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# EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism?

*Luca Enriques & Matteo Gatti\**

## I. INTRODUCTION

Company and capital markets laws are rapidly evolving everywhere: there are few countries around the world where they have not been the subject of reform or where at least a reform agenda has not been devised. There are various reasons for this, both global and local. Among the global (or common) reasons for reform, two at least deserve to be singled out: large-scale market crises or prominent economic scandals, and financial development.

Corporate frauds and stock market collapses are traditionally the main drivers of company and securities law reforms.<sup>1</sup> After major scandals first erupted in the United States, the U.S. Congress quickly reacted to them with broad-sweeping reforms. Policymakers in other countries also felt compelled to react in a similar way, often even in the absence of local scandals (or before they erupted). Gérard Hertig has used the term “me too reforms” to highlight the fact that the Sarbanes-Oxley Act (SOX)<sup>2</sup> had a ripple effect on company and securities lawmaking.<sup>3</sup>

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<sup>1</sup> See generally Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741 (2000).

<sup>2</sup> Sarbanes-Oxley Act, 15 U.S.C. §§ 7201–7266 (2003) [hereinafter SOX].

<sup>3</sup> See Gérard Hertig, *On-Going Board Reforms: One Size Fits All and Regulatory*

The second driver of company law reform around the world has to do with advances in financial economics. One of the most influential contributions in this area is the famous series of articles by Andrei Shleifer and his co-authors on the relevance of company and securities laws to financial development.<sup>4</sup> Their influence went far beyond the academic world: it reached the main international financial and economic institutions like the World Bank, the International Monetary Fund (“IMF”), and the Organisation for Economic Co-operation and Development (“OECD”) itself. If law does “matter”—that is, if it is a major driver for financial development—then bad laws have to be revised and improved in order to make them more similar to the best ones around.

These drivers of company law reform have been present also within the European Union (“EU”). The influence of the “law and finance” theories can especially be seen at the national level, where countries such as Italy consciously enacted reforms that took the La Porta et al.’s antidirector rights index as a benchmark for reform.<sup>5</sup>

At the European Community (“EC”) level, the company law reform agenda was almost empty during the 1990s, or at least the prospect of having anything meaningful adopted by the European Community in this area would have seemed highly unlikely at the time.<sup>6</sup> Things started to change in 1999, when the Commission launched an ambitious plan to integrate EU financial markets through law: the Financial Services Action Plan (“FSAP” or “the Plan”),<sup>7</sup> which also included measures in the area of company law and issuers securities regulation. The Plan was effectively implemented in the following five years and the implementation measures were even more relevant in scope and content than originally envisaged.

When the financial scandals that spawned SOX erupted in the United States, EC institutions were already busy implementing the FSAP and

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*Capture*, 21 OXFORD REV. ECON. POL’Y 269, 270 (2005).

<sup>4</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Governance Around the World*, 54 J. FIN. ECON. 471 (1997).

<sup>5</sup> See Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765, 779–80 (2002) (showing how, following the 1998 corporate law reform, Italy impressively improved on the La Porta et al.’s antidirector rights index, jumping from a score of one to a score of five).

<sup>6</sup> See Klaus J. Hopt, *Common Principles of Corporate Governance in Europe?*, in THE CLIFFORD CHANCE MILLENNIUM LECTURES 105, 127 (Basil S. Markesinis ed. 2000) (describing the “political and other difficulties with company law harmonization” experienced by the European Commission during the 1990s).

<sup>7</sup> *Communication of the Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232 (May 11, 1999) [hereinafter *Communication, Financial Services*].

investing a lot of time and effort in the company and securities law area. U.S. scandals provided the occasion to broaden the scope of the European Community's intervention in company law matters. At the beginning, the idea was that reforms were needed to prevent the importation of (ever) suspicious U.S. market practices, such as stock options, from provoking scandals in Europe as well. After Ahold, Parmalat, and other scandals erupted in Europe,<sup>8</sup> the case for an "EC SOX-style" intervention became even more justified in the eyes of European policymakers. There was, to be sure, one difference between the U.S. Congress' activism and that of the European Community. While the U.S. Congress acted under at least some direct pressure from an outraged public wanting a prompt response from politics at the federal level, in Europe the reaction of the public was smaller and focused on national, rather than EC, policymakers.<sup>9</sup>

Further, the European Community's activism in company law in the last six years or so has also had a "local" explanation: EC company legislation dates back mainly from the 1960s and 1970s and has not changed much since then. As a result, it is widely perceived as a sort of petrified forest—far too cumbersome for today's businesses and in great need of a thorough review. In fact, one of the Commission initiatives in the 1990s had been to promote a simplification of EC company law directives.<sup>10</sup> In the revived spirit of the beginning of this century, the Commission took a more aggressive stance and started talking, more broadly, about the modernization of EC (and EU) company law.<sup>11</sup>

As a result, since 2002, the European Community has adopted thirty-four directives and regulations—a very high number in itself, but also considering that a total number of twenty-nine directives had been enacted between 1968 and 2001.<sup>12</sup> Of these thirty-four measures, twenty-one deal with the law of accounting, nine are securities law measures, while the rest are either core company law measures or at the crossroads between company law and accounting or securities law.

This essay provides an overview of the most relevant measures

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<sup>8</sup> See, e.g., Kerry Capell, Gail Edmondson, Carol Matlack, Ariane Sains, Jack Ewing & Juliane von Reppert-Bismarck, *Europe's Old Ways Die Fast*, BUS. WK., May 17, 2004.

<sup>9</sup> See Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911, 914–15 (2003) [hereinafter Enriques, *Bad Apples, Bad Oranges*].

<sup>10</sup> In October of 1998 the European Commission announced that its *Simpler Legislation for the Internal Market* ("SLIM") initiative, launched in May of 1996 to identify ways to simplify European Union law, would cover company law. See Eddy Wymeersch, *European Company Law: The "Simpler Legislation for the Internal Market" (SLIM) Initiative of the EU Commission 1* (Fin. Law Inst., Working Paper No. 2000-09, 2000), available at <http://www.law.rug.ac.be/fli/WP/WP2000-pdf/wp2000-09.pdf>.

<sup>11</sup> See *infra* Parts III and IV.

<sup>12</sup> See *infra* Apx. 1.

enacted over the last six years in the corporate governance and securities areas,<sup>13</sup> with particular attention as to whether and how such measures are useful to tackle the main corporate governance problem in most economies, i.e., how to curb the extraction of private benefits of control by dominant shareholders or other insiders to the detriment of outside investors. Our focus will be exclusively on listed companies. Part II describes the FSAP and its output in the securities law field. Part III deals with the post-scandal initiatives that the European Community took in the accounting area, while Part IV covers company law reforms. Part V provides a conclusion to the analysis.

## II. THE FSAP AND ITS OUTPUT

The FSAP was launched in 1999 with the aim of promoting a fully integrated European capital market. It soon became a distinctive symbol of the ambitious Lisbon strategy, whereby in 2000 the European Council announced the goal of making Europe the world's leading knowledge-based economy by 2010.<sup>14</sup> The FSAP contains a wide-ranging set of measures touching upon several fields of EU law, such as securities markets, banking, pension funds, and insurance. In this Part, we describe the provisions contained in the FSAP measures dealing with corporate governance issues that more directly affect dominant shareholders' opportunism. Our focus is thus on (i) Regulation 1606/2002/EC on the application of international accounting and financial reporting standards ("IAS/IFRS Regulation");<sup>15</sup> (ii) Directive 2003/6/EC on insider trading and market manipulation (the Market Abuse Directive, "MAD");<sup>16</sup> (iii) Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (the Prospectus Directive, "PD");<sup>17</sup> (iv) Directive 2004/25/EC on takeover bids (the Takeover Bids Directive, "TBD");<sup>18</sup> and (v) Directive 2004/109/EC on the harmonization of transparency

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<sup>13</sup> For a broader overview of the EC securities law Directives discussed in this article, see Luca Enriques & Matteo Gatti, *Is There a Uniform EU Securities Law After the Financial Services Action Plan?* (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=982282](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982282) (login required).

<sup>14</sup> See Presidency Conclusions, Lisbon European Council, (Mar. 23–24, 2000), available at [http://ue.eu.int/ueDocs/cms\\_Data/docs/pressData/en/ec/00100-r1.en0.htm](http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.en0.htm).

<sup>15</sup> Council Regulation 1606/2002, On the Application of International Accounting Standards, 2002 O.J. (L 243) 1 [hereinafter IAS/IFRS Regulation].

<sup>16</sup> Council Directive 2003/6, On Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16 [hereinafter MAD].

<sup>17</sup> Council Directive 2003/71, On the Prospectus to Be Published When Securities Are Offered to the Public or Admitted to Trading and Amending Directive 2001/34, 2003 O.J. (L 345) 64 [hereinafter PD].

<sup>18</sup> Council Directive 2004/25, On Takeover Bids, 2004 O.J. (L 142) 12 [hereinafter TBD].

requirements with respect to issuers with securities admitted to trading in regulated markets (the Transparency Directive, “TD”).<sup>19</sup>

### A. IAS/IFRS Regulation

The IAS/IFRS Regulation requires EU companies that are listed in a European regulated market to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (“IFRS”).<sup>20</sup> The goal is to “ensure a high degree of transparency and comparability of financial statements and hence an efficient functioning of the Community capital market and of the Internal Market.”<sup>21</sup> Member States have the option to impose the IFRS requirements also with respect to the preparation of stand-alone accounts and may extend duties to prepare consolidated and/or stand-alone accounts to non-listed companies.<sup>22</sup>

Two features of IFRS are likely to play a significant role in EU corporate governance. First, thanks to the fair value principle<sup>23</sup> (one of the cornerstones of IFRS), hidden reserves, which companies of certain EU countries such as Germany and Italy were once able to accumulate due to conservative accounting policies, are likely to emerge. As a consequence, investors should be better able to understand if companies retain excessive cash in the effort to maximize the size of the firm and the ensuing private benefits. Thus, agency costs should be reduced.<sup>24</sup>

However, the new rules on accounting may in some instances actually decrease the breadth of agency costs. In fact, there are several cases in which the newly introduced fair value principle is just an alternative to historical cost accounting.<sup>25</sup> With the fair value principle, companies are

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<sup>19</sup> Council Directive 2004/109, 2004 O.J. (L 390) 38 [hereinafter TD].

