DISCLOSURE REGULATION IN THE EU
THE EMERGING FRAMEWORK

RAPPORTEURS: KAREL LANNOO &
ARMAN KHACHATURYAN

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This report is based on research and discussions in the CEPS Task Force on Financial Disclosure Standards in Europe. The members of the Task Force participated in extensive debates in the course of several meetings and submitted comments on an earlier draft of this report. Its contents faithfully convey the general tone and direction of the discussion, but its recommendations do not reflect a common position reached among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong. A list of participants and invited guests and speakers appears at the end of this report.

The authors are Karel Lannoo, CEPS Chief Executive and head of the Financial Markets research programme, and Arman Khachaturyan, Visiting Fellow at CEPS. They wish to thank Kyriakos Gialoglou for research assistance and the members of the Task Force for their contributions.

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Centre for European Policy Studies
Place du Congrès 1, B-1000 Brussels
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51
E-mail: info@ceps.be
Internet: http://www.ceps.be

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EXECUTIVE SUMMARY & POLICY RECOMMENDATIONS

The EU is well advanced in (re-)shaping the regulatory structure for securities markets. As part of this exercise, the EU is rapidly finalising a more harmonised framework for disclosure in the directives on prospectuses and market abuse and the draft directive on transparency. It has also created a structure for harmonised financial reporting principles with the International Accounting Standards regulation.

Disclosure is a fundamental factor in investors' decision-making, the functioning of capital markets, stock performance and market integrity. Policy-makers should be aware, however, that regulating disclosure is a moving target and that one can never mandate an optimal level of disclosure. Adequate room and flexibility must be built in for market-driven improvements. Moreover, the benefits and costs of any additional fraction of disclosure regulation must be duly considered.

This report is the result of a CEPS Task Force that discussed the different elements of the proposed new EU structure. Its discussions can be synthesised in the following findings and recommendations:

- **Either no or full mandatory quarterly reporting**. Quality is more important than the frequency of reported information. The mandatory quarterly reporting requirement, as proposed in the draft transparency directive, does not increase the level of relevance or reliability of the disclosed information. It cannot meet the objectives of enhanced stock performance and investor protection. Furthermore, there is no reason to exclude debt securities from this requirement.

  If the EU opts for quarterly reporting, then it should go for full and comprehensive quarterly reporting, giving a menu of options at the level of implementation. Mandatory quarterly reporting could also be supported from a practical point of view, as a way to overcome the strong differences in ad-hoc disclosure in the EU. However, the costs and benefits of such a move should be carefully assessed.

  Promoting more competitive disclosure regulation among national regulators and stock exchanges is the right step forward. This would meet the diverse preferences of disclosure standards, facilitate investor and issuer choice as well as promote a more competitive framework for the emergence and diffusion of best disclosure practices. The EU has to leave the regulatory power in the hands of local regulators and stock exchanges by retaining the authority to suppress anti-competitive practices.

- **The architecture for simultaneous European-wide disclosure is missing.** The "disclosure" directives should support equal treatment of investors through a system of simultaneous European-wide disclosure and dissemination of price-sensitive information. It is questionable whether the current system, however, as contained in the directives on prospectuses and market abuse and the draft directive on transparency, will allow this to materialise, as the dissemination of company information is not expressly required beyond the national borders or beyond the state where a company has been authorised to issue securities or has its listing. While the mandatory posting of regulated and price-sensitive information on websites is a welcome development, the traditional forms of dissemination have not been altered, or are left to secondary legislation. The architecture of a European disclosure system is an essential element of a single capital market and needs therefore to be shaped in primary legislation.

- The use of maximum harmonisation in the prospectus directive makes **free choice of the competent authority** self-evident, as the standards will be the same in every jurisdiction. On the other hand, **the interaction with minimum harmonisation** in the directives on market abuse and transparency obligations will need to be clarified, as it may give rise to problems. Overall, the use of maximum harmonisation is inconsistent with the basic single market rules in general and with disclosure regulation in particular. Disclosure regulation is a moving target, which must leave room for market-driven adjustments.
- **The EU vs. the US regulatory framework.** The requirement for setting up independent supervisory authorities in the disclosure directives should allow for easier cross-border co-operation and better enforcement, and thus ensure a more integrated framework for disclosure in the EU. At the same time, the EU should maintain a degree of competition between its different jurisdictions rather than simply mimicking the US in setting the EU disclosure regime. The diversity might be the very source of long-term competitive advantage of the EU.
- **Adequate enforcement.** This factor will play a crucial role in making sure that the new framework works. Although the structure is now in place, standards of best practice in ad-hoc disclosure could be set amongst the supervisory authorities in the Committee of European Securities Regulators (CESR), in view of the huge diversity observed at present. An appropriate structure for enforcement of International Accounting Standards (IAS) at the member state and European level is not in place, however. Although CESR has been asked to ensure a common approach, the structure that is in place at the moment is insufficient and may create problems for the credibility of IAS at the global level.

DISCLOSURE REGULATION IN THE EU
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Disclosure is an excellent area for illustrating the difficulty of EU policy and decision-making. It crosses different areas of lawmaking: securities, company and accounting law; different systems of regulation: self-regulation vs. statutory legislation; and different ways of enforcement. It is a core principle of securities markets regulation, an area in which the EU member states have had limited experience so far. Member states operate fairly distinct systems that were designed with national contexts in mind and are not necessarily adapted to a more international environment. The EU's initial efforts at harmonisation accommodated the different systems, but were imprecise, badly implemented and unevenly enforced, and have therefore yielded limited effects so far.

The Financial Services Action Plan (FSAP) (1998) outlines a list of measures to be agreed upon by 2005 in an effort to create a fully integrated capital market. Inter alia, it contains measures affecting the regime for initial, periodic and ad-hoc disclosure, and the introduction of International Accounting Standards (IAS) by 2005. Some of these, such as the proposed introduction of quarterly reporting based on IAS for listed companies, represent a profound regime change for European corporations.

The Lamfalussy (2001) report provided the necessary underpinnings for the new regulatory framework, but also gave it much-needed publicity. In the meantime, the regulatory framework supporting the securities markets has been called into question by events in the best-functioning and most attractive capital market in the world, the United States. What started as a particular event seemed to be of a more systemic nature: the US disclosure regulation was systematically circumvented and defrauded by large corporations. Big finance acted in concert with these firms to deceive investors. The US GAAP (Generally Accepted Accounting Principles) was apparently not "the most transparent and comprehensive disclosure regime in the world" (Levitt, 2001). Enforcement was far behind.

From a policy perspective, crises are crystallisers in regulatory improvements. This can be amply demonstrated in financial regulation. The regulatory responses to the US scandals have not modified the fundamental role of disclosure as a policy tool. On the contrary, reforms point towards the strengthening of the current framework.

The purpose of this paper is to analyse the emerging framework of disclosure regulation in the EU. The paper is organised as follows. Chapter 1 discusses the feasibility of disclosure as a means of financial regulation. Chapter 2 describes disclosure regulation at the EU level. Chapter 3 presents disclosure regulation at the level of the EU member states. Chapter 4 dwells on the virtues and vices of the new regulatory framework and analyses it from a policy perspective. A final chapter offers some conclusions and policy recommendations regarding the emerging EU framework of financial market disclosure and transparency.

CHAPTER 1

DISCLOSURE AS A MEANS OF FINANCIAL REGULATION

Disclosure relates to the act of releasing and communicating relevant and reliable corporate information to users. By "relevant" is meant the timely disclosure of material information on events and activities, including linkages between them and their financial impact on corporate activities to allow the users to make informed investment and credit decisions. To be "reliable", the information imparted along with its associated risks and opportunities must be truthful. Disclosure may be voluntary or mandatory. The latter implies that it can be a part of self-regulation, or enshrined in statutory legislation.

1.1 Why mandate disclosure?

The first question that needs to be addressed is why disclosure should be mandated. If disclosure is good, i.e. in the interest of the provider, why is it not done voluntarily? Regulation should in that case not be necessary. Even if the provider only reveals the good news, lack of disclosure will be seen as bad news, and regulation is redundant. However, full voluntary disclosure rarely occurs in reality because of the costs associated with producing and disseminating information, the proprietary costs of having to reveal information to competitors and the possible impact on future investment opportunities of the firm. Secondly, regulation may be required on what precisely must be disclosed, when and in what format. Information users need to be in a position to distinguish between information that is provided on regulatory grounds and other forms of information that are provided for marketing purposes.

The use of disclosure in regulation is based upon some form of *information asymmetry* between the disclosing party and the information user. Policy concerns can arise on different grounds, such as the need for equity, allocative efficiency, civil participation or performance in democratic societies. In each case, disclosure policy involves an authority monitoring the collection and dissemination of standardised information. Disclosure can be carried out by authorities or by the parties that are required to disclose, or a combination of both. In some cases, disclosure is a complement to other forms of regulation, whereas in other cases, mandatory disclosure is applied independently of other forms of regulatory intervention. In each case, the goal is to redress the information asymmetry (Weil, 2002).

A disclosure system entails different steps from the provision of information by the disclosing party to the impact on the information users or providers. Overall, the effectiveness of the disclosure system will be determined by the combined changes in the behaviour of the information user and the disclosing parties in some specific policy-defined direction.

The use of disclosure in various forms of regulation has grown extensively in recent years. It is seen as a less onerous and more flexible form of regulation; it is less dirigist and more market-based. It is more adapted to an economy where the flow of information is becoming increasingly intrinsic to its operation. Opponents of disclosure argue that it represents a retreat on the part of the authorities from the regulatory field while providing the appearance of public intervention, but with little substantive impact. Disclosure also requires a certain level of economic and societal development, and the full and active participation of all parties in the process. The flow of information can be so immense that it requires a vigilant attitude on behalf of the information user. Disclosure-based regulation is, in this sense, a more elaborate form of regulation, which requires other enforcement skills from the regulators than required by the more traditional forms of regulation.

The architecture of a disclosure system is of fundamental importance to its effectiveness. It should allow the user to make a quick assessment of the information provided, which requires standardised forms and user-friendly systems. It is evident that information technology and its continuous advances play a crucial role in this respect.

1.2 Disclosure in Securities Market Regulation

The use of disclosure in securities market regulation is based on the same information asymmetry between issuers and investors. Issuers wish to receive the highest price possible for their securities, and want to disclose as little information as possible, or only the good news, whereas the opposite applies for investors. Given asymmetric information on the one hand, and the risk of managerial misappropriation on the other, statutory disclosure regulation can facilitate more informed investment decision-making by differentiating between efficient and inefficient firms if the markets fail to do so. Moreover, regulation will allow investors to distinguish between high-performance firms and low-performance firms. This prevents resources ending up in the "lemons" market where both good and bad companies on average get the same pricing (see Akerlof, 1970). Thus, any appropriate regulatory intervention in the market process is capable of decreasing asymmetric information and increasing social welfare. Thus, in order to ensure equity and efficiency of securities markets, regulation must ensure that a sufficient amount of credible information is delivered equally to investors, and that issuers receive a correct price for their securities.

The implementation and enforcement of this process depend upon a complex set of institutions. Not only do government bodies play a role, but also self-regulatory organisations and "reputational intermediaries" (Black, 2000). Accounting firms, investment banks, law firms and stock exchanges put their name at stake when participating in the dissemination of information regarding securities issuers and listed enterprises. They will suffer a loss of reputation if they support a bad security on the market. A second tier of intermediaries consists of investment and pension funds, which provide market demand for securities, and the financial press. The intermediaries are controlled by government and self-regulatory organisations (SROs). The latter can be subdivided into voluntary (professional organisations) and mandatory (SROs mandated and controlled by government) organisations. Legal rules make intermediaries liable for faulty information.

Accounting rules and the assessment of their application by auditors are a central part of financial information disclosure. In the US context, the Securities and Exchange Commission (SEC) monitors the transparency and level of detail of US accounting standards, which are set by the accounting profession in the Financial Accounting Standards Board (FASB), a self-regulatory organisation. To tighten control on accounting and the audit profession, the Sarbanes-Oxley Act (July 2002, see Box 1 below) created the Public Company Accounting Oversight Board (PCAOB), under the aegis of the SEC. At international level, International Accounting Standards (IAS) are being developed by the International Accounting Standards Board (IASB), which may soon become the global standard for accounting.

Non-financial information also plays a vital role in disclosure. Information regarding a company's prospects, its new products, its compliance with environmental standards and its governance processes plays an increasingly important role in disclosure. The way this information is reported is much less standardised, although this may be the result of recent corporate scandals in the US.

Disclosure also applies to the operation of organised securities markets, although not in the same way. Regulated markets are requested to publish all quotes and price information regarding publicly traded securities as soon as they become available. This should render markets fair and efficient. However, disagreement exists about which of the two principles takes precedent. Fair markets require immediate publication of all trades, although efficient markets may require exceptions for transactions involving large blocks of shares. Regulation in the US has become sharply focused on the first principle, which has provoked some degree of fragmentation, whereas EU regulation allows for exceptions on grounds of market efficiency for large blocks of trading (Investment Services Directive, Art. 21.2). This form of disclosure will not be further discussed in the context of this paper.

More recently, disclosure has also received increased prominence in the regulation of financial institutions. Public disclosure of key information on a bank's risk profile and level of capitalisation is one of the three pillars of the proposal for a *New Basel Capital Accord* (1999), which establishes a capital adequacy framework for internationally active banks. It is based on the view that markets can play a useful role in assessing the risks of financial institutions, above all when reliance is placed on the internal models approach of the New Accord. The national regulators will be expected to enforce required disclosures through the use of supervisory responses or penalties where necessary. Institutions will need to prepare a policy on public disclosure that complies with the Basel requirements.

1.3 History and Development

Historically, the use of mandatory disclosure in securities market regulation goes back to the *1933 Securities Act* and *1934 Securities Exchange Act* in the US. In order to rebuild confidence in capital markets after the crash of 1929, issuers of securities to the public were requested to provide all material information about a company to allow investors to make informed decisions. The philosophical underpinnings of the 1933 Act can be found in Supreme Court Justice Louis D. Brandeis' philosophy "sunlight is the best disinfectant". The 1934 Act established the Securities and Exchange Commission, which is in charge of implementing and enforcing the rules in the United States.

The 1934 Act required public companies to file periodic reports with the SEC and established a system of self-regulation of the brokerage industry. It required a broker-dealer to be a member of at least one self-regulatory organisation (SRO) and gave SROs, such as the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE), the authority to regulate their broker-dealer members. Although the initial acts left much to be desired, they have well withstood the pressures of time as a result of the broad implementing powers given the SEC and subsequent amendments. The latest financial crisis has led to a further continuation of this trend, i.e. a further adaptation and strengthening of the system in the Sarbanes-Oxley Act, although the integrity of the whole structure has been seriously called into question (see Box 1 below).

The US disclosure approach can be subdivided into informal and formal disclosure.[1] Informal disclosure is organised by the stock exchanges, which require listed companies to issue press releases regarding price-sensitive news in cooperation with agencies. Although not formally required by law, the action of the exchanges has been very important in increasing financial disclosure, and preceded mandatory reporting. Starting from 1923, the NYSE asked newly listed companies to report quarterly, and by the end of 1931, already 63% of the firms issued quarterly reports. By November 1962, this percentage stood at 95%.

