised content of disclosures.

For directors, a negligence standard would act as deterrent to accept directors' positions.

Besides, a negligence standard of care would encourage less informative reporting, responsible persons being overly cautious in the drafting to avoid liability.[1230] The consequence would be less helpful information spread on the market as a consequence of over-deterrence, which will ultimately reduce allocative efficiency, liquidity and corporate governance impacts of issuer-disclosure. Because of the delay with which information would be disseminated to comply with the standard, it would not contribute to promote market efficiency, encouraged by timely disclosure and minimum costs of compliance. Furthermore, it would increase audit and legal fees costs involved in the verification of secondary market information.[1231] Moreover, if one assumes that the incentives are likely to change significantly in the E.U. in favour of securities fraud class actions, speculative litigation, driven by the economic interests of law firms or third party funders, will be more likely under a negligence standard.

Instead, I favour a *deceit basis of civil liability*. In a nutshell, the common standard should amount to prohibit making a statement/an omission of a material fact unless the maker genuinely believes it not to be misleading. The European regulator should get inspiration from the definition given to "fraudulent misstatements or omissions" in the U.K., i.e., fraud as defined in the tort of deceit.[1232] The maker of the statement must either know that the statement is false or not care whether it is true or false. A genuine belief in the truth of the statement would be a defense to liability, even if that belief were based on inadequate checking, regardless of how irrational the belief is.[1233] The maker of the statement is not required to check whether the statement is actually true. The term "fraud" would thus encompass outright fraud or recklessness and would not refer to "gross negligence", as this latter concept exists in other European

[1230] *Accord* KLAUS HOPT, et al., *Prospekt- und Kapitalmarktinformationshaftung*, 61 JuristenZeitung, (2006)., at 127, cited by PAUL DAVIES, Davies Review of Issuer Liability : Final Report (2007).

[1231] See PricewaterhouseCoopers who investigated this issue and provided Professor Davies for its review with an estimate that a prospectus-type verification approach to annual statements would increase the audit costs by a fifth and that a similar further increase would be generated by additional legal work which would be involved. See however, Part III:Chapter II:III.C.2 above and my suggestion to have an external certifier which is likely to be costly.

[1232] See *Derry v Peek* (1889) 14 App Cas 337, HL; John Cartwright, Misrepresentation, Mistake and Non-Disclosure, London, Sweet & Maxwell, 2nd edition, 2007, chapter 5.

[1233] Comp. with new Schedule 10A of the UK FSMA and section 463 of the UK Companies Act 2006 (see note 1229 above and accompanying text).

jurisdictions.[1234] The middle-way alternative of "gross negligence" seems to be very similar to the US secondary market liability standard. Secondary market claims tend to be brought in the U.S. under Section 10(b) of the US Securities Exchange Act and US SEC Rule 10b-5 made under it, although this section appears to give rise to no private right of action. When the courts interpreted the section so as to provide this right, they adopted a "scienter" standard.[1235] In fact, the standard adopted was more than the making of a knowingly false statement with intention that it be relied upon: there was required to be an intention to "deceive, manipulate or defraud." So intentionality was required. However, later cases have relaxed this standard so as to embrace "recklessness". They have then given recklessness a broader meaning than in the U.K., so as to embrace "an extreme departure from the standards of ordinary care",[1236] in other words a high degree of recklessness. Where this is the case, there is a risk of over-deterrence as there is a risk of divergence between the standard as applied by the maker of the statement in good faith and subsequently by a court, which could make the maker of the statement overly cautious. This being said, the most recent legislative and judicial efforts in the U.S. seem to be aimed at restoring the scienter standard.[1237]

6. Burden of proof and presumption of causal link

In a case against *directors or the issuer*, there could be a presumption of causal link between the misleading statement or omission contained in *periodic reports and ad hoc disclosure* and the investment decision. This would mean that the claimant should not be required to prove that it relied on the misleading information or the misleading omission to buy (or sell) the securities. It would be presumed that it relied on the market

[1234] See, for instance, *Grobe Fahrlässigkeit* in Germany or *faute lourde* (or *zware fout*) in Belgium and France or *colpa grave* in Italy or *grove nalatigheid* in the Netherlands, i.e., the belief is honestly held but on very unreasonable grounds.

[1235] In order to limit the risk of liability under rule 10b-5 of the US Securities Exchange Act, the US Supreme Court has over-ruled decisions of the lower federal courts that had allowed claims in cases of negligence. Instead, it required the claimant to prove that the defendant acted with scienter (see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)). The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."

[1236] LOUIS LOSS, et al., Fundamentals of Securities Regulation (fifth edition) (2009)., at 1025. See as well, Broad v. Rockwell Intern. Corp., 642 F.2d 929, 961-962 (5th Cir. 1981); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) ("those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it").

[1237] See *Tellabs Inc v Makor Issues & Rights Ltd* 551 US 308 (2007).

price of efficient secondary markets, which, further to the ECMH, would be supposed to reflect the improper information or lack thereof.[1238]

Besides, it could be suggested to introduce a presumption of causal link between the misleading statement or omission contained in *periodic reports and ad hoc disclosure* and the damages, like depreciation of the stock price. This would take into account that it could be difficult to determine what has influenced the decline of the stock price and to what extent. In any case, this presumption of causal link should only apply provided that the misstatement/omission would be likely to have an impact on the market price, i.e., that it is a misstatement or an omission of a material fact.