<sup>20</sup> IAS/IFRS Regulation, *supra* note 15, art. 4. IFRS were formerly known as IAS (International Accounting Standards). We refer to them here IAS/IFRS or simply as IFRS or IAS.

<sup>21</sup> IAS/IFRS Regulation, *id.* art. 1. Comparable, transparent and reliable financial information was a fundamental goal of the FSAP for an efficient and integrated capital market. See *Communication, Financial Services*, *supra* note 7, at 7.

<sup>22</sup> IAS/IFRS Regulation, *supra* note 15, art. 5.

<sup>23</sup> For an overview of the fair value principle across IFRSs and the definition of “fair value,” see KEITH ALFREDSON ET AL., APPLYING INTERNATIONAL ACCOUNTING STANDARDS 29, 171, 383 (2005). For further details on the definition of “fair value” and its recent amendment, see also International Accounting Standards Board [IASB], *Fair Value Measurements: Principles and Definitions*, (Agenda Paper 8A, 2006), available at [http://www.iasb.org/NR/rdonlyres/B9A519D6-AAF5-4ACF-ABFF-F9958BFE519C/0/ObNotes\\_FVM\\_0605ob08a.pdf](http://www.iasb.org/NR/rdonlyres/B9A519D6-AAF5-4ACF-ABFF-F9958BFE519C/0/ObNotes_FVM_0605ob08a.pdf).

<sup>24</sup> See generally Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

<sup>25</sup> See, e.g., International Accounting Standard [IAS] 16.29, Property, Plant and Equipment (providing that, subsequent to initial recognition at cost, property, plant and equipment is carried either at cost, less accumulated depreciation and any accumulated

ultimately provided with a good degree of freedom in arbitrating between two valuation methodologies that may lead to different outcomes. This opportunity for creative accounting may increase agency problems, due to the possibly greater scope for earnings management.

Second, IAS 24<sup>26</sup> will be an important turning point in disclosure of related party relationships<sup>27</sup> and transactions. In particular, IAS 24 requires disclosure on: the nature of relationships between parents and subsidiaries, even if there were no transactions between those related parties; the name of the entity's parent and, if different, the ultimate controlling party; compensation of key management personnel; and, if there have been transactions between related parties, the nature of the relationship and information about the transactions and outstanding balances with related parties.<sup>28</sup> With IAS 24, investors should therefore have a clearer perception of whether and to what extent private benefits of control are being extracted.

### B. Market Abuse Directive

The MAD, together with the level 2 measures implemented by the European Commission, bans insider trading and market manipulation. The directive replaces an older directive of 1989 on insider trading<sup>29</sup> and

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impairment losses, or at revalued amount, less subsequent accumulated depreciation and any accumulated impairment losses); similar provisions may be found in IAS 38.72 (an entity must choose either the cost model or the revaluation model for each class of intangible asset) and in IAS 40.30 (choice between cost model or fair market value model for investment property).

<sup>26</sup> Commission Regulation 2238/2004, 2004 O.J. (L 394) 47, 110–15 [hereinafter IAS 24] (International Accounting Standard 24, Related Party Disclosures).

<sup>27</sup> According to IAS 24, *id.* para. 9, a party is related to an entity if it: directly or indirectly, “controls, is controlled by, or is under common control with, the entity;” “has significant influence over the entity;” “has joint control over the entity;” is a close member of the family of any individual who controls, or has significant influence or joint control over, the entity; is an associate of the entity; “is a joint venture in which the entity is a venturer;” “is a member of the key management personnel of the entity or its parent;” is a close member of the family of any of the aforementioned key management personnel; “is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with,” any of the key management personnel or their close family members; “is a post-employment benefit plan for the benefit of employees of the entity,” or of any of its related parties.

<sup>28</sup> *Id.* para. 17. According to paragraph 18, all such disclosures must be made separately for each of the following categories: “the parent; entities with joint control or significant influence over the entity; subsidiaries; associates; joint ventures in which the entity is a venturer; key management personnel. . . ; and other related parties.” *Id.* para. 18. According to paragraph 22, “[i]tems of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.” *Id.* para. 22.

<sup>29</sup> Council Directive 89/592, Coordinating Regulations on Insider Dealing, 1989 O.J. (L

introduces for the first time an EC prohibition on market manipulation. The MAD is aimed at both preventing and punishing a series of conduct such as entering into,<sup>30</sup> recommending, or inducing<sup>31</sup> transactions involving financial instruments on the basis of inside information; unduly disclosing inside information to third parties (so-called “tipping”),<sup>32</sup> or manipulating the market through dissemination of false information or various types of sham transactions.<sup>33</sup> The MAD also compels issuers to disclose inside information that directly relates to them “as soon as possible.”<sup>34</sup>

There is still some debate among legal and economic commentators on the very reason why to ban insider trading.<sup>35</sup> The underlying policy rationale for the prohibition of market manipulation and for mandatory duties of prompt disclosure of inside information is the interest in promoting efficient securities markets in which prices are adequately formed in response to rapid dissemination of information and in which investors can be confident to invest, with no fear of being cheated. Good information and public trust rule out adverse selection mechanisms and are thus considered essential to lower the cost of capital in a given economy.<sup>36</sup>

It is important to note that the prohibitions on insider trading and market manipulation alone may well be insufficient in the absence of adequate sanctions and effective enforcement. On the former aspect, the MAD is pretty generic, as it simply prescribes that Member States ensure sanctions that are effective, proportionate, and dissuasive,<sup>37</sup> thus leaving national legislatures free to choose the type (criminal, administrative, civil), and the optimal level, of sanctions. As to the enforcement powers of competent authorities, which is clearly of utmost importance in tackling market abuses and in particular insider trading,<sup>38</sup> the MAD provides

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334) 30 (EEC).

<sup>30</sup> MAD, *supra* note 16, art. 2, para. 1.

<sup>31</sup> *Id.* art. 3(b).

<sup>32</sup> *Id.* art. 3(a) (prohibiting the disclosure of inside information “to any other person unless disclosure is made in the normal course of the exercise of his employment, profession or duties”).

<sup>33</sup> *Id.* art. 1, paras. 2 & 5.

<sup>34</sup> *Id.* art. 6, para. 1.

<sup>35</sup> For an analysis of the pros and cons of prohibiting insider trading, see generally Stephen M. Bainbridge, *The Law and Economics of Insider Trading: A Comprehensive Primer*, 61–84, (UCLA School of Law Working Paper Series, 2001), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=261277](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=261277).

<sup>36</sup> *Cf.* John C. Coffee Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

<sup>37</sup> MAD, *supra* note 16, art. 14, para. 1.

<sup>38</sup> *See, e.g.*, Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 81 (2002).



authorities with a robust package of powers.<sup>39</sup> In any event, given that detecting insider trading and all other market abuses is a costly activity, both economically and politically, the effectiveness of the MAD measures will largely depend on whether local governments will provide authorities with adequate support to fight such market violations. In fact, absent a strong political intent to effectively enforce the underlying provisions, these powers may prove toothless in certain jurisdictions. Adequate funding of the relevant authorities—together with a highly motivated, sophisticated, and well-paid staff—are key factors in the detection of market abuses. Hence, whether, and how strictly, prohibitions on market abuses are enforced still depends on national politics.

The MAD also imposes disclosure duties on persons discharging managerial responsibilities with an issuer when trading on such issuer's securities.<sup>40</sup> To be sure, the provisions do not seem particularly strict, at least if compared to the corresponding prescriptions under federal U.S. law.<sup>41</sup> First, "persons discharging managerial responsibilities" comprise, as a matter of EC law, only directors and officers, while blockholders are not included.<sup>42</sup> Second, they are not required to return so-called short-swing profits to the company.<sup>43</sup>

Further, the tipping prohibition, which is triggered when an insider discloses inside information to third parties and such disclosure is not made in the exercise of the insider's "employment, profession or duties,"<sup>44</sup> may

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<sup>39</sup> While the old directive on insider trading was extremely generic with respect to the powers pertaining to authorities, compare Council Directive 89/592, *supra* note 29, art. 8(2) ("The competent authorities must be given all supervisory and investigatory powers that are necessary for the exercise of their functions, where appropriate in collaboration with other authorities"), the MAD expressly lists a set of minimal powers that authorities must be provided with. MAD, *supra* note 16, art. 12, para. 2. According to Article 12, paragraph 2, of the MAD, each local competent authority shall have "at least the right to: (a) have access to any document in any form whatsoever, and to receive a copy of it; (b) demand information from any person, including those who are successively involved in the transmission of orders or conduct of the operations concerned, as well as their principals, and if necessary, to summon and hear any such person; (c) carry out on-site inspections; (d) require existing telephone and existing data traffic records; (e) require the cessation of any practice that is contrary to the provisions adopted in the implementation of this Directive; (f) suspend trading of the financial instruments concerned; (g) request the freezing and/or sequestration of assets; (h) request temporary prohibition of professional activity." *Id.*

<sup>40</sup> MAD, *supra* note 16, art. 6(4).