Formal disclosure was instituted by the Securities Act, and is based upon filings by companies with the SEC, following a standardised form. In principle, it covers non-price-sensitive information. Further to Sections 12 and 13 of the 1934 Act:

- An issuer is required to file an annual report (10-K form), a semi-annual report (9-K form) and a quarterly report (10-Q form) as well as an 8-Q form for reporting significant company events with the SEC. The quarterly reporting requirement was enacted in 1946 for certain

[1] The following is based upon presentations by Joe McCahery, Tilburg University, and Luc Delboo, Euronext Brussels, to the CEPS Task Force on 16 May 2002 and on Butler et al. (2002).

items (initially an 8-K form), but it took until 1970 for it to reach its present fully detailed form.

- Informal disclosures are limited by a "materiality" standard (Rule 10b-5):
  - Materiality and timely disclosure of a contingent or a speculative event is determined on a case-by-case basis.
  - Public statements related to material facts ("new corporate developments") must be truthful and not misleading. In the case of false statements, the SEC makes a distinction between those that are intentionally misleading and those that become false by virtue of subsequent events. The issuer has a duty to update information.
  - Disclosure and materiality of information provisions also apply to the reporting of other corporate contexts, e.g. financial instability, product introductions, write-downs, etc.
- Forward-looking statements (management discussions) made in public filings or statements are encouraged. They are exempt from the obligation to be updated unless the issuer expects parties to rely on the forward intent of a statement to guide their investment activity.

An electronic data-gathering analysis and retrieval system (EDGAR, a form of business register), the use of which has been obligatory since 1996 for public companies, is in place to process and record corporate information. It is a huge database containing a host of information on all US listed companies, which is available for consultation by interested parties.

An important milestone was the 2000 Fair Disclosure Regulation (hereinafter referred to as RegFD). Aimed at curbing the selective disclosure of material non-public information by issuers to analysts and institutional investors, RegFD requires that when an issuer discloses material information, it does so publicly and ensures equal access to that information. Company management is prevented from using information as a commodity to gain favour with analysts. Technological innovations (such as conference calls and/or webcasts) are harnessed to facilitate broad non-discriminatory dissemination.

RegFD received both criticism and praise. The thrust of the criticism was that the regulation was unnecessary as market forces regulate the price per share, regardless of the amount of information disclosed, and that it would lead to a chilling of the information flow from issuers to the marketplace. It was also argued that there was limited empirical evidence of the harmful impact of selective disclosure. According to the SEC, RegFD was welcomed by individual investors and the media, believing that it levelled the playing field for the retail investor (Unger, 2001).

One of the key problems with RegFD, and with disclosure in general, is the definition of materiality. The US Supreme Court defined it as something that a reasonable investor would consider important in deciding how to act, but the Court refused to go further, stating that materiality is based on facts and circumstances. Defining materiality reveals a paradox in disclosure as a tool for financial regulation, as a closer definition could reduce the information flow and thus the use of disclosure in the first place.[2] Furthermore, non-material information plays a role to build a "material mosaic". The SEC has therefore been invited to clarify this in an interpretative release.

Another issue in the implementation of RegFD is the use of technology. Although the rule allows issuers to take advantage of technology, the flexibility is limited by the rules of the self-regulatory organisations, such as the NYSE and NASD, which require listed companies to

[2] One panellist at an SEC Roundtable on RegFD noted that "placing a regulatory structure based on materiality decisions around a voluntary disclosure process might well result in a chill on the flow of legitimate information, and that may be happening" (Unger, 2001, p. 5).

disclose material news through a press release, and the SEC's position that website publication alone does not satisfy RegFD's broad distribution requirement. Press releases, by which the press has the monopoly of news gathering and dissemination, are seen as antiquated means of distribution, and it was suggested that the SEC should insist that the SROs should allow other means of distribution, such as the Internet, webcasts and teleconferencing. The SEC may however become more willing to accept websites for widely followed stocks, as Internet access has increased dramatically.

Box 1. The 2002 Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOA), which was adopted by the US Congress on 24 July 2002, makes sweeping changes to US law in response to the widespread corporate fraud in the US. The bill brings about the biggest changes to US securities law since the 1933 Securities Exchange Act. It addresses public disclosure, trading by directors, the role of audit committees and the independence of auditors, the regulation of accounting and the accounting profession, and the securities industry.

- Public disclosure: SOA requires "real time" disclosure of material changes; annual and quarterly reports must be certified by the CEO and CFO.
- Trading by directors: SOA requires reports of changes in beneficial ownership and prohibits personal loans to executives and improper influence on audits.
- Audit standards oversight: SOA establishes a Public Company Accounting Oversight Board (PCAOB), which regulates the conduct of audits of public companies, and sets the standards for the audit under the final control of the SEC. The PCAOB is funded by public company shareholders.
- Accounting standards: SOA strengthens the independence of the accounting standards board (FASB) against the influence of big accounting firms, but leaves final control with the SEC.
- Audit committees must be composed solely of independent directors and have a central role in the companies' accounting process.
- Audit firms must be registered with the PCAOB; they cannot also provide certain non audit-services to their clients and the teams must rotate.
- Securities firms must tackle conflicts of interest between their divisions.

Some observers see the creation of the PCAOB and the strengthening of the independence of FASB as the only real achievements of the SOA. For the remainder, it is "heavy rhetoric" and more stunts to restore investor confidence than substantive reform. And, noteworthy from a European perspective, it strengthens the centre: the President, Congress and the SEC, which got a 43% increase in its 2003 budget (Cunningham, 2002).

The SOA has been strongly criticised for its extra-territorial implications. Since US securities law is based on the principle of territoriality, it also applies to non-US firms that are listed on a US stock exchange. It may therefore require non-US firms to adapt their governance structures to comply or third countries to adapt their laws. It could also allow the US PCAOB to inspect EU-based audit firms. The EU Commission has addressed some of these incompatibilities in its 2003 Communications on corporate governance and the statutory audit.

Box 2. Was Enron about bad disclosure?

Enron was founded through the merger of two natural gas pipeline companies: Houston Natural Gas and Internorth in 1985. On 31 December 2000, Enron had a $60 billion market capitalisation and its stock was priced at $83.13 which is 70 times the earnings and six times the book value earning 89% return vs. 9% decrease for the S&P 500.

On 8 November 2001, Enron restated its financial statements resulting in $2.6 billion increase in debt, $508 million decrease in net income, and $1.36 billion decrease in shareholder value over 1997-2000. On 28 November 2001, Enron's debt was downgraded to junk-bond status. On 2 December 2001, Enron filed for bankruptcy.

Enron used the market-to-market accounting system, which enabled it to recognise the revenues of future inflows and to expense out the present value of expected costs of contractual obligations under long-term contracts. Any unrealised gain or loss that was not hedged was accounted for in annual earnings. While the fixed rate contracts made it relatively easy to estimate the net present value of future cash streams, relatively illiquid forward markets coupled with regulatory issues allowed highly discretionary judgment on the net present value of contractual obligations. These valuations had been disclosed to the market and the SEC properly. Thus, the issue was in the valuation rather than in the disclosure on the one hand and investor overconfidence and regulatory negligence on the other.

Enron also used third-party "hedged" transactions to conceal large losses of its merchant investments. This might have given an impression that investments are perfectly hedged by third parties while in fact Enron itself held a substantial economic stake in these third parties. These transactions had been disclosed both to the market and to the SEC. So, once again the issue is not lack of disclosure but investor over-optimism and regulatory negligence.

Many of Enron's transactions had been structured through fully legal "special purpose entities" (SPEs) in order to fund or manage the risks associated with them. This allowed Enron to have non-consolidated financial statements with each SPE: it recorded the gains and losses on transactions with the SPE, while not reflecting the SPE's assets and liabilities on its balance sheet. Moreover, some of Enron's key employees became partners of the SPEs. Enron disclosed its relationships with the SPEs and gave a proper account of related party transactions. Despite the fact that all the information had been publicly available, both investors and the SEC failed to recognise its import.

It is said that policy-makers have largely contributed to Enron's collapse through "loose" disclosure regulation. However, a careful examination of its fall shows that weak disclosure regulation perhaps is the least-responsible factor in the whole affair. In general Enron publicly disclosed significant amounts of information on its transactions and partnerships in its quarterly and annual reports as well as in its proxy statements. Rather, it was Enron's creative talent to circumvent accounting principles through complex structuring of transactions combined with a spectacular level of investor optimism and regulatory negligence over an extended period of time. For any reasonable investor, and the SEC per se, it should have been clear that something was wrong with the company had they paid attention to the detail of the disclosed information.

Another problem revealed by the Enron affair is the relationship between accounting rules and economic reality. It has long been argued the US GAAP allows for a low earnings correlation with stock prices. US GAAP summarise the effects of actual rather than expected performance based on the revenue recognition principle, but stock prices primarily change because of the expectations regarding future profitability (see Watts and Zimmerman, 1986). Hence, accounting standards need to be adapted to better reflect economic reality, taking the revenue recognition principle into account (see Lee, 1999).

Thus, the collapse of Enron paradoxically does not evidently call for more corporate control or for more stringent disclosure regulation. It rather begs for urgent reconsideration of accounting rules, the role of supervisory authorities and the audit profession, and the herd-behaviour and greed of the investment community.

1.4 The Academic Debate

Not much academic and empirical work has been done on corporate disclosure in continental Europe. The bulk of literature and evidence on the economic consequences of disclosure comes from US scholars focusing on US companies with publicly registered securities under the US Generally Accepted Accounting Principles.

Many authors have argued that corporate disclosure is at the heart of efficient capital markets. Companies engage in mandatory and voluntary communication to the public. This communication has essentially three beneficial effects. First, disclosure mitigates information asymmetry between the firm and the information user. Typically, the company has superior information concerning activities and events and their associated risks. It possesses more accurate information on the investment opportunities than does the ordinary investor and/or creditor. Second, disclosure mitigates incentive problems between the firm and the user given the firm's propensity to overstate its profits and understate its losses. It increases the level of credibility of financial information and decreases the problem of mis-valuation.[3] Third, by solving information and incentive problems, disclosure facilitates informed decision-making with respect to capital allocation.

The next section discusses the wider implications of financial reporting in terms of its association with stock liquidity, the cost of capital, the role of information intermediaries, the value relevance of accounting information, the managerial motives for reporting and motivations for earnings management. It finally addresses the issue of regulatory competition in disclosure regulation.

The Economics of Disclosure

Disclosure, the Cost of Capital and Stock Liquidity. Conventional wisdom holds that increased disclosure lowers the cost of capital and increases stock liquidity by decreasing the level of information asymmetries. The positive effects of increased disclosure on the cost of capital are based on: i) investors' preference for securities with low future transaction costs and ii) investors' averseness to risk (preferring securities with relatively lower levels of uncertainty). Information asymmetries introduce adverse selection problems in relations between companies and investors, which is manifested in investors' demand for higher levels of return to compensate for higher levels of information asymmetry.[4] Against this background, companies haven an incentive to provide the market with more and better information in order to mitigate this problem and to facilitate better estimation on future returns by investors if they want to reduce the discount at which their shares are sold and hence, to lower the cost of capital.[5]

Several studies have examined the link between disclosure, the cost of capital and stock liquidity. Diamond & Verrecchia (1991) find that frequency of disclosure reduces asymmetric information and perceived "fairness of stock value". Therefore, increased fairness can lead to more liquidity. The authors also argue that the link between mandatory commitment to disclose and the cost of capital is much stronger than the link between voluntary disclosure and the cost of capital. Botosan (1997) finds a significant negative association between the quality of informative voluntary disclosure and the cost of capital for companies with low analyst coverage. Sengupta (1998), using analyst ratings for disclosure policy, finds a similar relation between voluntary disclosure and the cost of debt at the time of the issue. Piotroski (2000) finds that corporate earnings can be increased by additional segment disclosures. Healy et al. (1999) offers evidence that companies enjoy lower bid-ask spreads through sustained increases in their

[3] See Kreps (1990).

[4] See Copeland & Galai (1983) and Glosten & Milgrom (1985).

[5] See Barry & Brown (1985), Barry & Brown (1986) and Handa & Linn (1993).

disclosure rating. Botosan & Plumlee (2002) find a negative relation between analyst ratings of annual report disclosures and the equity cost of capital.

Overall, the existing evidence on disclosure effects on the cost of capital is mixed and inconclusive.[6] This is due to the fact that the cost of capital is affected by a mix of interrelated factors and it is difficult to attribute and assess changes of the cost of capital conditional upon changes in the level of informative disclosure. Hence the regulator should not overemphasise the role of disclosure as a regulatory tool in decreasing the cost of capital.

Disclosure and the Role of Information Intermediaries. Increased disclosure also affects coverage by information intermediaries. Analysts collect, analyse and assess firm-specific data and make earning forecasts and buy/sell/hold recommendations. The effect of reporting frequency is ambiguous on the information-gathering activities by information intermediaries. While more reporting might reduce the gap between the expectations of the market and the company's earnings position, it also serves as a source of direct competition with financial intermediaries and affects their capacity to gather and analyse information.[7]

It has been found that more disclosure increases the role of information intermediaries, which can be attributed to both the skills and the resources professional intermediaries possess and to the increased complexity and rapid change of the marketplace.[8] Analysts make more precise earnings forecasts than time-series models presumably because of the timely incorporation of company-specific and economy-wide news into their models.[9] Moreover, earnings forecasts and recommendations affect stock prices.[10] This implies that non-professional users of information will rely on the expertise and skill of professionals to process financial information in order to make capital allocation decisions.

Financial intermediaries also play an important role in promoting market efficiency. Greater coverage by information intermediaries results in faster incorporation of earnings and cash flows into stock prices.[11]

Disclosure and the Value Relevance of Accounting Information. The value relevance of accounting information measured as the degree of association between earnings and stock prices or returns has been widely analysed. [12]

Lev (1989) finds that earnings account for only 5-10% in the volatility of stock returns over return intervals of up to one year. Livnat & Zarowin (1990) and Lev & Thiagarajan (1993) report that non-earnings accounting data (such as capital expenditures) and R&D, along with earnings data account for 15 to 25% of stock returns. In a study of US stocks between 1982 and 1987, Role (1988), documents that standard asset pricing models explain only 20% of daily variation in stock prices. Cutler et al. (1989) study the 50 largest daily changes in stock prices between 1946 and 1987 and find that a majority of drastic price changes are not attributable to the arrival of new information.

The link between the level of disclosure and stock prices has been analysed to explain the association between the frequency of reporting and stock performance.[13] For a large sample of

[6] See Fields et al. (2001).

[7] See Healy & Palepu (2000).

[8] See Lang & Lundholm (1993) and Jacob et al. (1999).

[9] See Brown & Rozeff (1978) and Givoly (1982).

[10] See Giovly & Lakonishok (1979) and Francis & Soffer (1997).

[11] See Barth & Hutton (2000).

[12] See Kothari (2001), Collins & Kothari (1989) and Easton & Zmijewski (1992).

[13] See Butler et al. (2002).