If they were to be introduced, both presumptions of causal link should be rebuttable presumptions: the defendant should be able to prove that (1) the claimant did not rely on the misstatement to enter into the transaction, or (2) the damages did not result from his or her misconduct but would have occurred even in the absence of misleading information/omission. This should dissipate any doubt on the objective of private securities actions: they should not be meant to provide investors with broad insurance against market losses but should protect investors against those economic losses that misrepresentation/omission actually cause.[1239]

[1238] See Chapter Market Efficiency. See also BART J. DE JONG, *Class Actions Made Difficult – Causaal verband, schade en collectieve acties in geval van misleidende berichtgeving op de beurs*, 14 Ondernemingsrecht – Effectenrecht, (2007)., at 514.

[1239] *Accord* in the U.S., Dura Pharmaceuticals Inc. et al. v. Broudo et al., 544 U.S. 336 (2005).

With respect to the *primary markets*,[1240] one could further suggest to apply this presumption of causal link with respect to *issuers and directors* only when the issuer is making a *de minimis* secondary public offering, perhaps less than 30% or 40% of the outstanding shares.[1241] Indeed, in these circumstances, it is more likely that the offering price will be more efficient than when the issuer is offering a large amount of equity. As already mentioned, in the latter situation, the offering is likely to be accompanying a transformative event in the history of the firm and so the fact that the secondary market price prior to the offering was efficient provides much less assurance that the offering price will be efficient. Moreover, like an IPO, there will need to be significant marketing efforts to find new persons willing to hold the many new shares being offered and so again an efficient secondary market in the issuer's shares provides less assurance that the offering price is efficient.

These suggestions to introduce presumptions of causal link relying on the ECMH and on the fact that secondary markets and primary markets for small issues are efficient

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[1240] See section 45, §2, nr. 2, of the German stock exchange act (*BörsG*), Law of July 16, 2007, BGBl. [Federal Law Gazette] I, at 1330 with respect to primary market liability (providing for a presumption relating to transaction and loss causation. The burden of proof is shifted to the defendant. The defendant can avoid liability by showing that the plaintiff did not purchase the securities by reason of the prospectus, or that the incorrect information did not contribute to the decrease in the stock exchange price of the securities). Comp. with article 61, §2, alinea 2 of the Belgian law of 16 June 2006 with respect to primary market liability (providing for a presumption of reliance where the incorrect information or the omission was likely to create a positive impact in the market or to positively impact the acquisition price of the securities); Dutch case law (see the recent Dutch Supreme Court ruling in VEB v World Online/Goldman Sachs/ABN Amro (27 November 2009, LJN: BH2162), providing that if a statement is misleading, reliance on the misstatement is assumed, without –automatically - implying that causality exists between the (amount of) loss and the misleading statements)); and with the U.S. (providing for a distinction between reliance and loss causation in legal actions involving a misleading statement or omission in periodic reports: there is a rebuttable legal presumption of reliance via the fraud-on-the-market theory under certain conditions to recover damages under US SEC rule 10b-5, i.e., no need to prove transaction causation, i.e., reliance on the incorrect or misleading information, but no presumption concerning loss causation. See founding US Supreme Court decision, Basic v. Levinson, 485 U.S. 224, 231-232 (1988). For a commentary, see JOHN C. COFFEE, et al., Securities Regulation (Foundation Press ed., Thomson West 10th ed. 2007)., at 961 et seq.; LARRY E. RIBSTEIN, *Fraud on a Noisy Market*, 10 Lewis & Clark Law Review 137, (2006).). See for a discussion of a possible application of the fraud-on-the-market theory in Dutch law, K. RAAIJMAKERS, *Causaliteit bij aansprakelijkheid van uitgevende instellingen voor misleidende informatie: toepassing van de "fraud on the market theory"*, 3 Tijdschrift voor Ondernemingsbestuur, (2008). Comp. with new schedule 10A, 3(4) of the UK FSMA (providing that the claimant has to show reliance on the misstatement and that reliance must have been reasonable ("[a] loss is not regarded as suffered as a result of the statement or omission unless the person suffering it acquired, continued to hold or disposed of the relevant securities (a) in reliance on the information in question, and (b) at a time when, and in circumstances in which, it was reasonable for him to rely on it.").

[1241] See for the same suggestion, MERRITT B. FOX, *Civil Liability and Mandatory Disclosure*, 109 Colum. Bus. L. Rev. 237, (2009).

on average are to be considered together with all other aspects of the harmonised liability regime that I suggest. The proposed civil liability regime, which would work in conjunction with the public enforcement regime, should aim to ensure optimal incentives for prompt and accurate disclosures, without encouraging costly speculative litigation and settlements by defendants based on a desire to terminate litigation, rather than on the harm done to shareholders.