<sup>41</sup> See Securities and Exchange Act of 1934, 15 U.S.C. § 78p (2003) (requiring disclosure of trades also by beneficial owners holding more than ten percent of any class of equity securities, prohibiting short sales by insiders, and allowing the issuer to recover any "short-swing" profit realized by an insider from any purchase and sale or any sale and purchase within a timeframe of less than six months).

<sup>42</sup> Member States are free to prescribe more stringent provisions.

<sup>43</sup> *Cf.* Securities and Exchange Act of 1934, *supra* note 41.

<sup>44</sup> TBD, *supra* note 18, art. 3(a).

have the effect of barring information flows from the company to parent companies and dominant shareholders.<sup>45</sup> This is an issue that is likely to be construed differently in the various Member States, depending on local company law doctrines on the powers of controlling shareholders. Therefore, different local interpretations with respect to the legitimacy of disclosing certain inside information to the parent company will not come as a surprise. In any event, in those Member States where, following the implementation of the MAD, judges will read the tipping prohibition as preempting inside information to parent companies, the impact of the MAD on corporate ownership and control structures will be substantial. In fact, if a dominant shareholder is not in the position to have lawful access to inside information relating to the company it controls, holding relevant stakes in listed companies will be less appealing and the use of the group structure to control listed companies might become less common than it currently is in continental Europe. Predicting whether the MAD will ever represent a turning point in the way corporate ownership and control are shaped in Europe is obviously impossible at this stage. It might also depend on whether and how the Committee of European Securities Regulators adopts a uniform interpretation.

### C. Prospectus Directive

Similarly to what IAS/IFRS Regulation imposes to issuers which are subject to it, in the level 2 measures adopted by the European Commission to implement the PD, companies are required to disclose details of related party transactions that they have entered into during the period covered by the historical financial information and up to the date of the registration document. If applicable, such information must be disclosed according to IAS/IFRS Regulation. Otherwise, the issuer must disclose the nature and extent of material transactions, the amount or percentage to which related party transactions form part of the turnover of the issuer, the amount of outstanding loans (including guarantees) and, if applicable, explain the reasons why the transactions were not at arm's length.

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<sup>45</sup> To be sure, the old directive on insider trading contained an identically phrased tipping prohibition. Interestingly, some Member States implemented the rule introducing a different wording that ultimately allowed more permissive interpretations. For example, Italy contemplated an exemption to the prohibition in case of a "justified reason" for disclosure of information (note that both the old directive on insider trading and the MAD grant an exemption only when disclosure is made "in the normal course of the exercise of his employment, profession or duties"). This way, arguing from this open-ended exemption, legal commentators were able to conclude that upstream information flows within groups did not violate the tipping prohibition. As one of us has noted elsewhere, diverging implementation and parochial interpretations often make EC law quite different from what it looks like on the books. Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT'L ECON. L. 1, 17–20 (2006).

#### D. Takeover Bids Directive

The TBD was adopted after almost fifteen years of negotiations among Member States and an unprecedented dismissal by the European Parliament of a former proposal. The compromised outcome, a framework directive with several options for national legislatures to depart from the EC standards, largely disappointed those who considered the TBD pivotal for the creation of a pan-European market for corporate control.<sup>46</sup> By providing rules governing the allocation of corporate control, there are several features of the TBD that are relevant in the perspective of containing the extraction of private benefits of control by insiders. Our focus will be on three controversial provisions: the mandatory bid rule (“MBR”),<sup>47</sup> the board neutrality rule (“BNR”),<sup>48</sup> and the break-through rule (“BTR”).<sup>49</sup> We will also mention certain disclosure requirements imposed by the TBD in order to give investors a clear picture of the contestability of a company.<sup>50</sup>

The MBR requires any person acquiring, alone or in concert with other persons, a percentage of voting rights sufficient to grant control of a company to make a mandatory bid for all of the voting shares of a company at an “equitable price,” that is, at the highest price paid for the same securities by the acquirer over a given period prior to the bid. Among the various justifications that have been put forward by legal and economic commentators (e.g., equal opportunity for minority investors, fiduciary duties of controlling shareholders towards minorities, and leveling the playing field among various EU jurisdictions), one of the most compelling rationales for the MBR refers to the disincentives that the rule creates for acquisitions exploiting minority shareholders. Specifically, in companies with concentrated ownership, given the requirement to provide all shareholders with the same consideration paid to the selling controlling shareholder, the MBR screens out transfers of control that may harm minorities, whereby the goal of the acquirer is to extract private benefits of control to a larger extent than currently done by the existing controlling shareholder.<sup>51</sup> In companies with widely diffused shares and with control

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<sup>46</sup> Press Release, Frits Bolkestein, Comments on the Results of the Competitiveness Council of Ministers, Brussels, (Nov. 27, 2003) (MEMO/03/245, Brussels).

<sup>47</sup> TBD, *supra* note 18, art. 5.

<sup>48</sup> *Id.* arts. 9 & 12.

<sup>49</sup> *Id.* arts. 11 & 12.

<sup>50</sup> *Id.* art. 10.

<sup>51</sup> The prospective acquirer is compelled to buy shares at the same per-share price paid to the current controlling shareholder. Given that the price incorporates, among other things, the consideration for the transfer of the ability to extract private benefits, and that such consideration may be benefited pro-rata by all minority shareholders, prospective acquirers cannot get their acquisition gains from the extraction of private benefits of control. This is

contestable in the market, the MBR represents an obstacle to partial bids and creeping acquisitions through so-called street sweeps on the market. In both cases, the ultimate goal is to eliminate, or at least limit, the occurrence of inefficient acquisitions whereby the acquirer conquers control by exploiting minority shareholders. To be sure, this deterrence effect has a downside: not only do the higher costs the MBR imposes on acquisitions imply a reduction of harmful transactions, but they suggest a reduction of efficient acquisitions as well.

In any event, the MBR gives Member States wide freedom in carving out exemptions to the duty to launch a mandatory bid, sets forth criteria on how to depart from the rule imposing to make the bid at the highest price paid, does not ban partial bids, and is quite generic in protecting equal treatment among shareholders within the bid.<sup>52</sup> As a result, at least potentially, the MBR may run the risk of being solely on the books in those Member States that will implement it loosely, by providing market actors, one way or the other, with the opportunity to escape it.

Two other distinctive features of the TBD are the BNR and the BTR, which are considered chief devices for increasing takeover activity, as they both aim to neutralize anti-takeover defenses.

The BNR compels a target company's directors to obtain a prior shareholders' authorization when engaging in defensive actions to preserve the company's independence. Supporters of the rule highlight that board neutrality prohibits conflicted incumbent management from raising obstacles to hostile takeovers, which in turn are considered beneficial as they promote synergies and economies of scale or scope, sanction inefficient management teams and put pressure on managers to work harder in order to keep stock prices high (thus avoiding, or limiting, the risk of becoming a target in the future).<sup>53</sup> By impeding management entrenchment and facilitating hostile takeovers, which are considered effective and spontaneous market devices for the reduction of agency costs between shareholders and managers in widely held firms, the BNR plays an important role in corporate governance.

The BTR, whose proposal was first advanced in the *Report of the High*

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because if all minority shareholders tender, there will be no one from whom the new controller will be able to extract wealth. Rather, the ability to better manage the firm is the only purpose that, under the MBR, should motivate an acquisition. See generally Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994); Einer R. Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465 (1992).

<sup>52</sup> Luca Enriques, *The Mandatory Bid Rule in the Proposed EC Takeover Directive: Harmonization as Rent-Seeking?*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 767, 776–79 (Guido Ferrarini et al. eds., 2004).

<sup>53</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 171-73 (1991).

*Level Group of Company Law Experts on Issues Related to Takeover Bids*<sup>54</sup> as a device with which to create a “level playing field” for shareholders around the different legal systems in the European Union, seeks to promote, inter alia, a principle of proportionality between risk bearing capital and control. In order to make corporate control of European companies more contestable, the BTR contains several provisions aimed at making certain pre-bid defenses, such as differential share structures (multiple voting shares, capped or time-phased voting restrictions, or non-voting shares), or restrictions on transfers of shares ineffective *vis-à-vis* a bidder. Particularly:

(i) Restrictions on the transfer of securities provided for in the articles of association of the target company, or in shareholders’ agreements relating to the company and entered into after the approval of the TBD, do not apply to the bidder during the bid period;<sup>55</sup>

(ii) Restrictions on voting rights (with the exclusion of restrictions that are compensated by specific pecuniary advantages) provided for in the articles of association of the target company, or in shareholders’ agreements relating to the company and entered into after the approval of the TBD, do not have effect at the general meeting of shareholders resolving upon defensive measures. In such a meeting, multiple-vote securities carry only one vote each;<sup>56</sup>

(iii) Where, following a bid, the bidder holds seventy-five percent or more of the capital carrying voting rights, no restrictions on the transfer of securities or on voting rights nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the target company shall apply and multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following the bid, called by the bidder to amend the articles of association or to remove or appoint board members.<sup>57</sup>

Both the BNR and the BTR have raised substantial debate for the adoption of the TBD. The BNR gave rise to strong hostility from certain Member States (Germany in particular) that were worried that their “national champions” would end up being taken over by foreign companies not facing similar duties of board neutrality.<sup>58</sup> The BTR encountered wide

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<sup>54</sup> European Commission, High Level Group of Company Law Experts, *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, Brussels, at 21–22 (Jan. 10, 2002) (Brussels) [hereinafter *Takeover Bids Report*].