US firms, it has been shown that more frequent financial reporting affects the speed at which accounting information is reflected in the stock price. The net effect of reporting frequency is ambiguous, however. On the one hand, earnings are being impounded into prices more rapidly for firms reporting on a quarterly basis. On the other hand, the timeliness of earnings over a long horizon is mixed. Semi-annual and annual earnings seem to have a greater impact on the long-term price position of the company.

Other authors have found that for a sample of US firms the relationship between stock returns and earnings, and between stock prices, earnings and book values has declined over the last 20 years.[14]

Disclosure and Managerial Motives for Improved Disclosure. Research on disclosure identifies six broad motives that facilitate managerial decisions to disclose information:

- *Capital market transaction hypothesis.* Companies disclose information to reduce the cost of capital. Any securities transaction requires lower levels of information asymmetry, positive investor perceptions and thus a lower cost of capital.[15]
- *Corporate control contest hypothesis.* Companies disclose information to reduce the likelihood of undervaluation and to justify poor earnings. The latter is associated with CEO turnover, management changes and a higher incidence of corporate control contests.[16]
- *Stock compensation hypothesis.* Companies disclose information because managers benefit from a variety of stock-based compensation plans. Managers make disclosure decisions to increase their stock-based compensation.[17]
- *Litigation cost hypothesis.* Companies disclose information because managers are prone to reduce the cost of litigation through pre-disclosure of bad news and reduction of forward-looking information. Companies with bad earnings news pre-disclose poor earnings performance more than twice as often as companies with good earnings news.[18] However, pre-disclosure can be equally relevant to companies with good earnings news and it is not likely to be a deterrent to litigation.[19]
- *Management talent signalling hypothesis.* Companies disclose information because managers are interested to signal their managerial talent to the market. Through signalling managerial type and capacity, managers try to affect the market perception of the firm's earnings position and its market value.[20]
- *Proprietary cost hypothesis.* Informative disclosure can potentially harm the firm's competitive position by disclosing strategic operational and financial information to competitors.[21]

Disclosure and Motivations for Earnings Management. Earnings management occurs when managers use their discretion either to misrepresent the economic performance of the firm and/or to influence contractual outcomes that depend on the value of reported accounting

[14] See Chang (1998), Lev & Zarowin (1999) and Brown et al. (1999).

[15] See Healy & Palepu (1995), Myers & Majluf (1986) and Lang & Lundholm (1993).

[16] See DeAngelo (1988) and Morck et al. (1990).

[17] See Miller & Piotroski (2000) and Noe (1999).

[18] See Skinner (1994 and 1997).

[19] See Francis et al. (1994) and Miller & Piotroski (2000).

[20] See Trueman (1986).

[21] See Verrecchia (1983), Darrough (1993) and Gigler (1994).

numbers.[22] The first component of earnings management is the managerial judgement over the choice of reporting standards. The second component is the potential misleading of investors and creditors.

Research identified the capital market expectation and valuation motivation as the major motives of earnings management. This hypothesis claims that firms manipulate earnings to affect short-term stock performance.[23] Prior to management buy-outs, managers tend to understate earnings.[24] Unexpected negative accruals also occur prior to a management buyout.[25] Research has also identified that prior to seasoned equity offers, initial public offerings and stock-financed acquisitions, companies report positive unexpected accruals to overstate their earnings.[26]

It has been found that 12% of firms manage earnings and that the magnitude of earnings management varies between 2-5% measured by unexpected accruals.[27] However, this sample has been selected in such a way that it maximises the likelihood of earnings management. In general, the evidence suggests that some firms do manage earnings for manipulating stock performance. However, the effect of the incidence, frequency and magnitude of earnings management on stock prices is still open to wide debate.

In general, a wide consensus exists in corporate disclosure research on information asymmetries and incentive problems. By mitigating the effects thereof, corporate disclosure might enhance investors' decision-making capacity. However, it is not possible to single out the precise nature and magnitude of capital market effects of disclosure, nor more specifically its impact on improved performance. This suggests that policy-makers should not overemphasise the role of disclosure in capital markets and impose costly and unjustified regulation upon the market participants.

Regulatory Competition in Disclosure Standards

Notable differences exist among jurisdictions and organisations in disclosure standards. They pose a different set of questions to whether a disclosure regime can be set up via regulatory competition among national regulators and self-regulatory organisations, or whether it should be established through an international agreement.

A broad literature exists about the appropriateness of regulatory competition in disclosure standards for listed companies. The two most vocal scholars are Roberta Romano and Merritt Fox. Romano (2001) argues that issuers should have a broader choice of regulatory regimes. At present, the US employs a territoriality-based system, i.e. foreign firms issuing securities on the US market need to follow US rules, which severely restricts competition. More competition would allow for much faster regulatory correction, would foster innovation and would be better tailored to the differing needs of issuers and investors. Romano refutes the criticism that more regulatory competition would lead to a race to the bottom; on the contrary, she argues that more issuer choice would induce more disclosure and encourage countries with bad disclosure regimes to introduce reforms.[28] Moreover, Romano finds no evidence that the US regime has

[22] See Healy & Wahlen (1988).

[23] See McNichols & Wilson (1988).

[24] See DeAngelo (1988).

[25] See Perry & Williams (1994).

[26] See Teoh et al. (1998 a and b), Teoh et al. (1988) and Erickson & Wang (1988).

[27] See Erickson & Wang (1988).

[28] This argument is also supported by Boot et al. (2001) as applied to firms and exchanges.

increased social welfare; on the contrary in fact, she finds it has decreased it, as there is no clear indication of externalities.

Although agreeing with some of Romano's basic assumptions, Fox (2001) argues the opposite, i.e. competition between disclosure regimes would reduce social welfare, because each issuer would select a regime requiring a level of disclosure that is less than is socially optimal. Issuer choice would lead to a significant market failure arising from the fact that each issuer's private costs of disclosure would be greater than the social costs of such disclosure. The agency costs for the manager would be higher under issuer choice than under mandatory disclosure. Fox thus pleads for retaining the US mandatory disclosure regime, although he would let it be determined by the home country of the issuer, i.e. it would not apply to foreign issuers on the US market (Fox, 1997). The reason for this is not investor protection, but rather efficiency, since each issuer would be regulated by the country that benefits most from getting disclosure right. Some form of regulatory competition between jurisdictions would be possible, but there would be no full issuer's choice. Such a system is also proposed, at least for equity, in the EU's prospectus directive, as discussed below.

What might be the implications of regulatory competition for the EU disclosure regime? Regulatory competition in disclosure regulation requires the presence of two elements:

- diversity of disclosure standards to give the issuers choice over which regime to choose, and
- mobility to move between jurisdictions without prohibitively high costs.

Both elements are present in the EU. Securities market regulation in the EU is based on the principles of minimum standards and mutual recognition. While the minimum standards are set by directives, the national regulators can elaborate on the detail and depth of securities regulation in the implementing legislation, without prohibiting issuers from other jurisdictions to enter the market. Mutual recognition ensures that by satisfying the requirements of the home country, issuers can access any market across the EU. Though the mutual recognition principle does not force the issuer to comply with the requirements of the host country, neither does it prohibit it. Any issuer can voluntarily commit to satisfying more/less stringent requirements of the host market. From its inception in 1985, the Commission's Single Market Plan intended to achieve regulatory harmonisation through generating competition among rules.

Whether the structure of regulation facilitates a creative "race to the top", in which companies improve their disclosure standards over time, or a destructive "race to the bottom", in which companies seek the minimum level and lowest quality disclosure possible has been a topic of debate for some time.[29] We would tend to agree with Black (2000) that the real competition is between complex national systems and not only between disclosure regimes. Regulatory competition should lead to continuous improvement in disclosure practices rather than downgrade them in the EU. Giving an issuer a choice of securities law in general and a choice of disclosure regime in particular in the EU will facilitate competition among national regulators and exchanges to promote a superior system of disclosure regulation. Jurisdictional competition will increase the number of possible alternatives to meet a diverse range of needs in disclosure regulation. Firms will choose the place of their incorporation or relocate, thus revealing the choice of disclosure regime, which approximates their preferences. Local disclosure regulations will be either "fit" or be "selected out". If disclosure is taken exogenously, i.e. it is assumed that disclosure simply exists without looking into its rationale, then competition between and among national regulators and exchanges in the EU will drive the "race-to-the-top" and lead to the best outcome in the production of disclosure regulation.[30] However, if disclosure is endogenised, i.e.

[29] See Romano (1993), Fischel (1982), Romano (2001), Choi & Guzman (1998), Winter (1979), Easterbrook & Fischel (1991) and Cary (1974).

[30] See Weingast (1995).

one considers why disclosure exists in the first place and what its rationale is, then it is clear that decentralisation of disclosure regulation and jurisdictional competition will not achieve the best outcome in disclosure regulation. They will simply reinforce the possibility of cooperation and competition and will thereby continuously drive the race-to-the-top in response to changes in exogenous and endogenous environments.

Opponents of decentralisation in the EU argue that markets may not facilitate investment decision-making by properly differentiating between efficient and inefficient firms and preventing the resources from ending up in the "lemons" market.[31] In the US, the SEC has monopolistic power to set disclosure regulation which effectively fixes the price of disclosure regulation and inflicts dead-weight social losses, as is the case with every monopoly.[32] It has also led to the maximisation of the revenues and expansion of the agency in charge (SEC).[33]

[31] See Akerlof (1970).

[32] See Macey (2002).

[33] See Brennan & Buchanan (1980).

CHAPTER 2

DISCLOSURE REGULATION AT THE EU LEVEL

Disclosure regulation at EU level is older than one might initially think.[34] The first piece of legislation dates back to 1979, relating to the conditions for admission to a stock exchange listing (see Annex 1 for a compendium of EU securities markets regulation). That directive was followed in the 1980s by legislation regarding the regime for initial disclosure for issuers on capital markets and rules for ad-hoc disclosure. The common deficiency of these directives, which also applied to the other securities markets directives, was their low degree of minimum harmonisation, which did not allow mutual recognition to work. This problem was furthermore exacerbated by the poor enforcement of rules and insufficient cooperation among the authorities. More generally, the regulatory framework was unclear, complex and overlapping. It was a reflection of the low level of development and the high degree of state protection and fragmentation that characterised Europe's capital markets until recently.

The advent of EMU gave rise to a late plan to adapt the regulatory framework to allow a single European capital market to emerge in the Financial Services Action Plan (FSAP, 1998). It was followed by the creation of the Lamfalussy Committee in July 2000, which adapted the procedures and instituted the structures for securities market regulation and its modifications in the EU. The issues related to corporate disclosure regulation, however, have not proven to be easy to resolve. The draft directives on market abuse and prospectuses were strongly contested. The communication on disclosure obligations, on the other hand, has not provoked much debate. The discussions relate to the questions raised in academic discussions in the US: What degree of harmonisation is needed? How much regulatory competition can remain? To what extent should supervision be centralised?

2.1 The First Wave of Directives

Disclosure for Primary Issues

Two directives set the basic standards for issuers in capital markets, covering the minimum financial and non-financial information that must be published and providing mutual recognition: i) the 1980 *listing particulars* directive, which covered the information about securities when listing on an organised market (exchange) in the EU, and ii) the 1989 *prospectus* directive, which concerned initial public offerings of securities that are not to be admitted to listing. This distinction was not based on a specific logical reason, but had grown organically and become intertwined over the years.[35]

The 1980 listing particulars directive was amended in 1987 to introduce mutual recognition and in 1990, to introduce mutual recognition of public-offer prospectuses of euro securities, for example, as stock exchange listing particulars.[36] In theory, listing approval by any member state

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[34] This section draws upon earlier work on EU securities market regulation; see Lannoo (2001).

[35] We do not include the prospectus regime for investment funds in this section, which are covered by the UCITS directives. This has recently been updated in the UCITS III (see Official Journal of the EU, 21 January 2002). For an overview, see Lannoo and Levin (2003).

[36] Council Directive 87/345 of 22 June 1987 amending Directive 80/390 co-ordinating the requirement for the drawing-up, scrutiny, and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing, OJ L 185 of 4.7.1987; Council Directive 90/211 of 23 April 1990 amending directive 80/390 in respect of the mutual recognition of public-offer prospectuses as stock exchange listing particulars, OJ L 112 of 3.5.1990. The listing particulars directive was repealed in 2001

guaranteed mutual recognition by the others. Listing on the basis of the home country disclosure requirements, which were at least as strict as the minimum required by the directive, was to be recognised mutually.

The 1989 prospectus directive applied to the public offer of debt, equity and euro securities, with many exceptions (Art. 2).[37] It defined the required content of a securities prospectus when it is offered to the public. It must contain sufficient information to enable the investor "to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of the issuer and of the rights attaching to the transferable securities" (Art. 11). Once a prospectus was approved in one member state, it received mutual recognition in the others. The prospectus directive allowed for a validity of twelve months.

The listing particulars directive set a low disclosure standard and was based on a complex and only partial mutual recognition process. The minimum disclosure standard of the directive was too low for mutual recognition to work. It would mean that the listing particulars of less developed capital markets of the EU would have to be accepted in the more developed markets, a problem that also arose in the discussions on the update. Furthermore, the directive gave member states substantial discretion to limit the liberalising effects in the implementing legislation. For example, listing particulars needed to be published in the language of the host country; they could be required to carry information on the income tax system; and they ceased to be valid after three months.

The utility of the prospectus directive was principally hampered by the lack of a common definition of public offer and private placement. This was left to the member states, which interpreted it according to their own provisions, without mutual recognition. Only four member states implemented a specific regime for euro-securities, i.e. Eurobonds, which was of course not identical either. As a consequence of these problems, the offering of equities on a pan-European basis has been severely hampered. Issuers eager to work in Euroland as a single securities market were caught in a maze of legal technicalities. There was ample room for member states to obstruct pan-European capital-raising exercises.

Admission to a Stock Exchange Listing and Ad-Hoc Disclosure

As early as 1979, the Community adopted harmonised requirements for the admission of securities to an official stock exchange listing. The directive specifies the conditions for admission of equity and debt securities, as well as obligations for issuers. To qualify for a stock exchange listing, a minimum of 25% of the subscribed capital of a company should be distributed to the public. When securities are admitted, companies need to extend equal treatment of shareholders, ensuring that they are able to exercise their rights and have access to all necessary information. Shareholders need to be informed of meetings and be able to exercise their right to vote. Major new developments, which may lead to substantial movements in share prices, modifications in share rights and the shareholding structure need to be made public as soon as possible, using widely distributed newspapers. This information must be simultaneously sent to the authorities.

(as part of an exercise on legislative simplification), but the existing provisions were transferred without any change to the new codified directive 2001/34 (see below).

[37] Council Directive 89/298 co-ordinating the requirements for the drawing-up, scrutiny and distribution for the prospectus to be published when securities are offered to the public, OJ L 124 of 5.5.1989.

The stock exchange admission and listing directives were recently replaced by a single text.[38] The consolidated text makes no substantive changes to the acts in force but aims at making them simpler and more transparent. Clearly, even if this exercise was part of the earlier planned codification project, it should have been delayed to fit into the major overhaul of legislation contained within the FSAP. Moreover, a separate stock exchange admission directive no longer makes sense once a truly single passport for issuers, discussed below, is in place. The rules on stock exchange admission date from the time when exchanges were public entities. Now that most of them have acquired a private status, it is no longer appropriate to insist on harmonised exchange admission criteria, apart from the harmonised rules on listing. Admission to stock exchange trading is fully in the hands of the securities exchanges. By setting their own admission-to-trading criteria, exchanges can differentiate and compete on the strength of their respective reputations.