In that context, I fear at first sight that providing for presumptions of causal link, taken together with the possibility to sue directors, the suggested liability standards and the suggested prohibition of D&O insurance and indemnisation clauses would lead to unintended consequences, like over-deterrence, difficulties in finding competent directors at affordable costs, disclaimers in information documents or frivolous litigation.

Therefore, I would not suggest at first sight to introduce a reversal of the burden of proof nor presumptions of causal link on primary or on secondary markets with respect to transaction or to loss causation. These suggestions should first be subject to a comprehensive costs-benefits analysis of the entire suggested liability scheme. And this is left for further research.

V. Conclusions

This chapter focussed on issuers who have a reporting history and are widely followed by analysts. The market for these firms is supposed to be efficient: information is deemed to be reflected into the price of their stock resulting in secondary market price being a good determinant for primary market price of a secondary public offering. The application of the ECMH for those firms makes it possible to draw regulatory implications relating to disclosure requirements.

I made several policy suggestions, starting from the premise that, as developed in Part II, the EU issuer-disclosure regime is important for its positive impact on market efficiency and corporate governance, on primary markets as well as on secondary markets, in other words, whether or not the issuer is offering securities at the time of disclosure.

I suggested that the *content* of disclosure be the same on primary and secondary markets. To make sure this goal is achieved, I suggested to draft a new European regulation to set the grounds for a disclosure system fully integrated between the primary and the secondary markets.

Once the content of disclosure is similar on both markets, a so-called "company registration system" becomes more feasible to replace the current transaction-based disclosure system. The European-flavoured company registration system I suggest requires issuers to register once, i.e., at the time of the IPO, by submitting for approval a "registration prospectus" accompanied by a "summary registration prospectus" to be used for marketing purposes.[1242] After the primary offering, the company has to update the information contained in the registration prospectus and summary registration prospectus with material information according to the specific schedule set out by the regulator on the basis of the nature of the information, and/or further to any MAD or any Prospectus Directive supplements requirements. This continuous updating duty is subject to review by the supervisory authority on a regular rotating basis, avoiding delays at the time of subsequent offerings. Each time it wants to make a further issue, the company has to file a "short-form offering prospectus" only, which incorporates most information by reference to previously disseminated information, except issue-specific disclosure, together with a "summary offering prospectus". Incorporation by reference allows to avoid repeating information already disclosed to the public. Only large secondary issues are subject to full-fledged prospectuses.

I also suggested that the level of disclosure be the same on primary and secondary markets. I drew attention to some elements to be taken into consideration in assessing the *optimal level* of disclosure to be required from issuers on primary and secondary markets. I considered the specificities of European financial and corporate markets to assess the form of regulatory intervention to promote and to assess the alleged lower level of disclosure required in Europe when compared to the U.S.

[1242] An exception should be provided for large secondary public offerings, which can be assimilated to IPOs. See Part III:Chapter II:II.B.2.b above.

I then derived policy implications in connection with the *format* of disclosure. I pleaded for the suppression of periodic reports as they do not contain any new information for the market and therefore their separate drafting leads to unjustified costs. What I am really driving at is periodic disclosure requirements drawn up on different lines. Indeed, I urged for the registration prospectus to be considered as the main disclosure document. It should be updated on a periodic basis. There would not actually be much substantive changes compared to the current disclosure regime of on-going disclosure, except to the extent required by the integrated disclosure system. But this approach allows to elicit all the information currently generated by the existing disclosure system although arguably at a lower cost to issuers and with increased possibilities of effective comparisons by investors. I made some further practical recommendations for investor protection purposes which essentially relate to the need of easily identifying changes made to previous disclosure.

Moreover, I suggested to assess by a proper costs-benefits analysis the necessity to have the *quality* of issuer-disclosure checked by an independent competent third party. This already happens on primary markets as it became common standard to request underwriters' intervention in public offerings. However, the same could be provided for secondary market's issuer-disclosure as disclosure on both markets is socially equally important. This would require a continuous due diligence by the external certifier.

Lastly, I drew the contours of a somewhat more ambitious common specific civil liability regime which would provide the right incentives for the responsible persons to comply with disclosure duties. To be sure, before being enacted, this suggested harmonised civil liability regime should be subject to a thorough costs-benefits analysis to assess the extent to which there exists a market failure in Member States' legislation in that respect and to what extent my suggested scheme resolves it. I focussed on the two objectives of a liability regime, i.e., compensation and deterrence, and tried to strike the right balance between responsible persons' and investors' interests. I suggested to have a single conflict of jurisdictions rule, i.e., the court of the issuer's home Member

Sate, as well as a single conflict of laws rule, i.e., the law of the issuer's home Member State. I moved on to make some suggestions relating to the civil liability regime as such.

In that respect, I first identified the possible defendants in case of violation of disclosure requirements. These should include the issuer as well as the directors, whether or not the issuer is offering securities. For directors' personal liability to have some bite, I then suggested to prohibit issuers' indemnification clauses or D&O insurance which are paid by issuers to cover directors. As complementary measure necessary to avoid deterring directors from accepting the job given the risk of erroneous judgements which could lead them to bankruptcy, I suggested, *inter alia*, to cap damages. I considered that investors who traded during the relevant period should be the indemnified persons. I further suggested a European liability standard for issuers and directors in connection with offering disclosure, i.e., negligence, and for issuers and directors any time after the offer , i.e., deceit. To avoid excessive litigation and difficulties in finding competent directors at reasonable price, I did not suggest, without running a comprehensive costs-benefits analysis, to introduce a presumption of causal link for small offerings and on secondary markets, which would comprise both US concepts of transaction causation and loss causation, to be rebutted by the defendant, although a convincing case could have been made in order to ease procedures and further to acceptance of the ECMH.