<sup>55</sup> TBD, *supra* note 18, art. 11, para. 2.

<sup>56</sup> *Id.* art. 11, para. 3.

<sup>57</sup> *Id.* art. 11, para. 4.

<sup>58</sup> This is not the only criticism that the BNR has historically generated. According to some authors, limiting managerial response is unwarranted, as often times takeovers come at the expense of weak constituencies, which might well be protected by directors. *Cf.*

opposition from both Member States and interested parties on two main grounds: first, it imposes a big cost in terms of flexibility and freedom of contract among companies and investors in the market; and second, it creates incentives for substituting differential voting structures with functionally equivalent pyramidal structures.<sup>59</sup>

Due to criticism and as a political compromise necessary to overcome resistances by some Member States and thus to have the TBD eventually approved, neither the BNR nor the BTR are mandatory. According to the TBD, Member States have the option to introduce a reciprocity provision and, most importantly, to choose whether or not to implement any such provision and, in the negative, must provide companies with the option to enact any of them on a voluntary basis.<sup>60</sup> As a consequence, the impact of both the rules, at least as a matter of pure EC law, is trivial.<sup>61</sup> Indeed, so far in the biggest markets—the United Kingdom, France, Germany, and Italy—each of the regimes adopted, or soon to be adopted, is different from the

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Margaret Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1 (2002); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (A.J. Auerbach ed., 1988). Others claim that the BNR is dangerous because it can generate collateral reactions in some Member States aimed at rendering takeovers more difficult by way of various types of administrative obstacles. See Christian Kirchner & Richard W. Painter, *Takeover Defenses Under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451, 471–72 (2002). Another line of thought criticizes the BNR on the basis that takeover defenses and board response might represent useful tools against coercive bids and creeping acquisitions. Cf. Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defense: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917 (2002); William Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 2 AM. B. FOUND. RES. J. 341 (1983).

<sup>59</sup> See, e.g., Lucian A. Bebchuk & Oliver Hart, *A Threat to Dual Class Shares*, FIN. TIMES (U.S.), May 31, 2002, at 11; Luca Enriques, *Silence Is Golden: The European Company Statute as a Catalyst for Company Law Arbitrage*, 4 J. CORP. L. STUD. 77, 93–94 (2004); Guido Ferrarini, *Share Ownership, Takeover Law and the Contestability of Corporate Control 6* (Ctr. for Law & Fin., Working Paper Series, WP 1–2001, 2001), available at <http://www.giuri.unige.it/cedif/WP%201-2001%20-%20G.%20Ferrarini.pdf>.

<sup>60</sup> TBD, *supra* note 18, art. 12.

<sup>61</sup> Cf. Enriques, *supra* note 45, at 18–19. In any event, as one of us has noted elsewhere, notwithstanding the criticism toward the compromised solution enacted by the EC legislature, optionality represents a sound approach with regard to the BTR, as the beneficial impact of the rule is still highly debated among commentators, and is a good compromise for the gradual implementation of the BNR: quite plausibly, at this stage, an abrupt introduction of a mandatory BNR would have generated, at least in some Member States, a backlash in both national politics and corporate practice. Matteo Gatti, *Optionality Arrangements and Reciprocity in the European Takeover Directive*, 6 EUR. BUS. ORG. L. REV. 553 (2005).

others, and have essentially left things where they were prior to the TBD (with the notable exception of the reciprocity feature in France), and the implementation of the TBD will lead to four different takeover regimes across the European Union.<sup>62</sup>

In any event, whether or not they are subject to a harsh statutory regime with respect to takeover defenses, companies are required to give full detail in their annual reports on a set of aspects affecting their contestability in the market for corporate control, such as the presence of takeover defenses or devices that can be used as takeover defenses.<sup>63</sup> The underlying rationale is that these transparency duties signal to investors the degree of contestability of a given company and this is likely to push issuers to adopt optimal arrangements in order to avoid undervaluation of their stock. In other words, the provision aims at leaving up to the market whether to punish the adoption of excessive barriers to changes of control.<sup>64</sup>

### E. Transparency Directive

Following a very similar rationale, the TD contains a set of disclosure

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<sup>62</sup> See Commission Staff Working Document, *Report on the Implementation of the Directive on Takeover Bids*, at 12, SEC (2007) 268 (Feb. 21, 2007) (showing that (i) the United Kingdom adopted the board-neutrality rule, but not the break-through rule, nor the reciprocity option, (ii) France has adopted the board neutrality rule and the reciprocity option, but not the break-through rule, and (iii) Germany adopted the reciprocity option only and neither the board neutrality nor the break-through rule). Aside from the patterns *sub* (i), (ii), (iii) above, a fourth regime has been adopted by Estonia, Latvia, and Lithuania, and is expected to be adopted in Italy. These are the only countries that have opted (or are about to opt) into the whole package provided by the EC, by adopting the BNR and the BTR.

<sup>63</sup> Cf. TBD, *supra* note 18, art. 10. According to the rule, companies are required to provide information with respect to: (a) their capital structure, with description of the different classes of shares and, for each class of shares, the rights and obligations attaching to it and the percentage of total share capital that it represents; (b) any restrictions on the transfer of securities, such as limitations on the holding of securities or the need to obtain the approval of the company or other holders of securities; (c) significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings); (d) the holders of any securities with special control rights and a description of those rights; (e) the system of control of any employee share scheme where the control rights are not exercised directly by the employees; (f) any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, time-phased voting rights; (g) any agreements between shareholders which are known to the company and may result in restrictions on the transfer of securities and/or voting rights; (h) the rules governing the appointment and replacement of board members and the amendment of the articles of association; (i) the powers of board members, and in particular the power to issue or buy back shares; (j) any significant agreements to which the company is a party and which take effect, alter or terminate upon a change of control of the company following a takeover bid; and (k) any agreements between the company and its board members or employees providing for compensation if they resign or are made redundant without valid reason or if their employment ceases because of a takeover bid.

<sup>64</sup> Cf. *Takeover Bids Report*, *supra* note 54, at 25–26.

duties applicable to significant holders of shares admitted to trading on a regulated market, as well as to issuers of those shares. Shareholders are required to promptly notify companies upon acquisitions or disposals of shares as a result of which they reach, exceed or fall below certain relevant thresholds of voting rights.<sup>65</sup> Shareholders are also required to make such notifications publicly available.<sup>66</sup> In this respect, the TD amends and replaces the similar duties provided for in a 2001 directive.<sup>67</sup> What is worth mentioning here is that, while the lowest threshold under the old EC regime was ten percent, the TD extends information duties to holdings of five percent of the voting rights, in line with the prescriptions of the federal U.S. legislature.<sup>68</sup> Even if at first sight one might conclude that these stricter disclosure duties better protect outside investors who can benefit from a clearer picture of the ownership structure of a company, it should be reminded that harsh disclosure duties on significant holdings have chilling effects on takeover activity: all else equal, strict disclosure duties limit expected returns for prospective bidders, thus reducing their incentives to bid.<sup>69</sup> As a consequence, such disclosure requirements might end up harming investors.

The TD also prescribes that issuers “shall ensure that all the facilities and information necessary to enable holders of shares to exercise their rights are available.”<sup>70</sup> In particular, companies are required to: “(a) provide information on the place, time and agenda of meetings, the total number of shares and voting rights and the rights of holders to participate in meetings; (b) make available a proxy form . . . to each person entitled to vote at a shareholders’ meeting or, on request, after announcement of the meeting; (c) designate as [their] agent a financial institution through which shareholders may exercise their financial rights; and (d) [provide information] concerning the allocation and payment of dividends and the issue of new shares.”<sup>71</sup> Meeting certain conditions, companies are allowed to use electronic means to convey such information to shareholders.<sup>72</sup> All these protections have been broadened by the directive on shareholders’ rights. We will revisit this issue in Part IV.

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<sup>65</sup> Cf. TD, *supra* note 19, arts. 9–16.

<sup>66</sup> *Id.* art. 12, para. 6.

<sup>67</sup> Cf. Council Directive 2001/34, Admission of Securities to Official Stock Exchange Listing and On Information to Be Published on Those Securities, arts. 89–95, 2001 O.J. (L184) 1 (EC).

<sup>68</sup> Member States are free to set lower thresholds. TD, *supra* note 19, art. 9, para. 1.

<sup>69</sup> See, e.g., Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

<sup>70</sup> TD, *supra* note 19, art. 17, para. 2.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* para. 3.



Pursuant to the TD and proposed level two measures, companies with shares admitted to trading on a regulated market are also subject to certain reporting duties (including disclosure on related party transactions) with respect to annual and half-yearly reports, as well as, if they have no duty to issue quarterly reports under national rules or listing requirements, interim management statements.<sup>73</sup> Similar to what the SOX has imposed with respect to issuers registered with the Securities and Exchange Commission (“SEC”),<sup>74</sup> the TD requires that annual and half-yearly financial reports must be certified by the persons responsible within the company.<sup>75</sup> This ideally leads us to the next part of this article, which takes into account post-scandal initiatives.

### III. THE POST-SCANDAL INITIATIVES

After the Enron scandal erupted, European politicians’ reactions were ambivalent. On the one hand, they were keen to claim that corporate governance in Europe works better than in the United States, claiming their part of the credit for this.<sup>76</sup> On the other hand, they saw U.S. corporate scandals as providing plenty of justification for a review and possibly a reform of at least some areas of corporate governance, especially the auditing function and the role of the accounting profession.<sup>77</sup> In other words, U.S. corporate scandals have provided an occasion for “political activism” within the European Union, at the European Community as well as at the national level.<sup>78</sup> This second reaction has of course gained momentum as large-scale scandals such as Parmalat have come to light within the European Union.