Periodic and Major Holdings Disclosure, Prohibition of Insider Dealing

Periodic disclosure is governed by directive 82/121 on the information to be published on a regular basis by companies whose shares have been admitted to official listing. It obliges companies to publish semi-annual reports, the contents of such statements and the publication requirements (within four months in one of more newspapers). Differences in local practices, interpretation and exemptions (e.g. unconsolidated reports) have left markets fragmented. Some companies have started to adapt to global standards, whereas others still play the tune of the local market.

Disclosure of major holdings by listed companies is the subject of a separate directive. The directive covering the publication of information on major holdings (1988) sets minimum rules for the disclosure of information when a major shareholding in a company listed on an EU stock exchange is acquired or disposed of. A major shareholding is defined in voting right terms, and the acquirer must inform the competent authorities and the company concerned when the proportion of voting rights held reaches, exceeds or falls below the thresholds of 10%, 20%, 33%, 50% and 76%. Member states are free to set lower thresholds and narrower intervals. In Italy, for example, lower bounds are set at 2% and 3% in the UK (for certain holders), while it is 5% in most other countries and 10% in Portugal and Finland (Barca & Becht, 2001).

The insider dealing directive of 1989 coordinates the rules governing treatment of this activity and makes it a statutory offence. Unlike the practice in the US, a charge of illegal trading is not based on breach of fiduciary trust, but on the unfair use of non-public price-sensitive information (information that would have a significant impact on the stock price if it were to be made public). Primary insiders are prohibited from either trading or tipping, and secondary insiders are prohibited from trading, but are not subject to anti-tipping provisions. Beforehand, some member states placed no statutory restraint on insider dealing, and the regulations that did exist differed widely. As with the major holdings directive, implementation was uneven. Germany, for example, only implemented the directive in 1995, four years after the required date.

Accounting Standards

The financial information currently published by companies listed in the EU is not sufficiently comparable to amount to a single market of financial information. The EU's accounting directives (fourth and seventh company law directives) did not go far enough in their harmonisation as a result of many implementation options (62 in the 4th directive, 50 in the 7th)

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[38] Directive 2001/34/EEC of the EP and of the Council on the admission of securities to official stock listing and on information to be published on those securities, OJ L 184, 6.7.2001. This text also incorporates the provisions of the listing particulars and prospectus directives.

and differences in interpretation. As a result, the mutual recognition of accounts published in another member state was not working.

Historically, the EU was confronted with different conceptual frameworks in accounting (FEE, 1997). They can be reduced to two broad national traditions: one in which the process is driven by the needs of financial markets and the other in which it is primarily driven by law – the former represented mainly by the English-speaking countries (and to a certain extent by the Netherlands) and the latter by the other continental countries. In the former grouping, the accounts are expected to convey information of an adequate quality, in accordance with the currently accepted standards and practices developed by the profession. In the latter, it is based on compliance with statutory requirements, whereby there is a strong linkage between accounting and the taxable base.

The problem from a capital market perspective is that disclosure of financial information in more than one language confuses investors. Contrary to what might be commonly thought, double accounting does not necessarily allow for better decisions because it provides more information. Rather, it tends to create an information overload and a credibility problem. This was exemplified when Daimler listed on the NYSE in 1993 and had to convert its accounts to US GAAP, which led to totally different results than it had posted under German standards, for which the firm had to pay a premium. Another more recent example is Deutsche Bank's shift to US GAAP, which was subsequently considered an error by analysts, as it confused investors, reduced transparency and increased earnings volatility. Differences in tax treatment of disposal of industrial holdings resulted in net profit distortions in US GAAP of minus 88% in 2001 to plus 220% in 2000.[39]

Corporate Governance

Corporate governance matters have become more prominent on the agenda of several European states in the 1990s, following the example set by the Cadbury Committee in the UK, whose 1992 "Code of Best Practices" aimed at raising the standards of corporate governance and the level of confidence in financial reporting and auditing. Discontent with the quality of financial reporting and a lack of corporate disclosure were some of the driving forces behind the creation of national committees. Important in the context of this report is that, while the recommendations of most groups were broadly similar, the European dimension of the debates was absent, and the European Commission explicitly refrained from taking any initiative in this area – although the OECD did (Lannoo, 1999). This has changed however as a result of developments abroad, which forced European authorities to intervene.

2.2 The FSAP and Beyond

The new EU regime for disclosure by listed issuers is structured around three measures: 1) the regime for initial disclosure in the prospectus directive, 2) ad-hoc and periodic disclosure in the draft transparency directive and 3) rules on market abuse and insider trading in the market abuse directive. Harmonised financial reporting criteria for listed issuers will become a fact through the implementation of the regulation on International Accounting Standards by 2005.

The Regime for Initial Disclosure in the New Prospectus Directive

The new regime for prospectuses is the centrepiece of the new disclosure framework. It should allow firms to organise European-wide capital-raising exercises on the basis of a single document. A common position was reached on the amended proposal on 5 November 2002, after a first draft had given rise to much controversy, the final agreement on the text was reached on 7 July 2003.

[39] *Financial Times*, 10 September 2002.

The new regime is composed of three different segments, one for equity issuers, a second for non-equity issues with a denomination of at least €1,000 and a third for professional investors.[40]

The key features of the new regime are:

1. The *definition of "public offer"* and "private placement" at EU level.
2. The introduction of *an enhanced disclosure standard*, based on the IOSCO model, in the form of harmonised requirements for debt and equity securities. Accounts need to be prepared on the basis of IAS or local GAAP if "equivalent" to IAS.
3. The introduction of a new *prospectus system* composed of a single document or three sets of documents. If a single document, it must also contain a summary. In case it is composed of three sets of documents, it should be composed of 1) the basic registration document, or shelf filing, containing the general information about the issuer and its financial statements, which is to be updated each year; 2) the securities note, the details about the securities offered and the modalities of the operation; and 3) the summary note, containing the main items of both. For offerings under a programme, a single base prospectus applies.
4. The introduction of a *new language regime*: Only the summary will have to be translated for cross-border offerings in case the prospectus is (also) published in a language that is "customary in the sphere of finance".
5. The possibility to offer securities cross-border on the basis of *a simple and straight notification procedure* to host country authorities, and the concentration of supervisory responsibilities with the home administrative authorities. Equity issuers need to have the prospectus vetted in their home country, that is, the country where the issuer has its registered office. For non-equity issues with a denomination of at least €1,000 (or the equivalent in another currency) and for issues for professionals, there will be free choice of the home country of approval of the prospectus. Strict time limits apply by which the home country has to approve a prospectus, or make comments known to the issuer.
6. The requirement to split off the listing authority in an independent supervisory agency, away from for-profit exchanges, or the *decoupling of admission to listing and trading* (subject to a transition period of a maximum of five years).
7. The *maximum harmonisation approach*, meaning that one single standard applies throughout the EU, and that member states cannot set additional requirements for issuers based in their jurisdictions.

In the first draft of May 2001, only one prospectus format was proposed, composed of the set of three documents, without the possibility of choosing the country of approval of the prospectus. This led issuers to complain that the regime would become far too onerous and costly, certainly for SMEs (small- and medium-sized enterprises). It was furthermore argued that the draft was drawn up primarily with equities in mind, without sufficiently taking into account the specificities of bonds, in particular the eurobonds market.

More disclosure is of course a cost for issuers, but it would attract more investors. Investors are however a diverse group, which is hardly represented at European level. Since securities market regulation is a matter of matching the interest of issuers and investors, and the latter are hardly present in the European debate, it was up to the European Commission to defend investors' interests. Secondly, it is difficult to reduce the quantity of the disclosure without reducing the quality. Allowing SMEs to disclose less without undermining the purpose of the whole exercise is indefensible.

[40] See Deutsche Bank Research (2002) for an extensive discussion of the negotiation process on the directive so far; see also Wilmer (2002) for an overview.

The obligation for an issuer to get its prospectus approved in its home country is a step forward as compared to the US regime, which is territory-based, but was seen by critics as a restriction on regulatory competition, and would limit the City-based eurobond market. Issuers would be forced to rely on the authorities of their country of incorporation, which may lack the expertise and the resources to deal with the securities offerings concerned. The European scheme would, in its initial proposal, thus have been closer to that of Merritt Fox than to Roberta Romano's, discussed above. The final outcome is something a mixture of both, with almost free choice for bond issuers and almost no choice for equity issuers.

The criticism on the first draft was to a certain extent taken into account in the amended proposal, which was issued on 9 August 2002.[41] It introduces a lighter regulatory regime for securities designed to be traded by professionals (eurobonds) and a broader choice of prospectus formats for frequent issuers. The other elements of the first draft remained.

The use of maximum harmonisation is a novelty of the draft directive. It is a new approach that started to emerge as a response to remaining barriers under the minimal harmonisation approach of the single market programme, but has, in the area of financial services, only been used in the area of retail finance so far. Under the maximum harmonisation approach, member states cannot introduce additional requirements other than those set in the directive (except for admission to trading requirements set by stock exchanges, as introduced by the European Parliament in the second reading). The Commission justifies this requirement on the basis that loopholes and disparity in treatment accorded to retail investors must be avoided. Something cannot be a private placement in some member states (for which no prospectus has to be published under the directive) and a public offer in another, which was a problem with the former directives. It is argued that member states will be deprived in cross-border offerings of the possibility to request the inclusion of additional information in the prospectus, which would facilitate market integration.[42]

Maximum harmonisation, however, excludes regulatory competition. It presupposes a high degree of integration of capital markets and implies that a single standard will be applicable throughout the EU. It is not consistent with the basic principles of the single market which call for keeping the harmonisation of standards to a minimum and allowing convergence to emerge over time in a process of mutual recognition of rules and regulatory competition. It is a form of centralisation that contradicts the proportionality principle of EU law and puts a heavy burden on those arguing in favour of its use.

Maximum harmonisation also undermines the sense of the home country control principle. Since standards are the same throughout the EU, there is no real home country any longer. All home countries will apply the same standard. There can only be competition between authorities in the performance of their task, not in the degree of disclosure. Insisting on prospectus approval by the home country authorities does not make much sense in this regard. It is also clear that it would not be such a large step under this approach to move to a single prospectus agency, as was proposed at some stage in the discussions by the German Minister Eichel.[43]

As regards the prospectus formats, the common position maintains the structure of the initial draft, but extends the possibilities for issuers, while at the same time extending the exemptions. A prospectus can be drawn up as a single document or as separate documents. In the latter case, the required information must be divided into the three initial pieces: registration document,

[41] Amended proposal for a directive of the EP and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending directive 2001/34/EC, COM (2002) 460 of 9.8.2002.

[42] Ibid., Explanatory Memorandum, pp. 3-5.

[43] Reference is made to this proposal in Recital 37b of the prospectus directive (final draft).

securities note and summary note. In case it is a single document, it still must contain a summary, which will have to be translated into the host country language for cross-border offerings. For securities admitted on regulated markets, annual updates of the information are required. This applies to all details published in the last 12 months.

For securities traded by professionals, special rules apply. In that case, there will be no obligation to provide a summary and an annual update, to have the prospectus approved in the home country, to have IAS equivalence, etc. The minimum nominal value for such securities is €50,000. Other exemptions from the directive are the issue of securities already listed, continuous offerings by credit institutions, and issues with a total value of less than €2.5 million. The surprise element in the Council common position was the waiver for the prospectus approval by the home country for non-equity issues with a denomination of at least €5,000. This was lowered to €1,000 further to the second reading by the European Parliament.

Overall, the draft prospectus directive is seen as a big step forward as compared to the previous measures in place. However, the general obligation to have the prospectus approved in the home country for equity issues, the language and translation requirements, and the IAS requirement or "equivalent" for non-EU issuers are seen as important remaining burdens. The implementation of the directive by the Commission in cooperation with the Committee of European Securities Regulators (CESR) will need to demonstrate whether and how the directive will work in practice.[44] Will practices relating to prospectus vetting really converge? Is there no risk that other matters, not harmonised by the directive, will prevent market integration? This comes back to the question whether maximum harmonisation can co-exist with minimal harmonisation, which has been the rule so far in the context of the EU's single market. This will also be important in the context of the ongoing disclosure obligations, which are proposed to remain under the minimum harmonisation approach.

The Regime for Periodic and Ad-Hoc Disclosure

A formal proposal for a new regime for periodic and ad-hoc disclosure by listed issuers was adopted by the European Commission on 26 March 2003, following two consultative papers. The so-called draft transparency directive integrates all ad-hoc and periodic disclosure requirements of EU law into a single text, broadens the scope of securities covered so far and upgrades the current regular reporting requirements to quarterly reporting for equity issuers, based upon International Accounting Standards. However, periodic and ad-hoc disclosure also covers non-financial information, which are related to different company law or corporate governance requirements, and are addressed further to the second report of the Winters Group (a body created to recommend reform of company law regulation in the EU).

The proposal is as follows:

- A full *annual financial report* should be published by issuers within three months of the end of the fiscal year and should not only contain the audited financial statements, but also a management report.
- A full *semi-annual financial report* should be published by issuers within two months, containing a condensed set of financial statements, and an update of the management report. This report does not need to be audited.
- *Limited quarterly reports* will become mandatory, and are to be published within two months. They should contain the consolidated turnover, the results and a statement on the

[44] CESR has issued various documents and organised hearings on the implementing measures, but it is too early to make a general assessment about it.

issuer's activities over the last three months. Forward-looking information is optional. Debt securities are exempted from this requirement.

- For the definition of *price-sensitive information*, reference is made to the text contained in the market abuse directive (Art. 6, see heading below).
- For disclosure of *capital structures*, the thresholds of the major holdings directive will be lowered and extended to 5%, 15% and 30%. It should also include information on options, convertibles and shareholder agreements. This is lower than what was in place in the major shareholdings directive, discussed above, but still higher than what is the rule in several member states.
- *Corporate dissemination***.** Member state authorities may publish filed information on their web site and must ensure "timely access" to disclosed information. It shall require "the issuer to use such media as may reasonably be relied upon for effective dissemination of information to the public throughout its territory and abroad" (Art. 17). The use of the Internet for publishing all significant corporate events becomes mandatory.
- *Organised dissemination systems*. The draft directive insists on setting guidelines for dissemination of regulated information and information provision, but leaves practical arrangements to implementing legislation (level 2) and guidelines to be agreed among member states in the context of CESR (level 3).
- *Language regime*. The same language regime applies as in the prospectus directive, i.e. the home member state language and one international language (with the exception that there is no summary which needs to be translated in all cases in the host country language). For large issues (in excess of €50,000), only one language is required.

Two questions require further analysis: should quarterly reporting become mandatory and what is the best system for dissemination? Quarterly reporting is not yet widespread in Europe (see Table 1), which raises the question why it should become mandatory. Further to a parliamentary question by MEP Chris Huhne, some 43% of the EU listed companies report every quarter today in one way or another. If one excludes those markets where it is required by law, the corresponding figure is 34%. Quarterly reporting thus represents a deep regime shift for European enterprises. The arguments which the European Commission put forward to make it mandatory are not substantiated.