Part IV:

General Conclusions

I. Preliminary Remark

Issuer-disclosure became a major tenet of today's securities regulation on both sides of the Atlantic. This is an implicit recognition of the role of issuer-disclosure for the promotion of securities markets.

However, what issuer-disclosure can effectively achieve should be correctly understood to prompt adequate regulation. In that respect, this dissertation identified market efficiency and corporate governance as immediate objectives of issuer-disclosure in the European context while nuancing its role with respect to unsophisticated retail investor protection.

Then it drew the contours of policy and regulatory implications flowing from the suggested new taxonomy of objectives.

It took, where appropriate, a comparative law point of view, either with the national law of some pre-selected European jurisdictions or with US securities regulation, and tried to integrate the advances of behavioural finance.

In these general conclusions, I suggest to summarise the main ideas that the dissertation tried to convey by grouping them along different themes. This offers a different angle of approach than the one adopted throughout the dissertation.

These general conclusions also give me the opportunity to share some additional thoughts inspired by the dissertation.

II. A New Taxonomy of Objectives for the EU Issuer-Disclosure Regime

In Part II of the dissertation, I argued that, contrary to conventional wisdom, issuer-disclosure is *not an effective means to protect unsophisticated retail investors*.

It seems that unsophisticated retail investor protection should be considered as the historical objective of the EU issuer-disclosure regime. Indeed, at the time of drafting of European disclosure requirements, the European regulator was concerned by the creation of a single securities market which would prompt economic growth and provide an alternative to publicly supported pensions. In that context, investor protection and investor confidence were used to give credit to this political and economic agenda. It was believed that issuer-disclosure could bring about the protection necessary to inspire confidence of investors, and unsophisticated retail investors in particular, for the promotion of European securities markets.

However, no strong empirical evidence was suggested to back up the claim that issuer-disclosure could effectively promote investor protection.

In this dissertation, I referred to evidence suggesting that unsophisticated retail investors do not have the time, nor the will, nor the skills to read, proceed or act on the information provided to them.[1243] I pointed out to behavioural works according to which unsophisticated retail investors are bound up in a web of cognitive illusions and processing deficiencies, with little appetite for the truth.[1244]

It does not seem to be surprising therefore that unsophisticated retail investors often deviate from rational investment decisions, no matter the level, content and quality of information made available to them.

This being said, in my opinion, unsophisticated retail investors should not be prohibited from directly investing in securities markets. They form an important constituency to promote the growth of European securities markets as they provide, *inter alia*, liquidity to those markets. But, as (direct or indirect) investments in securities markets could be risky, unsophisticated retail investors should receive minimum protection. In this respect, I suggested other means than issuer-disclosure to protect unsophisticated retail investors more effectively and more efficiently. I promoted diversification as investment strategy especially for unsophisticated retail investors; enforcement of existing rules and the drafting of an adequate civil liability regime which would achieve the goals of compensation of damages suffered by the claimants and deterrence from misstatements or misleading omissions in the disclosure by responsible persons, and especially issuers and directors, and which would strike the right balance between issuers’ and investors’ interests; the assessment of existing regulations relating to institutional investors subject to MiFID or UCITS IV and financial advisers with unsophisticated retail investor protection in mind; the allocation

[1243] See Part II:Chapter I:IV.B.2 in Chapter Investor Protection.
[1244] See Part I:V in General Introduction.

of more resources on behavioural research to understand unsophisticated retail investors' investment needs and behaviours. I also critically assessed two other popular means which are considered to promote unsophisticated retail investor protection, i.e., the involvement of unsophisticated retail investors in the law-making process of regulations which are aimed at their protection and education programmes relating to financial literacy.

In contrast, I strongly contended that the EU issuer-disclosure regime is a means to *effectively improve market efficiency*.

Taking due account of the advances of behavioural finance and the many critics of the conventional definition of market efficiency, I suggested a definition which can be labelled "relative market efficiency" and which I believe is consistent with market realities.

I consider that stock price is an objective and accurate measure of shareholder maximand and the best source of information for governance and business policy. I believe in the robustness of the market price of equity as a predictor of fundamental value. This being said, I am aware that price is set under conditions of information asymmetry and is therefore not fully informed. The best case would be that any divergence between market price and fundamental value will not hold out perverse effects. I can only stress in that respect that market prices became more informed across the past half century, as showed by empirical evidence, both in the E.U. and the U.S., partly due to stricter mandatory disclosure requirements and partly due to thicker markets and a larger sector of information traders.