The European Community was quick to move after the Enron scandal broke. In April 2002, taking advantage of the existence of the High Level

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<sup>73</sup> *Id.* arts. 4–6. See also Commission Directive 2007/14, art. 4, 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, 2007 O.J. (L 69) 27 (EC).

<sup>74</sup> See SOX, *supra* note 2, § 7241.

<sup>75</sup> TD, *supra* note 19, art. 4, para. 2(c) & art. 5, para. 2(c). See also *id.* art. 7.

<sup>76</sup> See Enriques, *Bad Apples, Bad Oranges*, *supra* note 9, at 912–13.

<sup>77</sup> *Id.*

<sup>78</sup> In the European Commission’s words, “[e]arning the right to be recognized as at least ‘equivalent’ alongside other national and international rules [is] a legitimate and useful end in itself.” *Communication from the Commission to the Council and the European Parliament Modernizing Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward*, at 5, COM (2003) 284 (May 21, 2003) [hereinafter *Modernizing*], available at [http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2003/com2003\\_0284en01.pdf](http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2003/com2003_0284en01.pdf).

Group of Company Law Experts (“the Group”),<sup>79</sup> the European Council and the EC Commission asked the Group to “review further corporate governance and auditing issues in the light of the Enron case.”<sup>80</sup>

The Group issued its report on company law in November 2002. The report covered most corporate governance topics and, reflecting the fact that company law and corporate governance practices widely differ from member state to member state, called for little, but significant legislative action by the European Community. While the report suggested that the European Community should mainly focus on issuing soft-law “recommendations”<sup>81</sup> on corporate governance, it also urged the adoption of a number of rules in the form of hard-law EC directives. For instance, in the Group’s view, listed companies should be required to include in their annual report a corporate governance statement providing information, *inter alia*, about the operation of the board and its committees, the role and qualifications of individual board members, the system of risk management applied by the company, and related party transactions.<sup>82</sup> The Group further recommended that companies should be given a choice between a one-tier and a two-tier board structure,<sup>83</sup> and responsibility for financial statements and for statements on key non-financial data should be attributed to all board members, consistent with a rule already in place in many Member States.<sup>84</sup>

On May 25, 2003, the European Commission issued a Communication to the Council and the European Parliament setting out its agenda to modernize European company law and to enhance corporate governance in the European Union.<sup>85</sup> The Communication (also known as the Company Law Action Plan) planned to adopt a wide set of measures covering a broad range of issues, like corporate governance, disclosure requirements, shareholder communication and voting rights, minority shareholder rights, and so on.

In the last three years, the EC institutions have taken measures to

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<sup>79</sup> The Group had originally been set up in September 2001 in order to help the Commission prepare a new proposal for a takeover directive and “to define new priorities for the broader future development of company law in the European Union.” European Commission, High Level Group of Company Law Experts [the Group], *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*, at 128 (Nov. 4, 2002) (Brussels) [hereinafter *Modern Regulatory Framework Report*], available at [http://europa.eu.int/comm/internal\\_market/company/docs/modern/report\\_en.pdf](http://europa.eu.int/comm/internal_market/company/docs/modern/report_en.pdf).

<sup>80</sup> *See id.* at 129.

<sup>81</sup> *Id.* at 46.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at 59.

<sup>84</sup> *Id.* at 67.

<sup>85</sup> *Modernizing*, *supra* note 78.

implement the Company Law Action Plan. With respect to corporate governance-related issues, the Commission has issued three recommendations<sup>86</sup> and proposed four directives, all of which have been enacted already.

Recommendations are non-binding acts by the EC Commission, the effectiveness of which relies on moral suasion and greatly varies from case to case. Although at times disregarded by Member States, recommendations function as warnings, explicitly or implicitly threatening hard law initiatives in case Member States do not follow suit. The recommendations' main impact, however, is in the national policy discussions. If the content of the recommendations fits the policy agenda of policymakers (or lobbying groups) at the national level, the policymakers may be able to increase the chances that the desired policy measures will be adopted; otherwise, these recommendations will easily be ignored.

The three recommendations deal with auditors' independence (most of their contents have already been transfused in the proposal for a Directive on statutory audits that is very close to adoption),<sup>87</sup> the remuneration of directors, and the role of non-executive directors. Predictably, the latter two measures stand little chance to ever become "hard" EC law, as they deal with aspects that are not the matter of legislation in most Member States themselves. Additionally, it would be difficult to adopt a single policy choice on issues in which practices vary quite broadly across Member States and across companies. At this stage, it is also too early to tell whether and to what extent Member States have taken any follow-up steps.<sup>88</sup> Hence, it is impossible to assess these recommendations' relevance.

Among the four directives enacted thus far, the one on statutory audit and the one revising the accounting directives are more clearly connected with the American and European scandals of the past few years.

#### A. The Directive on Statutory Audit

The directive on statutory audit is an overhaul of the EC legal framework for auditing with a strong focus on auditors' independence, an

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<sup>86</sup> See Commission Recommendation 2002/590, Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, 2002 O.J. (L 191) 22 (EC); Commission Recommendation 2004/913, Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies, 2005 O.J. (L 385) 55 (EC); Commission Recommendation 2005/162, On the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board, 2005 O.J. (L 52) 51 (EC).

<sup>87</sup> See *infra* Part III.A.

<sup>88</sup> In both cases Member States were "invited to take the necessary measures to promote the application" of the two recommendations by June 30, 2006. For an analysis of such recommendations focusing on directors' remuneration issues see Guido Ferrarini & Niamh Moloney, *Executive Remuneration in the EU: The Context for Reform*, 21 OXFORD REV. ECON. POL'Y 304 (2005).

area in which, despite concerted efforts, the European Community had been previously unable to act due to a lack of political consensus and pressure by accountants. Following are the four major changes in the EC framework for statutory audit following the new directive:

1. *Public Oversight.* Member States are required to set up “an effective system of public oversight for statutory auditors and audit firms,” much along the lines of (and clearly inspired by) the SOX Public Company Accounting Oversight Board.<sup>89</sup>

2. *Auditors’ Independence.* New provisions aimed to grant auditors’ independence *vis-à-vis* their audit clients are introduced:

- a. First, there is a prohibition to carry out a statutory audit in the presence of “any direct or indirect financial, business, employment or other relationship between the statutory auditor, audit firm or network . . . and the audited entity from which an objective, reasonable and informed third party would conclude that the statutory auditor’s or audit firm’s independence is compromised;” in case of threats to their independence, auditors and audit firms have to “apply safeguards in order to mitigate those threats;” if “the significance of the threats compared to the safeguards applied is such that the independence is compromised, the statutory auditor or the audit firm shall not carry out the statutory audit;”<sup>90</sup>
- b. To ensure the auditor’s or audit firm’s independence of management, the decision to appoint them is given to the general meeting of shareholders of the audited entity; however, alternative systems or modalities for the appointment are allowed, if Member States so provide, so long as the independence of the auditor or audit firm is ensured;<sup>91</sup> further, “statutory auditors or audit firms may only be dismissed where there are proper grounds” and information on dismissal has to be promptly disclosed to the authority in charge of supervising auditors and audit firms;<sup>92</sup>
- c. For “public entities” (for listed companies) there is a requirement that annual disclosure is provided to the audit committee of the audited entity as to any additional services provided to the company, and that issues of independence are discussed with the

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<sup>89</sup> Compare Council Directive 2006/43, Statutory Audits of Annual Accounts and Consolidated Accounts, art. 32(1), 2006 O.J. (L 157) 87, 100 (EC) [hereinafter Directive on Statutory Audits] (amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC), with SOX, *supra* note 2, § 7211 (creating the Public Company Accounting Oversight Board).

<sup>90</sup> Directive on Statutory Audits, *supra* note 89, art. 22(2).

<sup>91</sup> *Id.* art. 37.

<sup>92</sup> *Id.* art. 38.

- same committee;<sup>93</sup>
- d. The rotation of key audit partners is made mandatory after seven years;<sup>94</sup>
  - e. A cooling-off period of two years is introduced, during which the statutory auditor or the key audit partner may not take up a key management position in the audited entity;<sup>95</sup>
  - f. The annual accounts of the audited company have to disclose separately “the total fees for the financial year charged by the statutory auditor or audit firm for the statutory audit of annual accounts, the total fees charged for other assurance services, the total fees charged for tax advisory services and the total fees charged for other non-audit services.”<sup>96</sup>
3. *Reinforcing the Statutory Audit.* In order to strengthen the statutory audit, new requirements on how to conduct them are introduced:
- a. First, similar to what the European Community has done with regard to international accounting standards, the European Community has decided to adopt generally accepted international auditing standards<sup>97</sup> by means of EC legislative measures implementing them;<sup>98</sup>
  - b. Second, the auditor in charge of the statutory audit of consolidated accounts “bears the full responsibility for the audit report in relation with the consolidated accounts” and must review the audit work performed by third country (i.e. extra-EU-based) auditors.<sup>99</sup>
4. *Audit Committees.* Finally, the Directive on Statutory Audits also dictates rules on audit committees of public interest entities (listed companies), requiring them (unless they are small or medium-sized enterprises as defined in Article 2(1)(f) of the PD) to have one.<sup>100</sup> The audit committee has to be composed of non-executives and at least one of them has to be independent (with no definition of independence being

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<sup>93</sup> *Id.* art. 42(1).

<sup>94</sup> *Id.* art. 42(2).

<sup>95</sup> *Id.* art. 42(3).

<sup>96</sup> *Id.* art. 49(1)(a).