An important argument in favour of quarterly reporting is the reduction of information asymmetries and the easing of access to financial information. Mandatory quarterly reporting gives shareholders of listed corporations a more regular and standardised information flow than in case more regular reporting was left voluntary. It also reduces the opportunities for insider trading by directors, since listed firms have to provide more regulatory information to the markets, and the periods when directors can trade are more limited.

It could again be argued that smaller listed firms should have a waiver for quarterly reports, to facilitate their access to capital markets. However, the issue is not being small or big, but being listed or not. Also, the cost element is not convincing as a reason for not doing it.

As regards dissemination, it is clear from a level-playing field point of view that the current European system is in urgent need of updating. It is not obvious, however, that this role should be played by public authorities. It would be sufficient for the authorities to delegate this role to the markets, under some form of supervision. The current framework of dissemination is a reflection of the fragmentation and state protection that characterised European capital markets until recently. This is discussed in more detail in the next chapter.

Table 1. Frequency of quarterly reporting in the EU

Member state	Number of domestic listed companies (main market)	Number of listed companies providing quarterly reports or at least quarterly information
Belgium[a]	125	43
Denmark[b]	197	127
Germany	715	429
Greece	344	344
Spain	273	273
France	796	12[c]
Ireland	70	1
Italy	279	265
Luxembourg[d]	45	8
The Netherlands	179	75
Austria	110	90
Portugal	57	55
Finland	143	135
Sweden	350	340
United Kingdom[e]	2177	350
EU-15	5860	2547

[a] Not including Nasdaq Europe.
[b] This figure includes also foreign issuers.
[c] Figure referring to the CAC 40, Euronext Paris. In addition, according to French law, all listed companies are requested to provide net turnover data on a quarterly basis
[d] This figure also includes foreign issuers whose shares are admitted to trading on the regulated market.
[e] 32 issuers in the FTSE 100, 17 issuers under the United Kingdom Listing Rules requiring quarterly reports from companies with a trade record less than three years.

Source: European Commission further to question by MEP Chris Huhne, July 2003.

Market Abuse and Insider Dealing

A new directive updates the current insider trading directive and adds new provisions on market manipulation, on which no harmonised rules existed before, and which is new for many EU member states. The aims of the directive are to avoid loopholes in Community legislation that would undermine confidence in securities markets. A common position was reached in the Council on 19 July 2002, the directive was formally adopted on 3 December 2002. The European Commission, following the proposals by the Committee of European Securities Regulators, has in the meantime proposed implementing legislation regarding several articles of the directive. In the context of disclosure, the most important ones are those relating to the definition of price-sensitive information (Arts. 1 and 6.1 and 6.2) and investment research (Art. 6.5).[45]

[45] Working documents on the implementation of Articles 1 and 6, paragraphs 1 and 2 and Article 6 paragraph 5 of the European Parliament and Council Directive 2003/6/EC, ESC 12/2003 and 13/2003.

- *Inside information* is defined as "information of a precise nature which has not been made public (…) and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments". This is also the definition that is used for ad-hoc disclosure. In the implementing proposals, this is further defined as "ex-ante available information an average person would be likely to use as part of the basis of his investment decisions in order to optimise his interests."
- The directive request member states to ensure that issuers of financial instruments *inform the public as soon as possible* of inside information. This information should be posted on the Internet sites of the issuers (Art. 6.1). Delays must be justified to the authorities (Art. 6.2). Disclosure of information to third parties must be complete and effective, and simultaneous for international disclosure (Art. 6.3).
- *Dealings by directors* in shares or options must be notified to the competent authorities. Member states shall ensure public access to information concerning such transactions (Art. 6.4).
- *Investment research* and recommendations must be fairly represented, and factors that are likely to impair its objectivity must be disclosed (Art. 6.5). In the implementing legislation, it is proposed that member states make sure that effective organisational arrangements are in place to prevent conflicts of interest in investment firms; that material conflicts of interest are disclosed, and that an overview of all "buy", "hold" and "sell" recommendations is published on a quarterly basis.
- *Single supervisory authority.* Member states must centralise the supervision of market abuse and insider dealing into one single administrative authority (Art. 11). This requires significant changes in some member states, where first line supervision is carried out by the stock exchange, or through code of conduct arrangements.

An important issue in the context of this paper, which is raised in the implementing legislation, is the synchronisation of inside information disclosure in all member states to guarantee equal treatment of investors. The question how this will be done is left to the member states (level 3) or to implementing legislation.

International Accounting Standards by 2005 for EU listed issuers

From 2005 onwards, EU listed companies will be required to prepare consolidated accounts in accordance with IAS. By year-end 2002, only some 275 EU companies were applying IAS. The goal is to increase this number to encompass the about 6,000 EU listed companies by 2005 – an enormous shift in itself. The EU regulation by which IAS will be obligatory for all listed issuers was formally adopted on 19 July 2002.

The regulation empowers the European Commission, assisted by a Committee, to decide on the applicability of IAS. It states that IAS can only be adopted if they are conducive to the European public good, and if they meet the criteria of understandability, relevance, reliability and comparability of financial information. Each adopted standard will be published as a Commission regulation (Art. 3).

In order to provide legal certainty on the standards that will be used in the EU, the regulation establishes an endorsement mechanism with a two-tier structure, consisting of a technical level and a political level at EU level, to verify that IAS respond to EU public policy concerns. Each of the proposed IAS norms will be the subject of an opinion issued by a consultative committee of professionals, the European Financial Reporting Advisory Group (EFRAG). Further to the advice of the latter, the decision will be taken by the Commission's Accounting Regulatory

Committee (ARC).[46] The standard will then be sent to the European Parliament for information, and implemented by a Commission regulation. The ARC will also be represented in the constituent bodies of the IASB. The Committee of European Securities Regulators (CESR) has been requested to ensure a common approach to enforcement, and has prepared a draft statement of principles for that purpose.[47] In this paper, CESR calls for the appointment of independent competent administrative authorities in the member states and the harmonisation of the institutional oversight system in Europe. These authorities should be responsible for the enforcement of IAS in the EU.

Ensuring a common approach will however not be easy, as so far only five European securities regulators have responsibility over the enforcement of accounting standards (Belgium, France, Italy, Portugal and Spain). And unlike the other draft directives as discussed above, the IAS regulation does not *formally* require the member states to designate an independent competent administrative authority. This is related to the fact that no agreement could be reached on a single model of oversight. CESR will thus be faced with an almost impossible situation of bringing together "competent authorities". As can be seen from the table below, in several countries, there is no institutional oversight system; in others, it may be private bodies such as the stock exchange or a review panel. Because of confidentiality reasons, CESR will not be in a position to involve private sector bodies.

Table 2. Summary information on institutional oversight mechanisms concerning consolidated accounts of listed companies

Institutional oversight mechanism for financial statements				No institutional oversight system[a]
Stock exchange	Stock exchange regulator	Review panel	Other government	
Norway	Belgium	UK (FRRP)[b]	Denmark[c]	Austria
Switzerland	France	Sweden	UK (DTI)[d]	Finland Germany
	Italy		Czech Republic[e]	Luxembourg
	Portugal		Ireland[f]	Netherlands[g]
	Spain			Hungary Slovenia

[a] In those countries the existing institutional oversight system is only responsible for enforcement in relation to documents other than annual financial statements (e.g. prospectus, preliminary results, interim financial statements) or is only prepared to undertake reviews limited to formal checks.

[b] Financial Reporting Review Panel (FRRP) for large and listed companies.

[c] In Denmark, the financial statements of financial institutions and insurance undertakings are reviewed by the Financial Supervisory Authority. For other companies, the financial statements are reviewed by the Danish Companies and Commerce Agency on a test/sample basis.

[d] Primarily small- and medium -sized companies.

[e] Securities Committee.

[f] Irish Accounting and Auditing supervisory authority.

[g] In the Netherlands, the Financial Markets Authority is being given an oversight role, although it is not yet operational.

Source: Updated from FEE (2001).

[46] The first set of IAS and related interpretations, with the exception of IAS 32 and 39, were endorsed by the ARC at its meeting on 16 July 2003, see www.europa.eu.int/comm/internal_market/accounting.

[47] CESR, Proposed statement of principles of enforcement of accounting standards in Europe, October 2002.

Another problem is the interaction between CESR and the EU institutions on this issue, which does not seem to be clearly defined. For securities markets matters, CESR reports to the European Commission, which can decide on implementing measures to be agreed upon by the EU Securities Committee. As regards accounting issues, CESR's means are more limited, and there is no formal role for a Committee to decide on enforcement matters. The question thus arises whether the structure will be in place at national level to cope with the implementation, and whether CESR and the European Commission will be in a position to ensure a common approach to enforcement.

Faced with these circumstances, the European Accounting Federation (FEE, 2002) has called for the creation of European Enforcement Coordination. FEE considers that a single enforcement system is an unrealistic goal at present, considering that it should be in place by 2005 at the latest. Therefore, a provisional European model should be based upon the co-existence of the different models for enforcement. For those countries having no oversight at all, the review panel model could be established relatively rapidly. The German audit profession, on the other hand, has proposed the creation of a pan-European Public Company Accounting Oversight Board, analogous to the US PCAOB created under the Sarbanes-Oxley Act.[48] This EPCAOB should coordinate the national systems of oversight, set principles for the quality of the audit, with the possibility of sanctions, and act as the European counterpart for the US PCAOB. The latter would therefore need to formally recognise the role of the former, which should free European audit firms from having to register with the PCAOB, or for EU member states to negotiate on a bilateral basis with the US to achieve recognition of their oversight system.

At international level, the key issue will be the acceptance of IAS by the US authorities. Before the scandals broke in the US corporate sector, the US business community and establishment were strongly against IAS, on grounds that they were inferior to US GAAP, implying that only the latter would be acceptable for quotation on US markets. The former SEC Chairman, Arthur Levitt, was a strong proponent of that view, arguing that the quality of disclosure under IAS was inferior to US GAAP.[49] Recently, however, the SEC has taken a more conciliatory stance on the subject. In a speech in Brussels on 10 October 2002, the former SEC Chairman Harvey Pitt called for "a single set of high quality accounting standards applied even-handedly". He indicated that "FASB and the IASB are committed to working together to produce high-quality accounting standards across the major international capital markets. They recently have announced the desire to undertake a historic and very important joint project aimed at eliminating the key differences between existing US generally accepted accounting principles and international accounting standards". But Pitt also referred to the challenge for the EU to ensure consistent interpretation and enforcement across 15 member states.[50] Some months later, his fellow Commissioner Roel Campos, in a speech at CEPS, stressed the progress already achieved in the convergence project between FASB and IASB, and called for a global infrastructure for interpretation and enforcement.

There remains substantial opposition to IAS among US business, however, as expressed in a letter from the Vice-Chairman of NASDAQ, Alfred Berkeley, to the Federal Accounting Standards Board, opposing the implementation of stock options as an expense under IAS. Berkeley warned in his letter that the rule change would strongly affect worker productivity and

[48] Institut der Wirtschaftsprüfer, Europäisches Qualitätskontroll- und Berufsaufsichtssystem für Abschlussprufer, 20 January 2003 (http://www.idw.de).

[49] See op-ed by Arthur Levitt, former Chairman of the SEC, "*In tempore non suspectu*", in the *Financial Times*, May 2001.

[50] Harvey Pitt at the Conference of the Institute of Chartered Accountants of England and Wales, Brussels, 10 October 2002, http://www.sec.gov/news/speech/spch589.htm.

that Europeans planned to use accounting convergence to "lower America to their own pitiful level of innovation and labour mobility".[51]

Proper European enforcement will also be crucial in this context. If the EU cannot demonstrate its capacity to deliver an integrated European approach, the support for IAS will vanish, and US GAAP will prevail. In view of the above, the US business community can be expected to carefully watch developments with regard to enforcement of IAS in Europe and will sound the alarm bells as soon as things do not advance satisfactorily.

The EU framework may however have its advantages. Competition between regulators can ensure that standards are more consistently enforced than in a system of a single regulator, such as exists in the US. Vivendi Universal, the troubled French media and utilities conglomerate, exerted heavy pressure on its auditors to adopt a favourable accounting treatment of its acquisitions. The issue ended up with the French securities regulator COB, which strongly defended the independence of the auditor against the pressures from the company.[52]

The EU-US dimension of the IAS debate should on the other hand not be overstated. Acceptance of IAS has become a global issue, and up to today more than 100 countries have indicated their acceptance of the international standard. The support of international bodies such as the World Bank and the International Monetary Fund for proper governance and reporting procedures and for the use of internationally agreed standards plays an important role in consolidating the position of IAS.

Corporate Governance and the Statutory Audit

Harmonised accounting standards alone will not do the job. If proper corporate governance and auditing procedures are not in place, the scope to mis-state financial statements will be higher. The incentives will need to be sufficiently high such that each party will assume its responsibility to deliver accounts of high quality. The management of the company has the duty to put proper procedures in place to ensure that financial statements are in compliance with an agreed set of GAAP. Investors need to monitor boards and audit committees and take action in case the interests of the company are in danger. Auditors need to observe high standards of quality and independence in their work.

A study carried out for the European Commission (Weil, Gothshal and Menges, 2002) concluded that European harmonisation or a European corporate governance code was not needed, since the many different national codes in the EU are remarkable in their similarity and serve as a converging force. Moreover, a European-wide code may become a lowest common denominator rather than a code of *best* practice. It would therefore be advisable for the European Commission to focus its efforts on the reduction of legal and regulatory barriers on shareholder participation and information, the study concluded. This line was reiterated in the report of the High-Level Company Law Group (Winters Group), which proposed that the EU should adopt a Company Law Action Plan, including an improved framework for corporate governance, through a combination of soft law measures and harmonisation of company law structures in the EU.

The fallout of the events in the US, and more particularly the Sarbanes-Oxley Act, has nevertheless pushed the EU towards a more statutory harmonisation of standards. Since the SOA also applies to foreign listed companies in the US, EU law may need to introduce harmonising requirements regarding the role of the statutory audit, the oversight of the audit profession and the liability of board members. Other issues of the SOA, such as directors'

[51] *Financial Times*, 30 January 2003.

[52] *Le Monde*, 11 September 2002.

dealings, are addressed in other pieces of new EU law, namely the market abuse directive, which should allow EU authorities to insist with their US counterparts that equivalent measures are in place.

In two recent Commission Communications, the European Commission has proposed to respond to the challenges raised by Enron in a European context.[53] In the area of corporate governance, it proposes to harmonise the collective responsibility of board members at European level, the annual disclosure by all EU-listed companies of key elements in corporate governance structures and practices, and to create a European Corporate Governance Forum to coordinate the corporate governance efforts of the member states (European Commission, 2003a). As regards the statutory audit, the Commission proposes to update the 8th company law directive regarding the principles of the statutory audit, to require the use of International Standards on Auditing (ISA) to harmonise national systems of public oversight of the audit profession and to create an EU coordination mechanism for the national systems of oversight (European Commission, 2003b).