I showed that issuer-disclosure can improve market efficiency by positively impacting price accuracy and liquidity. This is important for allocative efficiency, costs of capital's and transaction costs' reduction. I suggested however that the argument set out in US literature that issuer-disclosure indirectly impacts price accuracy on secondary markets by promoting the market for corporate control and the use of equity-based compensation is not entirely relevant because of doubts concerning the capacity of market for corporate control and equity-based compensation to work as corporate governance tools, even more so in the European context characterised by concentrated ownership.

I also suggested that the EU issuer-disclosure regime is a tool to *effectively improve corporate governance*, defined from the perspective of agency theory as the measures which aim to reduce the conflicts that may exist in the relationship between a principal, like shareholders, and an agent, like management, a controlling shareholder or dominant blockholders. It does so by facilitating the exercise of corporate governance tools, like voting right and other monitoring rights, including the right to file a claim. I showed that, contrary to conventional wisdom, the case of issuer-disclosure to contribute to increase corporate governance in European firms is strong. I explained that large retail investors and institutional investors have the right incentives to exercise their voting rights and their other monitoring rights. They are in a position to impact corporate behaviours and decisions in European companies. Indeed, the European companies which are commonly thought to be characterised by a concentrated ownership might be less concentrated than it appears. And the likely future seems to be toward more blockholdership. Besides, there is evidence of institutional investors' engagement in Europe, which the European regulator should try to promote even more. In a comparative law analysis of a few European jurisdictions that I selected, I discussed the ease with which investors can exercise their voting right and their right to file a claim in case of disclosure violations. In that respect, I discussed the remaining weak areas that still need to be improved after the implementation of the Shareholders' Rights Directive in those jurisdictions. I also highlighted the points of concern in connection with the enforcement of directors and controlling parties' duties, including the current limits to derivative actions in those jurisdictions. I concluded that, in terms of the adequate tools for large retail investors and institutional investors to exercise their voting and other monitoring rights in European firms, the picture is less dramatic than what conventional wisdom would make us think.

III. More Sophisticated Actors as Addressees of Issuer-Disclosure

A. Preliminary Remark: the Addressees of Issuer-Disclosure

There is no doubt that one of the premises of the EU issuer-disclosure regime was that it could protect unsophisticated retail investors by providing them with the information necessary to improve their investment decisions.

However, the image of the unsophisticated retail investor full of cognitive bias and with little financial literacy offers the possibility that the EU issuer-disclosure regime, as a strategy of investor protection, may not be worth the cost. All to the contrary, I believe that securities regulation has failed to develop a model of decision-making that incorporates the realities of human emotions, bias and limited cognitive capabilities, to the detriment of issuers' costs concerns.

The contention that issuer-disclosure can effectively promote market efficiency and corporate governance emphasises the importance for securities markets of more sophisticated actors, including large retail investors, institutional investors and financial analysts. Indeed, these actors are *a priori* the only ones who have the necessary incentives and skills to contribute to the prompt reflection of information into price, which is an important component of market efficiency, and to reduce agency problems within a company, which is the ultimate goal of corporate governance. I therefore suggested in this dissertation an innovative thesis which consists of *focussing issuer-disclosure on these more sophisticated actors*, who I called "informed traders" and "information traders". In this dissertation, I argued that this should enhance market efficiency and corporate governance on primary and secondary markets, which would in turn work for the best protection of unsophisticated retail investors.

B. Regulatory Implications

1. The importance of engagement

Market efficiency and corporate governance will not be promoted if more sophisticated actors do not live up to expectations.

In that respect, I argued that informed traders should promote *shareholder value with a long-term view*. This view takes all constituencies into account to reflect their respective concerns, be they social, corporate governance-related or environmental concerns, but only to the extent they contribute to the company's long-term value. I believe this is currently a very popular position, even more so in the aftermath of the financial turmoil of 2007-2008.

It also means that institutional investors should monitor the companies in which they have invested, at least long-only funds who have invested on behalf of end-beneficiaries and who have a *fiduciary duty* toward their clients. They should behave as committed shareholders. This means that they could have to reduce portfolio diversification up to the point where it becomes feasible to monitor companies. It may mean as well that short-term revenues could shrink a bit. But this would ultimately work for the long-term benefit of the company in which they have invested, the long-term revenues of any end-beneficiary and the economy as a whole. To be sure, as one cannot force a shareholder to be engaged, I suggested that commitment be an opt-out behaviour using the comply-or-explain type of regulation: either the institutional investor complies with the recommendation to be a committed shareholder or it explains why it chose a different strategy. This means that I do not suggest to prohibit short-term investments and that I recognise that different investors could have different investment strategies. This being said, my position means that pure speculative behaviours should be assessed with great scrutiny to make sure they are not detrimental to market stability.

This being said, if I share the view that "ultimate control" over the company should rest with the shareholders,[1245] I do not go as far as some commentators would like to go in the shareholder empowerment debate. I do not consider the "shareholder *sine qua non*".[1246] I am not in favour of empowering shareholders for them to have direct control of business policy. I support reforms designed to enhance the impact of existing activist strategies but I am not supporting outright subsidies to intervening shareholders. I trust the board in being able to be responsive to shareholders interests, ameliorating agency costs, provided that the improvements to existing law suggested in

[1245] See HENRY HANSMANN, et al., *The End Of History For Corporate Law*, 89 Geo. L. J. 439, (2001).