<sup>97</sup> Although no explicit mention is made to them, the EC will predictably turn to the International Standards on Auditing developed by the International Federation of Accountants.

<sup>98</sup> Directive on Statutory Audits, *supra* note 89, art. 26.

<sup>99</sup> *Id.* art. 27.

<sup>100</sup> *Id.* art. 41, para. 1. However, Member States may decide that the provisions of this article need not apply to any public-interest entity already audited by a body (such as Italy’s board of internal auditors) that performs functions equivalent to those of an audit committee. *Id.* art. 41, para. 5.

provided).<sup>101</sup> The Directive also identifies the key functions of the audit committee (monitoring the financial reporting process, monitoring the effectiveness of the company's internal control, monitoring internal audit and risk management systems, monitoring the statutory audit, "review[ing] and monitor[ing] the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity,"<sup>102</sup> and making the recommendation of the statutory auditor or audit firm on the basis of which the appointment will be made)<sup>103</sup> and provides that the auditor or the audit firm reports to it on key matters arising from the statutory audit.<sup>104</sup>

## B. The Post-Scandal Revision of the Accounting Directives

In 2006, the European Parliament and the Council approved a directive bringing changes to EC accounting rules.<sup>105</sup> The new measure is aimed to enhance the degree of transparency and reliability of annual reports by EU companies as a response to major corporate scandals. It is also a consequence of a long-standing policy debate on transparency regarding corporate governance arrangements. Since listed companies are required to draw annual accounts according to the IFRS (so that the accounting rules to be found in the accounting directives and amended by the proposed directive do not apply to them), the relevant innovations boil down to just two: the requirement that companies issue a corporate governance statement in their annual reports, and the collective responsibility of directors for annual accounts.

*1. The Corporate Governance Statement.* The idea of imposing by law a corporate governance statement on listed companies stems from a similar reform introduced in Germany in 2001. Until then, disclosure on corporate governance practices had been the outcome of self-regulatory initiatives mainly driven by stock exchanges and institutional investors.<sup>106</sup> In such a setting, disclosure on corporate governance was prompted by the relevant listing rules.

The European Community has chosen to transform this requirement into "hard law," perhaps with a view to increase the effectiveness of

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<sup>101</sup> *Id.* art. 41, para. 1.

<sup>102</sup> *Id.* art. 41, para. 2.

<sup>103</sup> *Id.* art. 41, para. 3.

<sup>104</sup> *Id.* art. 41, para. 4.

<sup>105</sup> Council Directive 2006/46, 2006 O.J. (L 224) 1 (EC) (amending Council Directives 78/660/EEC, 83/349/EEC and 91/674/EEC).

<sup>106</sup> Such initiatives were originally a reaction to scandals that occurred in the United Kingdom some fifteen years ago. See Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan Via Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 16–17 (1999).

enforcement mechanisms regarding false or misleading statements on corporate governance arrangements.<sup>107</sup> Under the directive, the corporate governance statement that listed companies shall include in their annual report “shall contain at least the following information:

1. A reference to:
  - (a) the corporate governance code to which the company is subject, and/or
  - (b) the corporate governance code, which the company may have voluntarily decided to apply, and/or
  - (c) all relevant information about the corporate governance practices applied beyond the requirements under national law.
- ... .
2. To the extent to which a company, in accordance with national law, departs from a corporate governance code referred to under points (1)(a) or (b), an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so. Where the company has decided not to apply any provisions of a corporate governance code referred to under points (1)(a) or (b), it shall explain its reasons for doing so;
3. A description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process;
- ... .
5. Unless the information is already fully provided for in national laws or regulations, the operation of the shareholder meeting and its key powers, and a description of shareholder’s rights and how they can be exercised;
6. The composition and operation of the administrative, management and supervisory bodies and their committees.”<sup>108</sup>

The directive also specifies that the statutory auditor must audit the corporate governance statement with respect to point (3). Point (3) and the requirement that the relevant statement must be audited come close to the notorious SOX Section 404, but are significantly more lenient, because no assessment of the effectiveness of the internal control structure and procedure has to be made nor, a fortiori, auditors have to report on it.<sup>109</sup>

2. *Collective Responsibility for Annual Accounts.* We have already seen how the SOX emphasis on the specific responsibility of the CEO and

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<sup>107</sup> On the issue of enforcement of corporate governance codes, see Eddy Wymeersch, *The Enforcement of Corporate Governance Codes*, 6 J. CORP. L. STUD. 113 (2006).

<sup>108</sup> Council Directive 2006/46, *supra* note 105, art. 1(7), at 4 (amending Council Directive 78/660, 1978 O.J. (L 222) 11 (EEC) to add Article 46a).

<sup>109</sup> See SOX, *supra* note 2, § 7262.

the CFO for the annual and quarterly reports has influenced a similar provision in the TD.<sup>110</sup> The directive contains a provision prescribing, like many Member States already do,<sup>111</sup> the collective responsibility of the whole board (or boards) in connection with the approval of annual accounts and reports. Therefore, Member States have to make board members liable at least toward the company for breach of the duty to ensure that the annual accounts and report are drawn up and published in accordance with EC provisions.<sup>112</sup>

#### IV. THE MODERNIZATION OF EC (AND EU) COMPANY LAW

In the aim of modernizing EC as well as national company laws, the Company Law Action Plan mainly focused on three areas directly connected with corporate governance: legal capital, which can greatly affect corporate finance decisions, ownership structures, and shareholders' rights. This resulted in a revision of the directive on legal capital and a brand new directive on shareholders' rights. Furthermore, following recent European Court of Justice ("ECJ") case law on freedom of establishment,<sup>113</sup> the EC legislature also enacted provisions aimed at facilitating cross-border mergers.<sup>114</sup>

##### A. Legal Capital

One of the priorities in the EC agenda has been the deregulation of certain capital requirements stemming from the second company law directive,<sup>115</sup> which was adopted thirty years ago in a completely different political and economic context. When enacted, the requirements were purported to protect creditors from shareholders' opportunism through a series of procedural rules whose aim was to guarantee that companies are set up with a minimum level of capital and maintain it during their life. However, over the years, the legal capital regime had become increasingly unpopular, mainly because of the doubts that its rule-based system is

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<sup>110</sup> See *supra* text accompanying notes 67 & 68.

<sup>111</sup> See European Commission, *Board Responsibilities and Improvement of Financial Information Relating to Financial and Corporate Governance Matters*, [http://ec.europa.eu/internal\\_market/accounting/board/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/board/index_en.htm) (last visited Sept. 24, 2007).

<sup>112</sup> Council Directive 2006/46, *supra* note 105, art. 1(8), at 5 (amending Council Directive 78/660/EEC to add Article 50c).

<sup>113</sup> See Case C-212/97, *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, 1999 E.C.R. I-1459; Case C-208/00, *Überseering BV v. Nordic Constr. Co. Baumanagement GmbH*, 2002 E.C.R. I-9919; Case C-167/01, *Kamer van Koophandel v. Inspire Art Ltd.*, 2003 E.C.R. I-10155; Case C-411/03 *SEVIC Sys. AG v. Amtsgericht Neuwied*, 2005 E.C.R. I-10805.

<sup>114</sup> Council Directive 2005/56, *Cross-Border Mergers of Limited Liability Companies*, 2005 O.J. (L 301) 1 (EC).

<sup>115</sup> Council Directive 77/91, 1977 O.J. (L 26) 1 (EEC).



effectively able to protect creditors, while it certainly gives rise to inflexibility and administrative costs.<sup>116</sup>

In parallel, since the end of the 1990s, the European Commission has been active to revise those aspects of current capital rules that are nowadays considered too burdensome and ineffective. The European Community has been working on two fronts: first, in late 2006, it enacted a directive for the simplification and modernization of the second directive, which is substantially in line with the Simpler Legislation for the Internal Market (“SLIM”) recommendations as supplemented by the Winter Group,<sup>117</sup> second, the European Commission has launched a feasibility study on alternatives to the capital maintenance regime. While it is premature to make any guess on whether a radical change of the legal capital system will occur in the near future, there are a few rules contained in the revised directive that are worth mentioning here.

First, the directive contains a substantial amendment to the current prohibition on financial assistance, which may result in bolstering M&A transactions and in particular leveraged buyouts (“LBOs”).

Traditionally, the former Article 23, paragraph 1, of the second company law directive (“[a] company may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party”<sup>118</sup>) was considered an obstacle, or at least a chilling factor, to LBOs. In fact, if one construed the prohibition as applying not only to transactions where a company *expressly* grants assistance to a potential acquirer, but also to transactions where a company *substantially* provides that assistance (in LBOs this was said to typically occur as a result of the target’s merging with the leveraged vehicle set up by the acquirer),<sup>119</sup> the financial assistance provision would have barred a significant amount of

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<sup>116</sup> See John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*, 63 MOD. L. REV. 355 (2000); Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001); Peter O. Mühlbert & Max Birke, *Legal Capital—Is There a Case Against the European Legal Capital Rules?*, 3 EUR. BUS. ORG. L. REV. 695 (2002); Friedrich Kübler, *The Rules of Capital Under Pressure of the Securities Markets*, in CAPITAL MARKETS AND COMPANY LAW 95 (Klaus J. Hopt & Eddy Wymeersch eds., Oxford Univ. Press 2003).

<sup>117</sup> See Directive 2006/68, 2006 O.J. (L 264) 32 (EC) (amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital).

<sup>118</sup> Council Directive 77/91, *supra* note 115, art. 23, para. 1.