The latter links up with the proposal for a "European PCAOB" to respond to the US PCAOB created under the SOA, discussed above. However, the European Commission argues that equivalent measures are already in place in the EU, and that the demand for registration of EU audit firms with the US PCAOB is a "regrettable decision". The Ecofin Council, meeting on 3 June 2003, came out even more firmly against the demand for registration of EU audit firms, arguing that "the PCAOB's registration process is burdensome, costly and unnecessary" and requested "a full exemption for its audit firms from the PCAOB registration process as permitted under section 106(c) of the Sarbanes-Oxley Act." It stated that "the potential implications of the PCAOB's audit registration procedure (e.g. PCAOB oversight of EU audit firms, PCAOB inspection, PCAOB sanctions and PCAOB access to confidential EU audit working papers) are unacceptable given the major conflicts of law that may ensue."[54]

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[53] The Commission Communications were analysed by both authors in a separate publication on the subject (see Lannoo and Khachaturyan, 2003).

[54] http://ue.eu.int/newsroom

CHAPTER 3

DISCLOSURE REGULATION IN THE EU MEMBER STATES

Current requirements for disclosure regulation in the EU reflect the limited degree of harmonisation in the first wave of EU directives, and thus the persistence of national practices. Tighter enforcement of EU rules could also have led to a higher degree of convergence, but pressure in this direction was, until recently, very limited. A survey of national disclosure practices reveals that there is a need to move to a higher level of harmonisation, but it also raises the question of the degree.

The highest differences in disclosure in the EU member states exist in the submission and dissemination of price sensitive news. Important differences exist in the a-priori 'control' of price-sensitive information, the dissemination channels and instruments, and the existence of special intermediaries. On the other hand, requirements regarding the frequency of periodic reporting are more comparable, as a result of EU harmonisation, although the question remains whether these rules are well enforced, considering the limited use of bi-annual reporting, discussed above, or the scarce and uneven prosecution of insider trading in the EU. The following is based on a survey that was sent to domestic stock exchanges and regulatory authorities (see Annexes 2-4 for results) and on a compilation of regulation and practice by PR Newswire.[55]

- **Frequency of periodic reporting** is at least semi-annual in all member states except Luxembourg (see Annex 2). Nevertheless, concerns come to the fore as to whether a move towards quarterly reporting will improve the status quo. Finland, Greece, Italy, Portugal and Spain request all listed companies to report every quarter. The Amsterdam, Brussels, Paris, Stockholm, Vienna and German exchanges ask for some form of quarterly reporting from companies listed in particular market segments. Respondents to the survey remain divided about the costs and quality of reported information. In Portugal, for example, semi-annual reporting follows the IAS 34 format, while quarterly reports include much less information.
- **The definition and the content of ad-hoc reporting** (see Annex 3) diverge. Although all respondents to the survey mention price-sensitive news and the need for public knowledge, the interpretation thereof differs importantly. This is clear when comparing the amount of corporate press releases in the UK and Germany. In the former, some 170,000 notices of information concerning 2,300 companies were released in 2001, or 74 per company, as compared to 7,300 notices regarding 1,040 companies in Germany, or 7 per company (PR Newswire, 2002).
- **Dissemination of information** (see Annex 4) is a major issue. Generally speaking, three systems can be distinguished in the EU, although every distinction is to a certain extent arbitrary.
  1) *Authorisation and dissemination by authorities*. The French, Italian, Spanish and Portuguese authorities are the examples of EU countries in this category. They possess a dominant position with regards to a priori information and dissemination. In some cases, they also formally authorise. Dissemination is organised at their initiative.
  2) *Dissemination by the stock exchanges* (which also includes some form of a priori control). This is the most common system in the EU, which indicates to what extent stock exchanges have kept regulatory functions.

[55] See http://www.disclosureresource.com.

3) *Dissemination by authorised information providers and press agencies*. Ireland and the UK have a system of Regulatory Information Services, which have the duty to disseminate information to the media. In other countries, the national press agency has this function, and has some form of dissemination monopoly, although they do not necessarily reach as wide an audience. In many EU countries, it is still sufficient for corporations to inform one national newspaper.

- **Form of information dissemination**: Some countries still expect information to be sent in hard copy or by fax. In others, electronic transmission has become an accepted form.
- **Time span for dissemination of price-sensitive news** is a broadly divergent issue. Some markets want it 'without delay', others 'without undue delay'. Requirements such as 'promptly' and 'immediately' are open to interpretation. Some countries accept that it is better to publish price-sensitive information after trading hours, and thus disregard certain delays.

Table 3. Ad-hoc disclosure requirements in the EU member states, Switzerland and the US

	A priori submission/ information	**Dissemination channels**	**Time span**
B	SE	Min. 1 national newspaper and national press agency (belga)	Immediate
DK	SE	Stockwise (owned by SE)	Immediate
DE	Notification to SE and BAFin	Min. 1 national newspaper	Immediate
EL	SE	Min. 2 national newspapers, se website	Outside trading hours
E	Sec Comm (CNMV)	CNMV website	Immediate
F	Sec Comm (COB)	Press agency and COB website (Sophie)	Immediate or with closure of market
I	SE/Sec Comm (CONSOB)	NIS (owned by SE), press agencies	Without delay
IRL	No	Primary Information Providers (pips)	Without delay
L	SE	Min. 1 national newspaper, se	Prompt reporting
NL	No	SE and national press agency (ANP)	Immediate
AU	SE	Min. 1 national newspaper and press agency	Without delay
P	Sec Comm (CMVM)	CMVM website	Immediate
SF	No	SE and news agencies	Without undue delay
SW	No	Min. 2 news agencies and 3 national newspapers	Immediate
UK	No	Primary Information Providers (pips)	Without delay
CH	SE	Min. 1 electronic news provider	Outside trading hours
US	SE/Sec. Comm (SEC)	Press agencies and EDGAR	Outside trading hours, real time in SOA

Notes: SE = Stock Exchange; Sec Comm = Securities Commission.

Source: CEPS survey (see Annexes 2-4) and PR Newswire (2002).

CHAPTER 4

PRELIMINARY ASSESSMENT OF THE NEW REGULATORY FRAMEWORK

The EU has advanced quickly in bringing the new regulatory framework in place. In this chapter, we assess some elements of the new regulatory framework as a background for the policy recommendations. A first section focuses on the consistency of the framework, which covers questions raised by the three disclosure directives. A second section discusses the issue of quarterly reporting, which is one of the most contentious elements of the new framework and more in particular of the transparency directive.

4.1 The Consistency of the Framework

The new disclosure framework still has to face its first tests, and imperfections may only appear over time. The EU is now equipped to respond rapidly as a result of the large scope for secondary legislation in the directives further to the Lamfalussy approach. But the directives are emerging as a result of amendments and compromises in the Council and the European Parliament, which means that some of the initial consistency of the texts may have been lost. Certain issues may also have been insufficiently addressed, or harmonisation may have gone too far in others. The following table gives an overview of the main items of the new disclosure regime.

Table 4. Initial, ad-hoc and periodic reporting requirements for securities with listed securities in the prospectus, market abuse and (draft) transparency directives

Directives/scope	Prospectus	Market abuse	Transparency (draft)
Disclosure regime/ trigger	Initial	Inside information Dealings by directors Conflicts of interest in investment research	Ad-hoc (price-sensitive information, change in major holdings) Periodic (annual, bi-annual and limited quarterly statements)
Frequency	Annual updates of all relevant information by issuer (possibly by incorporation)	As soon as possible	Max. 3-month delay for annual, 2 months for bi-annual and quarterly reporting Without delay for ad-hoc Max. 5 days for changes in major holdings
Dissemination	Press, issuer's website Home authority website	Company website	Issuers web Member states must ensure timely access
Language regime	Home plus international language or host country language, summary note must always be translated	(not discussed)	Home plus international language or host country language Single language for issues > €50,000
Exemptions	Lighter regime for issues >€50,000	Monetary policy and Treasury authorities	No quarterly reporting for debt issuers, and no periodic reporting requirement for debt securities > €50,000
Degree of comitology	9 of 31 articles	2 of 22 articles	9 of 31 articles
Competent authority	Home country for approval of equity issues Choice for approval of bond issues of >€1,000	(not discussed)	Home country or country of choice of issuer
Supervisory authority	Fully independent (with transitory period) Delegation of dissemination authorised	Fully independent	Fully independent Delegation authorised, but subject to caveats, and for a maximum period of 5 years after entry into force
Form of harmonisation	Maximum	Minimum	Minimum
Implementation deadline	Q2 2005	October 2004	Q4 2005 (expected)

Problems can be expected regarding the interaction of maximum harmonisation in the prospectus directive and minimal harmonisation in the other two directives, the relation between home and host countries, the insufficient degree of harmonisation of dissemination systems and the language issue.

Maximum vs. Minimal Harmonisation

Although the preference for maximum harmonisation in the prospectus directive can be understood, it is not difficult to imagine problems in the interaction between both regimes – apart from the more general single market considerations discussed above. If a single format has to be respected for primary issues, how can this interact with minimal harmonisation under the transparency directive? The prospectus directive requires a single format for annual updates by issuers, but regular and ad-hoc reporting falls under the transparency directive. In the latter case, member states would be allowed to ask for additional information for home country issuers, but not for annual updates of information further to the prospectus directive.

Home vs. Host Country Competencies

The former issue is also related to the role of home vs. host country authorities. Under the prospectus directive, supervisory authorities simply need to apply one unique format for issues. For ad-hoc and regular disclosure, requirements will depend upon the home country requirements, or on the country of trading. There is thus clearly a danger of inconsistency between the two directives. This is rendered even more difficult through the possibility of free choice of the country of prospectus approval for bonds. A large firm that issues securities on the capital market could rapidly have two "home countries", one for the issuance of equity and another for the issuance of debt. Moreover, this firm could be faced with additional secondary market disclosure requirements under the draft transparency directive, in case its main market of trading is still another member state. Such situations will not be of the nature to ease cross-border issuance significantly. Moreover, questions could be raised regarding the efficiency of supervision.

The Language Issue

The current approach of the language issue cannot be expected to be fully problem-free. Under the draft transparency directive, the language requirement is limited to the home country language plus an international language (except in case an issuer is only listed in a host member state). Under the prospectus directive, the summary note will still need to be translated into the language of the country where an issue is offered to the public, in addition to the general regime of home country and international language. Under the market abuse directive, which requires price-sensitive information to be disclosed as soon as possible, the language issue is not addressed, nor is the issue of competent authority.

From a market point of view, the language issue should not be overstated as a barrier to market integration, however. Operators seem to be adapting easily to the requirements of their relevant market, and technological progress is making translation services easier to afford, even for smaller operators.[56] The issue is not to provide excuses for supervisors to prevent cross-border capital-raising exercises and the integration of European capital markets in general.

[56] Jos Peeters, Managing Partner of a venture capital fund, remarked at a meeting of the Task Force that his company had no problems in communicating every single document in three languages on the website as well as in providing quarterly reports.

Diversity of Dissemination Systems

The disclosure directives do not expressly require companies to disclose information in all member states. The directive mandates that member states ensure "timely access" to disclosed information, but the requirements are limited to the member state(s) where the securities are traded. The obligation on the member states in the draft transparency directive is to "ensure that the issuer discloses timely information in a way guaranteeing effective and equal access to the public in all member states where the securities are traded" (Art. 20.4f). The same is proposed in the implementing legislation of the market abuse directive: "Public disclosure of inside information by an issuer should be as fast and synchronised as possible in all member states in which its instruments are admitted to trading" (Art. 5.3, Commission Working Document ESC 12/2003).

In the draft transparency directive, the European Commission proposes to leave dissemination of regulated information to implementing legislation (level 2) or to guidelines to be set among supervisory authorities (level 3). Implementing legislation should specify 1) minimum standards for dissemination via issuers' web sites, and the conditions for alerting interested parties; and 2) conditions and time limits by which information must be kept available to the public. Dissemination systems are left to guidelines (level 3) to be set among member state authorities for the creation of electronic networks at national level, or a single electronic network at European level.

In view of the diversity of dissemination requirements and systems, as outlined in Chapter 3, it is questionable whether the current proposal goes far enough. It does not allow for the adaptation of the information provision to the needs of a single capital market, nor does it provide investors with equal access to corporate information. This issue reveals a fundamental problem in the implementation of the "Lamfalussy" approach: what is framework legislation (level 1); what is left to implementing legislation (level 2) or to guidelines among supervisors (level 3). In our view, dissemination is a fundamental issue, which cannot be left to levels 2 and 3. Moreover, implementing legislation has so far not extended information requirements beyond the member state(s) of listing.

However, there are also strong vested interests in place which may prevent the emergence of a more European system. Some national information providers have a monopoly in their market, and will be reluctant or ill-equipped to function in a more competitive environment. Many national financial newspapers derive a large share of their revenues from mandatory publication of corporate information. This income stream may be in danger in the longer term if more efficient dissemination systems come into being.

Disclosure Enforcement

Enforcing disclosure is probably not difficult in primary markets, but it is for secondary markets. The market abuse and transparency directives require issuers of financial instruments to inform the public as soon as possible of price-sensitive information. In these circumstances, however, different views on what is price-sensitive, or more broadly different opinions on how to interact with the market, may play an important role. The large differences in information provision to the markets by listed companies, as referred to above, is an indication of the broad differences in views on this subject. But how will these converge? Is there a need for best practice among supervisors for the enforcement of disclosure of price-sensitive news? Or could this be better done by the stock exchanges? Moreover, the European Commission will also need to be vigilant in enforcement (level 4), which has not been an issue of much debate yet.

4.2 The Issue of Quarterly Reporting

In the explanatory memorandum to the draft transparency directive, the Commission argues that the measure is part and parcel of the "disclosure and transparency agenda". It is a step to eliminate information asymmetries, enhance investor confidence, reduce the cost of capital and finally lead to integration of securities markets across the EU. The proposed directive is aimed at imposing the level and detail of information and transparency that can strike a balance between sound investor protection and market efficiency. The level and detail for periodic disclosure is stipulated in a three-tier financial reporting model: annual, semi-annual and quarterly financial reporting.

The Commission acknowledges the fact that ten member states already have strict disclosure requirements in place, six of which mandate quarterly reporting in some form. In referring to the US dependence of the European securities market, the Commission holds up the US reporting standards as a benchmark, where quarterly reporting was introduced back in 1946.

The proposed directive requires firms to disclose the following information on a quarterly basis without mandatory audit certification:[57]

- Consolidated figures, the net turnover, the profit and loss statement;
- An explanatory statement related to the issuer's activities and to the profit and loss statement; and
- Optional forward-looking information on future developments, uncertainties and risks.

Quarterly Reporting and Users' Information Needs

The proposed directive offers a unified framework for quarterly disclosure both for investors and creditors by not differentiating between the information needs of the two. Generally, investors and creditors have different information needs. They use a variety of methods to value companies and securities that reflect their information needs and decision-making. The primary objective of investors is to assess the long-term viability of the company through evaluating the value of the company and its securities. Unlike investors, the primary concern of creditors is corporate ability to meet its debt repayment obligations on a timely basis.