[1246] See for such expression, WILLIAM W. BRATTON, et al., *The Case Against Shareholder Empowerment*, 158 University of Pennsylvania Law Review, (2010)., at 18.

that respect in this dissertation are implemented.[1247] I doubt that full shareholder empowerment would not yield new costs that would result from fundamental structural change.

2. *Cost-efficient regulatory implications*

If issuer-disclosure becomes explicitly directed to more sophisticated actors, there will be cost-efficient regulatory implications. These might contribute to lighten the regulatory burden of issuers without undue costs on other market participants. They include the following:

- a more wide-spread use of English in disclosure documents, to reduce costs of translation for issuers and to allow for comparison tools to be put in place to ease investment decisions;
- an extended and well-designed use of the Internet as dissemination and storage mechanism, to reduce costs of publication of issuers while not compromising investor protection, together with the use of regulated information service providers; and
- summary and advertisements as main marketing tools.

3. *Promotion of indirect investments for unsophisticated retail investors*

If more sophisticated actors are targeted by issuer-disclosure, it follows that unsophisticated retail investors are encouraged to *indirectly* invest in equity markets. It means that they should either seek professional advice or invest through informed traders in order to minimise the risks inherent in securities markets' investments.

This calls for attention to be focussed on the regulation of more sophisticated actors through whom unsophisticated retail investors invest or who give them professional advice.

[1247] See, *inter alia*, the sections relating to shareholders' voting right under Part II:Chapter III:II.E.3.d.ii in Chapter Corporate Governance; derivative actions under Part II:Chapter III:II.E.3.d.iiic in Chapter Corporate Governance; civil liability scheme under Part III:Chapter II:IV.D in Chapter Issuer-Disclosure of Well-Established Companies in Efficient Markets. See for an account of board's responsiveness due to institutional changes within corporate governance in the US context, WILLIAM W. BRATTON, et al., *The Case Against Shareholder Empowerment*, 158 University of Pennsylvania Law Review, (2010). (showing a move from hostile take-over to friendly take-overs and private equity buy-outs, the positive role of blockholders, including hedge funds, the increase of cash pay-outs).

In that respect, I suggested some areas for future research with a view to increase investor protection:

I stressed the importance of a proper regulation of the relationship between investment firms and their clients. I think that there lies an important concern of today's markets. I have some doubts that MiFID lives up to its expectations as investment firms do not seem to fulfil their new obligations by obeying to the spirit of the law instead of merely complying, for costs reasons, with its letter.

I also drew attention to the proper regulation of UCITS, for their popularity among retail investors. One of the major concerns relates to the inducements policy and the related conflicts of interests.

IV. A Reformed European Issuer-Disclosure Regime

A. Preliminary Remark: the Equal Social Value of Issuer-Disclosure on Primary and Secondary Markets

Issuer-disclosure helps to improve market efficiency and corporate governance on primary and on secondary markets.

This means that the social value of issuer-disclosure is similar whether or not the issuer is offering equity at the time of disclosure.

However, the EU issuer-disclosure regime does not reflect this.

I therefore suggested in the last chapter of the dissertation some regulatory implications flowing from the contention that issuer-disclosure has equal social value on primary and secondary markets, i.e., whether or not the issuer is offering securities at the time. Some of them might reduce the costs burden of issuers and ease their access to equity markets; others might work for a better protection of unsophisticated retail investors. The goal here is not to promote one constituency over the other. It is rather to draw a disclosure regime which is consistent with the fact that issuer-disclosure should be equal in content, level and format as well as in quality on primary markets and on secondary markets and that it should provide incentives with similar strength on both markets.

The regulatory measures I suggest only apply to large companies, which are heavily traded, as the market for their shares is more likely to be efficient.

B. An Integrated Disclosure Regime as Preliminary Step for a Move to a Company Registration Scheme

The Prospectus Directive and the Transparency Directive do not provide for the same content and level of disclosure. Information required on primary markets seems to be more exhaustive than information required on secondary markets.

I suggested in that respect to replace the Prospectus Directive, the Transparency Directive and the MAD, to the extent they relate to the EU issuer-disclosure regime, and any related European regulation, with what I called the “European Regulation”. The European Regulation should include the issuer-disclosure requirements at the time of a public offering and any time thereafter. This would assure consistency in the content of disclosure requirements.

Taking due account of the ECMH, I also suggested to move away from a transaction-based system of disclosure where issuers have to make disclosures every time they issue new shares, often duplicating information already available on markets.

This could be replaced, for costs and competitive reasons, by a company registration system where the issuer has to register once, at the time of the IPO, by filing a registration prospectus accompanied by a summary registration prospectus. Afterwards, the issuer would have to post on its web-site any inside information as defined under the MAD at the time provided for under the MAD. And the registration prospectus and the summary registration prospectus would have to be updated with supplements, and/or information already disclosed pursuant to a MAD requirement and/or with information corresponding to the type of information required under the Transparency Directive at the times provided under the Transparency Directive. This would allow for a continuous updating of the registration prospectus, which is important to allow investors to make comparisons, without the issuer having to incur the costs related to fancy periodic reports which in any case contain outdated information at the time of dissemination. Every time it wants to issue new equities, the issuer would only have to file a short-form offering prospectus and a related summary, except in case of large secondary issues which would give rise to a full-fledged registration prospectus.