<sup>119</sup> See, e.g., Eddy Wymeersch, *Article 23 of the Second Company Law Directive: The Prohibition on Financial Assistance to Acquire Shares of the Company*, in FESTSCHRIFT FÜR ULRICH DROBNIG ZUM SIEBZIGSTEN GEBURTSTAG 725, 734 (Jürgen Basedow et al. eds. 1998) [hereinafter Wymeersch, *Article 23*]; Marco Silvestri, *The New Italian Law on Merger Leveraged Buy-Outs: A Law and Economic Perspective*, 6 EUR. BUS. ORG. L. REV. 101, 103–10 & 114–17 (2005).

LBO structures.

By exempting certain transactions from the financial assistance prohibition, so long as certain conditions are met,<sup>120</sup> the amended directive might well help to make uncertainties and concerns with respect to the legal feasibility of LBOs disappear and, therefore, to lead to an increase in the number of acquisitions.<sup>121</sup> However, the conditions to be met are such that, as Eillis Ferran has argued, “barring truly exceptional circumstances, no-one will ever want to use [the proposed gateway procedure] because it is time-consuming, costly, runs the risk of transaction-disrupting minority shareholder actions and exposes directors to excessive personal risks.”<sup>122</sup>

Another interesting aspect of the amended directive is the partial deregulation of the regime governing purchases by a company of its own shares. Traditionally, EC law provided for a set of limitations that included, among other things, the requirement that the purchase be authorized by the general meeting of shareholders for a period not exceeding eighteen months, as well as the requirement that purchases of own shares do not result in the company’s owning its shares in excess of ten percent of its subscribed capital. Under the new rules, the eighteen-month limit is extended to five years, while Member States are free to eliminate the limit of ten percent of the subscribed capital. Although the latter will depend on

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<sup>120</sup> Such conditions include: (i) that the transaction is taken under the responsibility of the administrative or management body at fair market conditions, “especially with regard to interest received by the company and with regard to security provided to the company for the loans and advances referred to in the first subparagraph;” (ii) that the credit standing of the third party or, in the case of multiparty transactions, of each counterparty thereto are duly investigated; (iii) that the transaction obtains shareholders’ approval following extensive disclosure of “the reasons for the transaction, the interest of the company in entering into such a transaction, the conditions on which the transaction is entered into, the risks involved in the transaction for the liquidity and solvency of the company and the price at which the third party is to acquire the shares;” and (iv) that the aggregate financial assistance granted to third parties shall at no time result in the reduction of the net assets below the amount of the subscribed capital plus undistributable reserves and the company must include, among the liabilities in the balance sheet, a reserve, unavailable for distribution, of the amount of the aggregate financial assistance. Cf. Council Directive 77/91, *supra* note 115, art. 23 (amended by Council Directive 2006/68, *supra* note 117, art. 1).

<sup>121</sup> To be sure, given the sheer volume of private equity buy-outs in Europe, the hindering effect of current Article 23 of the Second company law directive was not as great as often contended. See Enriques, *supra* note 43, at 30–31. First, some Member States, and notably the United Kingdom, had introduced exemptions. Second, in all Member States “intricate . . . evasion techniques [had] been invented by smart lawyers,” Eddy Wymeersch, *About Techniques of Regulating Companies in the European Union*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 52, at 145, 177, which national courts, for better or for worse, had usually judged to be in line with the prohibition on financial assistance. Wymeersch, *Article 23*, *supra* note 118, at 735, 738–39 (reporting arguments developed in various Member States in order to construe the prohibition restrictively).

<sup>122</sup> Eillis Ferran, *Simplification of European Company Law on Financial Assistance*, 6 EUR. BUS. ORG. L. REV. 93, 99 (2005).

Member States' choices, both features are likely to boost repurchase programs and may galvanize investors in pressuring companies to reduce their cash in excess.

### B. "One Share, One Vote" and Pyramidal Structures

An issue that the European Community has been considering whether to take action on is the so-called battle for shareholder democracy that purports to ban, or at least limit, dual-class share structures and pyramids.

As to dual-class shares, the European Community's first attempt missed the target: as noted, the BTR was eventually made optional for Member States, due to wide political opposition (and significant criticism from academics). According to EC policymakers, dual-class structures are dangerous because they do not reflect a principle of proportionality between risk bearing and control. At this stage, it is far from clear whether the European Community will eventually take any formal steps; if so, it is highly unlikely that it will issue anything more than a non-binding recommendation.<sup>123</sup>

Bans on dual-class share structures do not find many supporters among most legal and financial commentators, who have two main objections: first, adoptions of dual-class share structures can be adequately assessed and, if the case, sanctioned by the market, as they trigger higher costs of capital; second, a mandatory "one share, one vote" principle would trigger undesirable collateral effects, such as the substitutes that it would generate to differential voting structures, and the reduction of firms eager to make access to capital markets.<sup>124</sup> Even embracing the underlying premise that such structures are always (or most of the times) inefficient, as the European Community seems to be inclined to hold, a general ban may have negative effects in terms of fewer firms going public, without being even capable of eliminating the inefficiencies it purports to get rid of: firms would most probably switch to functionally equivalent, yet arguably even more inefficient devices, such as pyramidal structures or cross-shareholding.<sup>125</sup>

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<sup>123</sup> Cf. Charlie McCreevy, European Commissioner for Internal Market and Services, Company Law Action Plan: Setting Future Priorities (Nov. 14, 2005) (transcript available as SPEECH/05/683, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/683&format=PDF&aged=1&language=EN&guiLanguage=en>); European Commission, *Report on the Proportionality Principle in the European Union—ISS Europe, ECGI, Shearman & Sterling*, IP/07/751 (Jun. 4, 2007), available at [http://ec.europa.eu/internal\\_market/company/docs/shareholders/study/final\\_report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf) (finding no conclusive evidence of a causal link between deviations from the proportionality principle and either the economic performance of listed companies or their governance).

<sup>124</sup> See articles cited, *supra* note 59.

<sup>125</sup> See articles cited, *supra* note 59.

Pyramidal structures actually raise more concerns than dual-class structures, as they represent a more opaque and costly way to separate controlling rights from cash flow rights.<sup>126</sup> However, what makes legislative initiatives quite problematic in this field (irrespective of whether they are adopted at the national or at the EC level) is that pyramids are so complicated to regulate, that any response would likely end up being overinclusive (as it can dampen efficient uses of group structures)<sup>127</sup> and/or ineffective (as market participants will likely find loopholes in the legislation that would allow them to adopt some substitutes). To date, no formal proposal has been put forward.

### C. Facilitating Shareholders' Voting

Another field where the European Community has been very active is shareholders' voting rights. Drawing on the report by the Group,<sup>128</sup> the Company Law Action Plan put the enhancement of shareholders' rights in listed companies as one of its main concerns.<sup>129</sup> Following a lengthy consultation process, in July 2007, the EC institutions finally adopted a directive on shareholders' rights,<sup>130</sup> which contains measures governing shareholders' meetings and the voting process. Among other things, the directive includes: the right to add items to the agenda and to table draft resolutions;<sup>131</sup> provisions concerning the admission to the meeting, with a ban over share blocking systems<sup>132</sup> and the option for Member States to introduce record date systems<sup>133</sup> within a maximum period of thirty calendar days preceding the general meeting,<sup>134</sup> the right to participate in a

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<sup>126</sup> See John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 52, at 677, 690 (noting that pyramids and cross-shareholdings make it more difficult for outside investors to understand, evaluate, and monitor existing controllers).

<sup>127</sup> See Guido Ferrarini, *European Corporate Governance Harmonisation Plans: A Critical Assessment*, in THE FUTURE OF CORPORATE GOVERNANCE 57, 68 (Mats Isaksson & Rolf Skog eds., 2004) (arguing that "it is often difficult to decide whether a pyramid is abusive or not").

<sup>128</sup> *Modern Regulatory Framework Report*, *supra* note 79, at 47–59.

<sup>129</sup> See *Modernizing*, *supra* note 78, at 14.

<sup>130</sup> Council Directive 2007/36, 2007 O.J. (L 184) 17 (EC).

<sup>131</sup> *Id.* art. 6 (the said rights must be guaranteed, at least, to holders of five percent of the share capital of the issuer).

<sup>132</sup> Under a share blocking system, in order to be admitted to the meeting, shareholders must deposit their shares (either at the company's headquarters or at designated institutions) at a certain date prior to the meeting and cannot dispose their shares in between. *Id.* art. 7, para. 1.

<sup>133</sup> In a record date system, only shareholders who are registered on the company's stock ledger as owners of the stock on the record date are entitled to participate to at the meeting.

<sup>134</sup> *Id.* art. 7, para. 2.

shareholders' meeting by electronic means;<sup>135</sup> the right to ask questions;<sup>136</sup> measures on proxy voting and the right to vote in absentia;<sup>137</sup> and provisions with respect to the management of securities accounts and to voting by intermediaries upon instructions from accountholders and post-meeting information.<sup>138</sup>

#### D. Cross-Border Mergers

The EC legislature is also involved in enacting measures that seek to facilitate cross-border mobility and restructuring: both the directive on cross-border mergers and the announced proposal for a directive on the cross-border transfer of the registered office are aimed at removing national barriers against EU companies' freedom to migrate and, hence, choose company law.<sup>139</sup> It is however at least debatable, if we take into account recent ECJ case law on freedom of establishment, whether these provisions will really be pivotal in facilitating mobility: only a few days following the adoption of the directive on cross-border mergers, the ECJ clarified in the SEVIC case<sup>140</sup> that national provisions restricting the ability for companies to enter into cross-border mergers violate Articles 43 and 48 of the EC Treaty. One can thus legitimately wonder whether the directive is ultimately trivial, as it allows companies to do something that, as a matter of EC law, has to be permissible in each Member State. Further, given that, according to the ECJ, even before the directive companies were able to enter into such cross-border transactions, the only problem for market players being legal uncertainty, it will be important to assess whether the benefits of the cross-border mergers directive, in terms of legal certainty and protection of the relevant stakeholders, will not be offset by the costs stemming from all the procedural measures it imposes.