The relevance and reliability of quarterly data can be increased by a mandatory audit requirement. In the absence of such a requirement, however, it is not clear how relevance and reliability can be enhanced to meet the information needs of users. While it is true that during financial distress, management is prone to smooth earnings by deferring expenses and losses, making adjustments and write-offs of assets to overstate accounts which consequently leads to loss of confidence in the accuracy and reliability of disclosed information, it is also true that without independent third-party verification of quarterly data, users' information needs are not adequately served.

The Nature of the Business and Stock Price Performance

The proposed directive neglects the influence of business and its environment on users' information needs despite their profound impact. Users need to evaluate and forecast business activities and events as well as to capitalise on the financial consequences of those events and activities. Risks and opportunities of capital allocation decisions cannot be properly assessed if users are deprived of information to understand the scale and the scope of operations as well as linkages and complementarities between different events and the nature of business activities.

[57] See Art. 6 (2) of the draft directive.

In general, depending on the nature of the business, quarterly reporting can convey three major economic determinants for price changes: persistence, risk and growth. These determinants affect price changes through affecting the earnings position.[58]

The more persistent the time-series properties of quarterly earnings are, the greater the impact of earnings "surprises" on investors' expectations of future earnings, and the larger is the price change (higher earning response coefficients).[59] This effect has indeed been statistically very significant. Thus, persistence can lead to higher volatility. The European Commission should substantiate why quarterly reporting will not have persistent effects on investor expectations, and thus not lead to a higher level of volatility.

Quarterly earning data might also indicate higher risks associated with gains and losses. Greater risk implies a greater discount rate. Greater discount rate implies lower discounted present value of expected earnings position. The latter implies lower price change.[60] On the other hand, higher risks are associated with higher volatility especially with transitory gains and losses. So, it is unclear which effect will dominate.

Finally, quarterly accounting information might also convey growth opportunities that might be pursued in projects with higher than the risk-adjusted market return. The stock price informativeness of quarterly accounting data implies growth opportunities will be reflected in prices. The magnitude of price changes will be more than that implied by persistence because persistence estimates cannot accurately reflect growth opportunities due to their historic nature.[61] Hence, one is likely to observe price volatility.

Against this background, it is clear that the nature of the business implies different risks and opportunities for capital allocation. While some companies are characterised by a steady path of revenues, costs and profits, corporate performance of start-ups, immature industries, highly capital-intensive industries and companies to be restructured might be associated with a higher level of risk due to the irrelevance of historical information. The former precludes any reasonable possibility for predicting and meaningfully quantifying associated risks. Consequently, stringent quarterly reporting for this category of companies might bring some value-added to the investors and creditors. For example, the UK and Luxembourg require quarterly reporting for companies with a trading record of less than three years.

For mature industries, however, quarterly reporting cannot change much in providing marginal information for updating expectations on corporate performance, trends and changes in trends. It will simply accommodate the information needs of short-term (myopic) users, reinforce existing predisposition to focus on the short term in securities market and enhance "short-termism" of managerial incentives. Consequently, it serves to increase the volatility of stock prices.

It has been found that the relationship between stock returns and earnings and between stock prices, earnings and book values has declined over the last 20 years for a large sample of the US firms.[62] It has also been shown that more frequent financial reporting affects the speed at which accounting information is reflected in stock prices. However, the net effect of reporting frequency is ambiguous. On the one hand, earnings are being impounded into prices more rapidly for companies reporting on a quarterly basis. On the other hand, the timeliness of

[58] The price change in response to a $1 change in the earnings position reflects not only the foregoing change but also the value of the discounted present value of the revised expectations of the future earnings position.

[59] See Kormendi & Lipe (1987) and Easton & Zmijewski (1989).

[60] See Easton & Zmijewski (1989).

[61] See Collins & Kothari (1989).

[62] See Chang (1998) and Lev & Zarowin (1999).

earnings over a long horizon is mixed. Semi-annual and annual earnings seem to have a greater impact on the long-term price position of the company.

Some evidence suggests that increased disclosure may indeed "hype" the stock prices rather than decrease information asymmetry.[63] Companies that increased the level and detail of disclosure around seasoned equity offerings enjoyed both an abnormal price increase before the offering and suffered an abnormal price decline at the offering announcement at a larger scale vs. companies that followed a consistent level of disclosure. The market appears to interpret increased disclosure as "hype."

By not acknowledging the impact of the business environment on information needs on the one hand, and by not differentiating among different industrial characteristics, quarterly financial reporting, as it is proposed, cannot mitigate the problems that arise in assessing company-specific opportunities and risks. While for "young" industries it might provide users with valuable information, for mature industries it will reinforce the tendency towards and lead to more "short-termism" in the market.

Quarterly Reporting and Monitoring of Debt vs. Equity

By implicitly pointing to the increased level of debt finance as a percentage of GDP as a systemic shortcoming, the Commission argues that structured and reliable information would increase market efficiency and competition through efficient and competitive capital allocation.[64] Moreover, the Commission believes that quarterly reporting offers increased monitoring of corporate debt: "were this [enhanced stock performance] the only argument in favour, it would point towards leaving companies to do so on a voluntary basis…[through mandatory quarterly reporting] investors are likely to monitor publicly traded companies' debt more closely."[65] Thus, seemingly increased monitoring of corporate debt is a crucial factor in choosing between voluntary and mandatory quarterly reporting options.

Capital structure in general and capital structure transactions in particular have important implications for the stock performance. They have significant signalling properties. Though the theory predicts that more profitable firms have incentives and ability to maintain higher levels of debt in order to signal their value, it has been documented empirically that there is indeed a negative relationship between financial leverage and profitability.[66] This might be associated with the fact that firms take the opportunity to issue equity in times of enhanced profitability.

The empirical evidence also suggests that there is a positive relationship between the level of leverage and stock price volatility. Increasing (decreasing) leverage leads to upward (downward) price movements. This relationship has been confirmed for four major types of leverage changing transactions: exchange offers (including swaps), conversion of bonds to equity, share repurchases, and seasoned equity offerings.[67] Moreover, while assessing the association between the expected cost of equity and the frequency of financial reporting, it is documented for a large representative sample of US firms that unlike semi-annual and annual

[63] See Lang & Lundholm (2000).

[64] However, the assertion that holding equity capital is a cheaper and more competitive source of capital allocation is at best questionable and at worst unsubstantiated.

[65] See the *Explanatory Memorandum*, p. 14.

[66] See Rajan & Zingales (1995).

[67] See Copeland & Lee (1991), Campbell et al. (1991), Lakonishok & Vermaelen (1990) and Lang & Lundholm (2000).

reporting, quarterly reporting increases the cost of equity capital. This increase can be attributed to increased price volatility.[68]

Against this background, if also enhanced monitoring of corporate debt is an aim, one should reasonably expect that quarterly reporting must first of all be directed towards the information needs of creditors and contain more stringent quarterly disclosure requirements for corporate debt. Timely and detailed disclosure in general, and quarterly reporting in particular can offer enhanced assessment of default risk given relatively short term nature of debt. By offering enhanced assessment of default risk, quarterly reporting thus offers reduced uncertainty and enhanced decision-making. For a large number of the US firms, it has been found that this can lead to a lower cost of capital.[69]

Paradoxically, the issuers of debt are not subjected to mandatory quarterly reporting requirements, whereas issuers of equity are. Hence it is unclear why the proposal mandates quarterly reporting in general and how increased monitoring of corporate debt can be achieved.

Quarterly Reporting, Decision-Making and Investors' Biases

The Commission implicitly assumes that an increased incidence of disclosure coupled with the Efficient Capital Market hypothesis will allow smart money to find its way and reveal fair prices at which investors will be willing to transact.[70] Under this hypothesis, competition for funding among rational profit-maximising issuers causes instantaneous and rational reflection of all available information in stock prices, and stock prices thereby fully reflect public information in its entirety. Under the rational investor hypothesis, investors perfectly incorporate information into their decision-making. Thus, by increasing the frequency of information disclosure, the EC hopes that quarterly data will be instantaneously and more accurately impounded into stock prices leading to enhanced investor confidence and market liquidity.

However, the very concept of the Efficient Market Hypothesis makes the idea of statutory disclosure regulation at best unnecessary and at worst wasteful. The presence (or absence) of legal sanctions simply affects the prices that investors are willing to transact. For a given level of risk, investors will adjust their rate of return. If companies fail to commit themselves to an adequate level of truthful disclosure, they will either pay high risk-premia or be unable to sell their securities at all.

Numerous studies have significantly challenged the Efficient Market Hypothesis and argued on the basis of reasonable irrationality.[71] In general, different investors have different needs and preferences. These needs and preferences are formulated upon investors' perceptions of the market and its trends. In the same way that markets are characterised by systemic and non-systemic risk, so too is an investor's decision-making. Decisions are affected by both systemic and non-systemic biases that drive needs and preferences for liquidity and profit maximisation. Not only do investors use biased or flawed heuristics that might prevent them from rationally incorporating an increased level of information into their decision-making, the regulator itself is also not immune to behavioural and judgmental biases.

[68] See Botosan (1997).

[69] See Sengupta (1998).

[70] See Fama (1970, 1965 and 1991) and Campbell (2000).

[71] See Shiller (1989), Langevoort (1992 and forthcoming), Jensen (1978), Stiglitz (1981), Rosenthal & Young (1990), Froot & Debora (1999), Fama & French (1993), Ball & and Brown (1968), Chan et al. (1996), Fama (1998), Wurgler & Zhuravskaya (1999) and Shleifer (2000).

Investors' Biases

In general, business reporting affects investors' decision-making by affecting their decision-making heuristics and market perceptions or simply by channelling their biases. Heuristics (shortcuts) refer to the process by which investors search for and discover price-sensitive information. It comprises a subjective judgmental process, information gathering methods, information-processing and decision-making strategies. Biases refer to behavioural and judgmental elements (errors) of investor heuristics.

As the frequency of business reporting increases, the nature and magnitude of investors' decision-making biases and heuristics are adversely affected. We believe that quarterly reporting further aggravates the problem of developing representative heuristics for investors' decision-making by making them even more biased or erroneous.

<u>Causality Bias.</u>[72] The causality bias leads investors to assume that there are always explanations for random but seemingly patterned events that have effects of similar magnitude. It might lead investors to make causal attributions without any foundation. If no pattern is apparent, then it is a lack of understanding rather than a random phenomenon.

In line with Lee & Andersen (1986), one can argue that investors' initial hypothesis might be retained even when the initial information (evidence) of causality is fully discredited.[73] At any point of time, any stock performance estimate based on highly volatile quarterly data might persist despite the fact that such data might be very short-term and transitory in nature. This is due to the fact that quarterly data are filtered and processed in a manner that is consistent with the initial causal attribution and decision-making model. Any resulting causal evidence will serve as additional confirmation for the initial model, while discomfiting evidence will be neglected. Hence, quarterly data can lead to higher stock price volatility.

<u>Anchoring and Adjustment Bias.</u>[74] The anchoring and adjustment bias occurs when investors form different expectations of stock prices based on different starting values and partially adjust some of these values to achieve some final estimates.

Because investors adjust their evaluation of stock prices on the basis of subjective adjustments up and down, quarterly data at a minimum might be impounded into prices with a delay and at most might be neglected. For example, investors with loss aversion will continue holding a losing position with or without quarterly data hoping for future recovery. Moreover, if for some reason an investor's initial stock estimates became 'biased', then quarterly reporting would lead to increasing robustness of the anchoring effects and would plague the investor's decision-making rather than correcting it from flawed heuristics. Hence, quarterly reporting can lead to higher stock price volatility in connection with the anchoring and adjustment bias.

<u>Confirmation Bias.</u>[75] The confirmation bias makes investors search for information and situations that confirm their initial impressions, preferences and decisions. After formulating and constructing a hypothesis, investors tend to overemphasise the role of confirming information and disregard the evidence of refuting information.

Quarterly data may lead investors to rationalise their investment decisions no matter how poor they perform by blaming situational factors such as chance rather then innately flawed decision-making heuristics, and extolling dispositional factors such as their own investment knowledge

[72] See Kelley (1973).

[73] For more detailed discussion on entity effects, see Lee & Anderson (1986).

[74] See Tversky & Kahneman (1974).

[75] See Lord & Lepper (1979).

and experience for success.[76] In line with Rabin (1998), one can argue that some investors will disregard dissonance effects and misread the same piece of evidence in such a way to confirm their initial beliefs.[77] Instead of looking into any actual relationship between variables, investors would be prompted to act on their preconceived knowledge of existing relationships. Hence, quarterly reporting can prompt higher stock price volatility by reinforcing the confirmation bias.

Overconfidence Bias.[78] The overconfidence bias makes investors put excessive weight on their investment abilities (even when they are faced with evidence to the contrary) and on an efficient investor protection system. This bias operates in tandem with confirmation bias insofar as when information confirms the validity of initial actions, it is then attributed to investment skills, whereas information that is inconsistent with initial actions is attributed to unfavourable exogenous factors.[79]

Hence, quarterly reporting might lead investors to discount both the systemic risk by overestimating its protective capacity and self-specific risk by overstating personal investment skills.[80] This might indeed prove to be a significant source of stock price volatility.

Availability Bias.[81] The availability bias makes investors rely on the availability of current information to estimate the frequency and probability of price movements. It might lead decision-makers to place undue weight on recent and readily available information by underestimating low-probability, high-magnitude risk events. Immediately after such an event, the probability of future loss is highly overestimated (as in the case of Enron).

By overestimating problems of recent corporate failures and mandating quarterly reporting as an interventionist tool, the EC risks leading investors to attribute too much weight to currently available information. Basing probabilistic judgments and decision-making on information made available by quarterly data will result in exaggerated probability estimates of future corporate failures or successes and lead to excess volatility.

Hindsight bias.[82] When investors exercise hindsight, they take their current state of knowledge and compare it with that of the previous period. Faced with ex-post certainty of the outcome of a past event, they usually construct a hypothesis that they would have allowed them to foresee the course of events and adequate actions, after learning the outcome. This generally makes them think and believe that events seem more comprehensible and predictable given the post-event certainty.

Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks. Under a given set of circumstances, the management can make only reasonable decisions. The quarterly reporting system can induce investors to overestimate their own ex-ante estimations of stock performance and managerial actions only after price shocks occur (they see the best decision-making in hindsight). Hence, it might fail to distinguish between bad decisions and reasonable decisions that turned out badly. Managers can always be blamed for a wrong

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[76] See Langevoort (1996).

[77] See Rabin (1998).

[78] See Prentice (2002), De Bondt and Thaler (1994, 1985 and 1990), Odean (1998), De Bondt (1992), Weinstein (1989), Klein (1990) and Abarbanell (1991).

[79] This stems from what is generally known as Attribution Theory in psychology. For detailed analysis of the latter, see e.g. Bem (1965) and Langevoort (1996). See also the concept of self-fulfilling prophecy of Jennings et al. (1982).

[80] Barber & Odean (2000), De Bondt & Thaler (1995), Chan et al. (2000), Daniel et al. (1998), Shleifer & Vishny (1988) and Bikhchandani & Sharma (2000).

[81] See Tversky & Kahneman (1974).

[82] See Tversky & Kahneman (1971) and Fischhoff (1975 and 1976).

course of action or a poor decision-making. As a result, one can expect increased litigation, which can be a source of higher stock volatility.