The short-form offering prospectus would only have to be approved in case equities of a type different than the ones already listed are issued. The system would thus imply that the review of the information by the competent supervisory authority at the time of secondary market issues is shifted to a review of continuous information to avoid delaying the approval process at the time of new issues.

C. The Intervention of an External Certifier

The Prospectus Directive and the Transparency Directive do not provide for the same quality check of non-financial information contained in disclosure documents.

In that respect I suggested to have a thorough costs-benefits analysis assessing the US literature suggestion for intervention of an external certifier to check the quality of non-financial information disclosed on a continuous basis in the same way as underwriters do with respect to information relating to public offerings. Indeed, the US literature suggestion may be, to a great extent, context-specific. This being said, if there is a move to a company registration system in the E.U., the European national supervisory authorities might be required to check the quality of disclosure on a less regular basis than what they currently do. If this is the case, there might be an increased need for an independent third party certifier in the E.U.

D. Steps to an Harmonised Civil Liability Scheme

The specificities of the civil liability regime related to violations of the EU issuer-disclosure regime is left, to a great extent, to the discretion of Member States.

Harmonisation of civil liability among Member States is a very politically sensitive subject. It is not on the policy agenda of the European Commission.

I believe that the case for harmonisation would be hard to win as it is not *a priori* evident that leaving civil liability to the discretion of Member States leads to market failure and as a thorough costs-benefits analysis would be required. This being said, one could get inspired for civil liability matters related to violations of issuer-disclosure by the solution promoted by the academics drafting the European Model Company Law

Act.[1248] They suggest a company law paradigm to be used by Member States as supporting tool to modernise their company law without international duty. In essence, they suggest to reform by free choice.

In this context, I drafted the first contours of an harmonised civil liability regime that should make sure concerned parties have similar incentives to disclose correct and not misleading information on primary and secondary markets.

I suggested harmonised solutions for the following issues:

- who should be the possible defendants: I made a case to sue the issuer but also the directors (and the external certifier, if any);
- who should pay the damages: I argued that directors and issuers (and the external certifier, if any) could be held liable to pay damages;
- who should be the possible claimants: I contended that only past and present shareholders, provided they entered a trade, should be allowed to file a claim;
- to whom should damages be paid: I am of the view that damages should be paid to claimants;
- what should be the standard of liability: I argued that:
    - with respect to the issuer and the directors at the time of a public offering: a negligence standard should apply, i.e., they will be liable unless they show that they were not aware of the misstatement and that that ignorance was not the result of negligence;
    - with respect to the issuer and directors any time after a public offering: a deceit basis should apply, i.e., they will be liable unless they genuinely believed the statement, or the lack thereof, not to be misleading;
    - and who should bear the burden of proof of the causal link: because optimal incentives for prompt and accurate disclosures should be sought without encouraging costly speculative litigation and other unintended consequences, and altough there are arguments to support the case, I did not suggest to introduce a rebuttable presumption of causal link between the misleading statement or omission and the damages or between the misleading statement or omission and the transaction..

[1248] See note 1156 above and accompanying text.

I am greatly indebted to Professor Fox whose contributions on the subject in the US context inspired the drawing of this scheme.

V. A Move Away from Consumerism in Securities Regulation

An important idea that I wanted to convey in this dissertation is that securities markets' investments are, and will always remain, a risky business, without securities regulation being able to entirely eliminate the risks involved. If it could take time to reap benefits from securities markets, it could just take seconds to lose one's investments. This is best illustrated by the financial crises of the last decade.

From that statement, two attitudes could be adopted.

Either unsophisticated retail investors could be prohibited from accessing securities markets. However, I argued that this reform would be unlikely to find a positive echo with the European regulator, for economic and political reasons.[1249]

Or, appropriate measures for the protection of investors could be adopted that do not subject issuers to undue costs.

I chose this second alternative, explaining in that respect that issuer-disclosure should not be considered an effective means to protect unsophisticated retail investors.

I think that investors should not be considered as "weak parties" in their relationship with the company in which they invested: this relationship is not a consumer-professional relationship.

To be sure, information asymmetry is likely to subsist in the relationship.

However, I showed in this dissertation that there are ways to reduce the information asymmetry that the regulator should encourage, including a proper issuer-disclosure regime that seeks to achieve appropriate objectives. I also suggested various ways to protect unsophisticated retail investors to duly take their interests into account, including a proper civil liability regime associated with disclosure breaches.

This being said, I believe that retail investors should be duly informed of the general risks involved in investment decisions by public campaigns. These could refer

[1249] See Part II:Chapter I:II in Chapter Investor Protection.

to public education programmes, set up by governments and supervisory authorities further to European recommendations on the subject. They should at a minimum draw attention to the fact that disclosure documents from issuers were not written with unsophisticated retail investors in mind. They should also stress the importance of seeking professional advice and emphasise the possibility to invest through a professional investor.