#### V. CONCLUSION: WHAT ROLE FOR EC LAW IN TACKLING INSIDERS' OPPORTUNISM?

These have been busy times for EC policymakers dealing with corporate governance and capital markets issues. We have described what we think are all of the relevant innovations enacted in this area and selected a few among those that are still under discussion.

Almost half of the measures enacted between 2002 and 2007 deal with accounting. It is perhaps too early to evaluate the overall impact of IFRS

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<sup>135</sup> *Id.* art. 8.

<sup>136</sup> *Id.* art. 9.

<sup>137</sup> *Id.* arts. 10–12.

<sup>138</sup> *Id.* arts. 13 & 14, respectively.

<sup>139</sup> Council Directive 2005/56, *supra* note 114.

<sup>140</sup> *See* Case C-411/03, *supra* note 113.

on EU companies' accounts and, by implication, corporate governance. Since enforcement takes place at the Member States level, there is still the risk that IFRS will be applied and construed differently across the European Union, that the ensuing degree of comparability of EU companies' annual accounts will be lower than expected and hence that national practices will somehow be maintained. However, we believe that IAS 24 is a major innovation in the field of disclosure of self-dealing (and therefore for the prevention of a widespread form of "tunneling") and that it greatly improves on existing accounting methods for such transactions in at least some of the Member States.

If consistently and strictly applied, some of the new measures may have an impact on ownership structures across the European Union: the MAD appears to prevent upstream information flows in groups of companies, making it more difficult for dominant shareholders to manage a group of listed companies and in any event to monitor their day-to-day management, unless they sit on the board of the relevant listed companies (which, among other things, will make them insiders for the purpose of trading disclosure requirements).

If adopted, the board neutrality rule would also affect ownership structures, possibly leading to *more* concentration of ownership. First, shareholders having working control of a company or managers themselves may be tempted to secure a more stable controlling position by building blocks so as to avoid or limit hostile bids altogether.<sup>141</sup> Second, the fear of leaving control up for grabs might convince companies to sell smaller stakes at the IPO stage, or to stay away from capital markets upfront.<sup>142</sup> Further, board neutrality may work as an incentive for companies to erect pre-bid defenses.<sup>143</sup> However, certain Member States, including Germany, Belgium, Denmark, Luxembourg, and The Netherlands, decided not to adopt the board neutrality rule. It will be interesting to see whether in such countries we might even gravitate toward the opposite outcome—that of greater diffusion of ownership—due to the enhanced possibility of adopting defensive tactics against hostile bids.<sup>144</sup>

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<sup>141</sup> Building blocks can either facilitate the approval of defensive tactics by the shareholders' meeting or, more simply, make the control of the company not contestable to begin with.

<sup>142</sup> Cf. Gatti, *supra* note 61, at 567.

<sup>143</sup> See Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

<sup>144</sup> To be sure, this will also depend on the extent to which national company law in the given Member State ultimately allows companies to adopt effective defenses. Cf. Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 52, at 542, 551 n.23; MATTEO GATTI, OPA E STRUTTURA DEL MERCATO DEL CONTROLLO SOCIETARIO 100–07 (2004) (arguing that, in jurisdictions endorsing a shareholder choice approach with respect to

Further, a number of measures are aimed to strengthen the statutory audit. Whether this will bring a net benefit to the corporate governance of EU companies remains to be seen. It will depend on whether the higher cost of auditing the reforms predictably involved will be more than offset by the improvements in management processes and decisions that the reforms also might prompt.

With the exception of the new accounting rules involving adoption of IAS 24 and of insiders' trading disclosure requirement,<sup>145</sup> rules against corporate self-dealing are noticeably absent from the EC agenda of corporate governance reforms for listed companies. While it would be easy to argue that such an absence is evidence of the failure to address core corporate governance issues by the European Community, we believe that inaction on this front is the wisest course of action for EC policymakers. In fact, as we have already noted elsewhere, the EC legislature would not be a good actor for the role of providing tougher checks on the extraction of private benefits of control.<sup>146</sup> First, an EC legislation aimed at reducing private benefits of control would turn out to be either ineffective (if the European Community decided to mandate certain standards that local judges may end up enforcing leniently) or inefficient (if it opted to impose rules that by definition are destined to be inflexible and both overinclusive and underinclusive). Second, effective policing of self-dealing is the outcome not only of a proper regulation, but of several other factors (e.g., business culture, economic and social norms, efficiency of the judicial system),<sup>147</sup> which are beyond the reach of the European Community. A mere legislative intervention to tighten fiduciary duties EU-wide, which is per se very unlikely to be adopted because of local resistances, would at best turn out to be insufficient.

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takeover defenses, company law obstacles to so-called structural defenses, such as poison pills, may result in the adoption of some other value-wasting defense and may therefore end up harming investors for lack of effective means to counter low-ball offers) (on file with authors).

<sup>145</sup> MAD, *supra* note 16, art. 6, para. 4.

<sup>146</sup> See Luca Enriques & Matteo Gatti, *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union*, 27 U. PA. J. INT'L ECON. L. 939, 994–95 (2006).

<sup>147</sup> See, e.g., Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, UCLA L. REV. 781, 804–15 (2001); Guido Ferrarini & Paolo Giudici, *Financial Scandal and the Role of Private Enforcement: The Parmalat Case*, in AFTER ENRON 159 (John Armour & Joseph A. McCahery eds., 2006); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

## APPENDIX 1

EC Company law directives and regulations (Jan. 1, 2002–Aug. 31, 2007)

1. Regulation 1606/2002/EC of the European Parliament and of the Council of 19 July 2002, as implemented by
  2. Commission Regulation 1725/2003 of 29 September 2003 and Annexes, adopting certain international accounting standards in accordance with Regulation 606/2002/ EC, as amended by
    3. Commission Regulation 707/2004/EC of 6 April 2004;
    4. Commission Regulation 2086/2004 of 19 November 2004;
    5. Commission Regulation 2236/2004 of 29 December 2004;
    6. Commission Regulation 2237/2004 of 29 December 2004;
    7. Commission Regulation 2238/2004 of 29 December 2004;
    8. Commission Regulation 211/2005 of 4 February 2005;
    9. Commission Regulation 1073/2005 of 7 July 2005;
    10. Commission Regulation 1751/2005 of 25 October 2005;
    11. Commission Regulation 1910/2005 of 8 November 2005;
    12. Commission Regulation 1864/2005 of 15 November 2005;
    13. Commission Regulation 2106/2005 of 21 December 2005;
    14. Commission Regulation 108/2006 of 27 January 2006;
    15. Commission Regulation 708/2006 of 8 May 2006;
    16. Commission Regulation 1329/2006 of 8 September 2006;
    17. Commission Regulation 610/2007 of 1 June 2007;
    18. Commission Regulation 611/2007 of 1 June 2007;
19. Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) as implemented by
  20. Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC as regards the definition and public disclosure of inside information and the definition of market manipulation;
  21. Commission Regulation (EC) 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC as regards exemptions for buy-back programmes and stabilisation of financial instruments;
  22. Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions



- and the notification of suspicious transactions;<sup>148</sup>
23. Council Directive 2003/38/EC of 13 May 2003 amending Directive 78/660/EEC on the annual accounts of certain types of companies as regards amounts expressed in euro;
  24. Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings;
  25. Directive 2003/58/EC of the European Parliament and of the Council of 15 July 2003 amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies;
  26. 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, as implemented by
    27. Commission Regulation (EC) 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements;<sup>149</sup>
  28. Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids;
  29. 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

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<sup>148</sup> Directive 2003/6/EC, MAD, *supra* note 16, is also implemented by Commission Directive 2003/125, 2003 O.J. (L 339) 73 (EC). The latter directive, which implements the former “as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest,” does not deal with company law issues and is therefore not included in the list. See also Committee of European Securities Regulators [CESR], *Market Abuse Directive: Level 3—First Set of CESR Guidance and Information on the Common Operation of the Directive*, CESR/04-505b, May 11, 2005 available at [http://www.cesr-eu.org/index.php?page=contenu\\_groups&id=22&docmore=1](http://www.cesr-eu.org/index.php?page=contenu_groups&id=22&docmore=1) (scroll down to “11 May. 2005”); CESR, *Market Abuse Directive: Level 3—Second Set of CESR Guidance and Information on the Common Operation of the Directive to the Market*, CESR/06-562b, July 12, 2007, available at [http://www.cesr-eu.org/index.php?page=contenu\\_groups&id=22&docmore=1](http://www.cesr-eu.org/index.php?page=contenu_groups&id=22&docmore=1) (scroll down to “12 Jul. 2007”)

<sup>149</sup> Commission Regulation 809/2004, 2004 O.J. (L 149) 1 (EC), has been amended by Commission Regulation 1787/2006, 2006 O.J. (L 337) 17 (EC), which addresses issues related to the equivalence of third countries accounting standards. See also CESR, *CESR's Recommendations for the Consistent Implementation of the European Commission's Regulation on Prospectuses No. 809/2004*, CESR/05-054b, Jan. 2005.

2001/34/EC;

30. 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.
31. Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.
32. Directive 2006/43/EC of the European Parliament and of the Council 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.
33. Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 Amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts.
34. Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital.
35. 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.