But once the proper protection framework is put in place by the legislator, unsophisticated retail investors should be considered able to make the decision to either personally invest in securities markets or seek further protection by investing indirectly (either through an institutional investor or on the basis of professional advice).[1250] And once they have decided to invest without asking professional advice or without professional intermediation, investors should bear the consequences of their investment behaviour. I believe that my point of view should inform the regulator and the courts in their attempt to strike the right balance between investors' and issuers' concerns.

VI. The Limits of Issuer-Disclosure: the Importance of Complementary Substantive Rules, the Quality of Disclosure and the Enforcement of Disclosure Requirements

If it is rather uncontroversial that one cannot manage without disclosure, one cannot manage only with disclosure. The major corporate, accounting and securities regulation scandals of the last hundred years showed that our instinct to invest in yet more disclosure as the only remedy for the failures of disclosure is not the cure to all evils.

I mentioned that the repeated scandals call for disclosure to be complemented by more substantive rules, like those relating to the composition, the election and the

[1250] The words of Professor Louis Loss should be recalled here (stating that every investor has "the right to make a fool of himself"), see Louis Loss, The Protection of Investors: the Role of Government, 80 South African Law Journal, 1963, at 60; see also Thomas L. Hazen, Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and Their Effect on the Underlying Securities Capital Markets, 86 Nortwestern University Law Review, 1992, at 987 (stating that "there is no need to protect a fool from his or her investment folly so long as no fraud or manipulation is involved.").

remuneration of management. These are hot topics on both sides of the Atlantic, the executive pay concerns in particular.

The successive breaches of disclosure regulations also highlighted the importance of quality disclosure, i.e., information that is necessary to increase market efficiency and that is likely to improve corporate governance.

In order to increase the quality of on-going non-financial information disclosed to the markets, I suggested to thoroughly assess in the European context the need to introduce an external certifier who would make a continuous due diligence of non-financial information disclosed by issuers.

Maybe most importantly in the context of the 2007-2008 financial crisis, I argued that what is needed is transparency beyond disclosure. The persons responsible for the drafting of disclosure documents will always find ways to hide or disguise the pieces of information they do not want the public to know or to understand, no matter the extensiveness of the disclosure regime. This stresses the fact that the most sophisticated disclosure rules will not achieve their goals if the persons responsible for the drafting of disclosure documents do not have a high level of professionalism which implies a real commitment to promote efficiency and accountability within the firm, thereby improving a sustainable economic development and financial stability. There is always the possibility that disclosure be reduced to a box-ticking exercise which would merely ensure compliance with current corporate fashion trends, totally missing the goal.

Corporate and securities laws scandals also stress that unilateral changes in disclosure are unlikely to yield the desired outcomes. An extensive issuer-disclosure regime without a proper enforcement regime is not likely to have the necessary bite. In that respect, I suggested to put in place a well-balanced liability regime which delivers from both compensation and deterrence rationales while at the same time considering issuers' and investors' concerns. But enforcement goes beyond setting an appropriate liability regime. It also requires a competent judiciary, which enjoys necessary funding to live up to its ambitious tasks.

VII. The Importance of Market Forces as Regulatory Means

This dissertation did well advocate the necessity of regulation or reforms to existing regulations. Most importantly in that respect, I suggested to replace the regulatory patchwork of existing issuer-disclosure regulations by one single disclosure regime to be set out in the European Regulation for all disclosure requirements mandated from well-established equity issuers toward investors. This would introduce internal consistency which would ultimately bring legal certainty to the benefit of issuers and the economy as a whole.

This being said, this dissertation did not undermine the importance of market forces in influencing corporate disclosure, both in isolation as well as the interactions with regulatory acts. All to the contrary.

For instance, I stressed that diversity in institutional and economic factors in European jurisdictions may limit the effectiveness of a "one-size-fits-all" set of disclosure regulations. Therefore, the European Regulation should allow the competent supervisory authority to be flexible enough when reviewing the disclosure documents depending on the specific circumstances of the issuer. The possibility for the arguments of the issuer to be heard should be provided for to work for issuer's protection.

With respect to the promotion of shareholders' engagement, as this is a strategy that cannot be forced upon shareholders, I advocated the adoption of a European recommendation which should set out principles-based measures to be further detailed in the section of the national best practice codes of conduct relating to institutional investors' behaviours.

Lastly, I suggested an opt-in system for investors to notify the issuer that they would be interested to receive corporate information. This scheme would avoid information over-load on the investors' side and unnecessary dissemination from issuers.

VIII. Concluding Remarks

What have we learnt since 1913 and the famous words of US Supreme Court Justice Louis Brandeis stating that “sunlight is said to be the best of disinfectants”, referring to the benefits of openness and transparency in financial markets?

The numerous scandals of the last 100 years would suggest that we did not much improve, notwithstanding our extensive disclosure regime.

I hope that the 2007-2008 financial turmoil will make everyone realise the importance of a proper issuer-disclosure regime, that is one which is fit to achieve proper objectives while not unnecessarily burdening issuers who so greatly contribute to our economies. This requires efforts from everyone in the community: the regulator with respect to the drafting of proper laws, issuers who should comply with their disclosure duties beyond their letter and investors, who should behave as committed shareholders, should they decide to invest in equity.

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