Quarterly Reporting and Its Costs

Mandating more disclosure is associated with more costs, which are associated with higher development, dissemination, litigation, and proprietary (competitive disadvantage) costs. Given the quarterly disclosure requirements as they are proposed, it can be expected that they will not induce a higher magnitude of development and dissemination costs. However, one might expect higher litigation costs especially for alleged misleading disclosure. These costs are not only the material costs related to the costs of judicial settlement but also the costs associated with a damaged public image. One can debate the overall effect of quarterly reporting on litigation costs and its possible impairment of the company's ability to raise external finance. Nevertheless, litigation costs cannot be underestimated.

There might be higher proprietary costs, if the management should disclose strategic financial and operational plans and strategies contingent upon different plans, detailed action plans, assessments of different categories of associated risks, their financial impact, product, and market development intentions, etc. In so far as quarterly reporting does not require mandatory disclosure of high-level financial and operating data on the one hand, and forward-looking management prospects on future events and activities with associated financial outcomes and risks on the other, quarterly reporting cannot significantly harm the company's long-run competitive position.

Summary Remarks on Quarterly Reporting

Quarterly reporting as proposed has little value-added in terms of relevance and reliability of financial information that would facilitate more informed decision-making. It offers a unified frame for quarterly disclosure that does not meet the information needs of different categories of investors and creditors nor does it take into consideration the factual nature of the business and its environment.

By not requiring disclosure of non-financial information on the one hand, and leaving the provision of forward-looking information and audit to the discretion of the management, it is hard to believe that the quarterly reporting can achieve the benefits of allocative and distributive efficiency at the level of individual investors, companies, aggregate economy and the society as a whole.

Quarterly reporting might create and channel decision-making biases on the side of investors. The evidence suggests that quarterly reporting does not seem to be significant for enhanced stock performance. Moreover, it might lead to price volatility and induce the "earnings management game".

Given the relatively short-term nature of debt, quarterly reporting indeed can offer enhanced assessments of default risks as seemingly promulgated to be a critical factor in mandating quarterly reporting. However, the proposed directive cannot achieve increased monitoring of corporate debt simply because there are no quarterly reporting requirements for debt issuers.

Quarterly reporting as it is proposed does not involve a higher magnitude of development and dissemination costs. It does not involve a higher level of litigation and proprietary costs either. But it also does not offer much in terms of increased relevance and reliability of disclosed financial information.

What is next?

In light of the above issues, one might naturally ask *what is next?* Among other things, it has been argued that investors are subject to biases of different scope and magnitude. Their investment decisions are influenced not only by their own evaluation of situation-specific data but also by wider situation-specific determinants. Given the bounded heuristics that they develop on the one hand and information incompleteness and asymmetry on the other, institutions will emerge to improve on poor decision-making. However, the same institutions are susceptible to a myriad of biases of different scope and magnitude and cannot eliminate information incompleteness and asymmetry.

This might apparently suggest that the regulatory intervention through increased disclosure might correct these biases by imposing coherence through standardisation of patterns. The latter might facilitate better signalling and causal attribution. However, the regulator itself is affected by its own behavioural and judgmental biases, although the magnitude differs. While evolution and adaptation of biases within private institutions are subject to market monitoring and competition in so far as they minimise the cost of biases on organisational performance, the Commission does not face any market constraints in its law-making enterprise. Consequently, biases within the regulator may persist and are prone to a higher level of self-propagation even though it might be very inefficient.

Given the prevalence of investors' biases, institutions and the regulator on the one hand and the impossibility of bias measurement on the other, the issue is how to address these behavioural biases and what the regulatory response should be. Biases emerge, diffuse and disappear. While their emergence and distribution might be a matter of chance, their survival is subject to their competitive performance vis-à-vis the market. The latter not only drives their adaptation but also their evolution at any point in time.

We argue that promoting cross-country competitive disclosure regulation among national regulators and exchanges along with regulatory oversight is an efficient step forward rather than mandating it. By promoting more competitive disclosure regimes in national jurisdictions, the regulator will substantially decrease the impact of its own and "local regulatory biases" on corporate performance. In so far as jurisdictional competition in disclosure regulation leads to value-increasing regulation for issuers and investors, it is straightforward that the competitive regulator is better positioned to mitigate and reconcile effects of different biases as compared to the "one size fits all" disclosure approach. Issuers and investors will "migrate" from jurisdictions and exchanges that are hesitant to tie the efficiency of their own biases to the needs of the markets.

In an effort to maximise their profits, securities exchanges themselves can set their own disclosure-related standards (see DAX and Stockholm Stock Exchange) and minimise the impact of their own biases on strategic interactions between companies and investors. Because the very existence of securities exchanges depends on minimising their own behavioural biases, they are likely to recover quickly from flawed heuristics, overconfidence and confirmation biases in setting their listing and disclosure standards. Increasing regulatory alternatives in disclosure regimes through securities exchanges will increase the market efficiency by facilitating convergence of biases of similar scope and magnitude.

Exchanges might also have more accurate expertise in dealing with the scope and magnitude of behavioural biases vis-à-vis the regulators. Thus, the regulators might take a secondary position of monitoring the regulatory competition and subsequent investor-related protection. The latter will not only diminish unjustified protectionism but also substantially lessen regulators' behavioural biases. This will identify potential problems more quickly, facilitate a more flexible disclosure regime and avoid regulatory "lock-in" effects.

If, indeed, the Commission decides to go for quarterly reporting requirements for whatever reason, then it should require more rigorous information to be disclosed. At the same time, a more comprehensive quarterly reporting (Level 1) should provide users and companies with a menu of reporting options at the level of implementation (Level 2 and 3) depending on the nature of the business and information needs of users. Because both the information needs of users vary and because there are different costs of disclosure, quarterly reporting should be customised to meet both needs and cost constraints in particular circumstances. The Commission should nevertheless carefully reconsider the costs and benefits of imposing such a disclosure regime.

CHAPTER 5

GENERAL CONCLUSIONS

Disclosure is functioning in a complex context of regulation and self-regulation and in an environment that must leave room for checks and balances. In the academic literature on the subject, a wide consensus exists that disclosure can help to overcome information asymmetries, mitigate incentive problems and facilitate decision-making. But the validity of many results of capital market effects of disclosure depends on the potential endogeneity: to what extent is increased disclosure associated with improved performance. Given this complexity, it is very difficult to isolate the precise nature of disclosure and assess the magnitude of its capital market effects. Consequently, these effects might be driven by company performance rather than disclosure per se. However, one thing is clear from this research: the problem of residual information is important, regardless of whether disclosure regulation is enforced by contracts, regulation or self-regulation. There is also a general consensus that some degree of disclosure should be mandated, but there should be enough scope for market-driven adjustments.

The EU is well advanced in reshaping the regulatory structure for securities market. From a disclosure perspective, it essentially concerns three directives [the prospectus, market abuse and (draft) transparency directives] and the International Accounting Standards regulation. Although the new framework still has to face its first tests, several questions could be raised from a regulatory and supervisory perspective.

There is first of all the use of maximum harmonisation in the prospectus directive. From an EU perspective, the reason is to make absolutely sure that the single licence functions, and that member states cannot impose additional requirements. This could be understandable, keeping in mind the problems with the old regulatory framework. However, maximum harmonisation excludes regulatory competition and market-driven adjustments, which seems difficult to defend from an EU single market and disclosure perspective. The draft transparency directive, on the other hand, will allow member states to set more stringent disclosure requirements, which raises the question how both regimes will interact. Annual updating of financial information, which is required under the prospectus directive, is an element of periodic reporting, and will thus also fall under the transparency directive.

Secondly, there is the question of the desirability of mandatory quarterly reporting. In the context of the wide differences in ad-hoc reporting in the EU, quarterly reporting may be a useful step to increase disclosure by listed companies. But mandatory quarterly reporting requirements as proposed may not change much for companies and investors, apart from increasing the costs and burdens.

Instead, promoting more competitive disclosure regulation among national regulators and stock exchanges is the right step forward. This will meet diverse preferences of disclosure standards, facilitate investor and issuer choice as well as promote a more competitive framework for the emergence and diffusion of best disclosure practices. Some decentralisation of disclosure regulation will subject the very existence of regulatory agencies and exchanges to market discipline and constrain their rent-seeking behaviour in setting their disclosure standards. The EU should leave some regulatory power in the hands of the local regulators and stock exchanges by retaining the authority to suppress anti-competitive practices.

If the EU opts for quarterly reporting, then it should go for full and comprehensive quarterly reporting, giving a menu of options at the level of implementation, and include debt issuers in this requirement. However, the Commission should carefully assess the costs and benefits of such a move.

On the supervisory side, the Commission has taken the right steps to arrive at a more consistent framework, by proposing to split admission to listing from admission to trading and by requiring member states to establish independent authorities to look after admission to listing, regular disclosure and insider trading. Seen in combination with the new structure for supervisory cooperation, as proposed in the Lamfalussy report, this should allow for easier cross-border cooperation and better enforcement.

A structure for good enforcement of IAS is not in place, however, where provisions for implementation by the member states are not harmonised, or sometimes are even non-existent, which raises the question how CESR will be in a position to perform its role. As events in the US have shown, stringent accounting standards alone do not prevent fraud. The framework for enforcement, as well as other elements of the corporate governance framework matter. The EU will need to consider more harmonisation regarding the structure of enforcement of accounting standards at national level, or probably even a pan-European accounting oversight board.

A final point that demands policy attention is the mechanics of disclosure. Dissemination systems are not harmonised by the draft transparency directive. One may wonder whether dissemination will effectively function if it continues to be organised on such a disparate basis across member states, or whether markets will adjust in time. It is useful that the EU formally accepts websites as a means of disclosure, but this is probably not sufficient. Some structure to allow for active dissemination of corporate news at European level may be required.

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ANNEX 1

COMPENDIUM OF EU SECURITIES MARKETS DIRECTIVES

The first wave of directives

- **Stock exchange admission**: Council directive of 79/279/EEC coordinating the conditions for the admission of securities to official stock exchange listing, OJ L 66 of 16.3.1979.
- **Stock exchange listing particulars:** Council Directive 87/345 of 22 June 1987 amending Directive 80/390 co-ordinating the requirement for the drawing-up, scrutiny, and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing, OJ L 185 of 4.7.1987; Eurolist amendments, Directive 94/18/EC, OJ L 135 of 31.5.1994.
- **Mutual recognition of public-offer prospectuses**: Council Directive 90/211 of 23 April 1990 amending directive 80/390 in respect of the mutual recognition of public-offer prospectuses as stock exchange listing particulars, OJ L 112 of 3.5.1990.
- **Prospectus directive**: Council Directive 89/298 co-ordinating the requirements for the drawing-up, scrutiny and distribution for the prospectus to be published when securities are offered to the public, OJ L 124 of 5.5.1989.
- **Codified listing admission directive:** Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on the information to be published on those securities, OJ L 184 of 6.7.2001 (Codifies the provisions of all the directives listed before).
- **Insider trading**: Council directive 89/592 coordinating regulations on insider dealing, OJ L 334 of 18.11.1989.
- **Investment services directive**: Council Directive 93/6 of 10 May 1993 on investment services in the securities field, OJ L 141 of 11 June 1993.
- **Periodic disclosure:** Council directive 82/121 on information to be published on a regular basis by companies the shares of which have been admitted to official stock exchange listing, OJ L 48 of 20.02.82.
- **Publication of information on major holdings:** Council Directive 88/627 on the information to be published when a major holding in a listed company is acquired or disposed of, OJ L 348 of 17.12.1988.

FSAP directives

- **Prospectus directive**: Directive on the prospectus to be published when securities are offered to the public or admitted to trading and amending directive 2001/34, adopted by the Council on 15 July 2003, awaiting publication in OJ.
- **Market abuse**: Directive 2003/6/EC on insider dealing and market manipulation, OJ L 096 of 12.4.2003.
- **Transparency directive**: Directive of the European Parliament and of the Council on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market and amending directive 2001/34, COM 2003(138) of 26.03.2003.

- **Investment services directive:** Proposal for a directive of the European Parliament and the Council on investment services and regulated markets, and amending Council directives 85/611/EEC and European Parliament and Council Directive 2000/12/EC, COM 2002(0625), OJ C 071 of 25.03.2003.
- **Comitology:** Decisions of 6 June 2001 creating two securities committees – the European Securities Committee (C(2001)1493) and the Committee of European Securities Regulators (C(2001)1501), OJ L 191, 13.7.2001.

Financial reporting directives

- **Fourth Company Law Directive (78/660):** public and private limited companies; presentation and content of annual report and accounts, valuation rules and disclosure, OJ L 222 of 14.8.1978; amended on 8 November 1990, OJ L 317 of 16.11.1990
- **Seventh Company Law Directive (83/349):** consolidated accounts of public or private limited companies, OJ L 193 of 18.7.1983; amended on 8 November 1990, OJ L 317 of 16.11.1990
- **International Accounting Standards (IAS):** Regulation (EC)1606/2002 on the application of IAS for listed companies in the EU, OJ L 243 of 11.9.2002.

ANNEX 2

FREQUENCY OF PERIODIC REPORTING IN THE EU AND SWITZERLAND

B	Annual, semi-annual, quarterly for companies listed in Next Prime and New Economy (Euronext)
CH	Annual, semi-annual, New Market stocks follow quarterly reporting, those listed abroad inform the market about foreign announcements
DK	Annual, semi-annual
DE	Annual, semi-annual; quarterly reports requested by Deutsche Börse for companies listed in the DAX segment and for Neuer Markt
EL	Annual, semi-annual, quarterly
E	Annual, semi-annual, quarterly
F	Annual, semi-annual, quarterly turnover figures
I	Annual, semi-annual, quarterly
IRL	Annual, semi-annual plus preliminary statements
L	Annual plus foreign law provisions from the country where the company is registered
NL	Annual, semi-annual, quarterly for companies listed in Next Prime and New Economy (Euronext)
AU	Annual, quarterly for companies listed in the Official Market
P	Annual: management report, financial information etc. plus a report on corp. governance, Semi-annual: management report, balance sheet, report by a registered auditor, Quarterly report: firm's operations, profit/loss situation, economic financial situation
SF	Annual, semi-annual, quarterly
SW	Annual, semi-annual, quarterly requested by Stockholm Stock Exchange
UK	Annual, semi-annual plus preliminary statements

ANNEX 3

AD-HOC REPORTING REQUIREMENTS

B	Price-sensitive news
CH	All factors likely to materially affect value, provisions for specific situations (e.g. board of directors change)
DK	Price-relevant news, changes in the board of directors, management, auditors, capital structure changes, listings
DE	Ad hoc of any price-sensitive information, changes in percentage of voting rights reaching or passing above/below 5, 10, 25, 50, 75%, directors' dealings (plus family), take-over offers, changes in shareholding during take-over phase, directors' dealings,
EL	Information made public of any new relevant event that may cause a significant fluctuation of the company's share price (decisions on distribution of dividends, launching new shares, distribution, inscription, withdrawal or conversion of shares)
E	Standard price-sensitive information rules
F	Any important price-sensitive event must be publicised immediately by the issuer
I	Standard price-sensitive information rules
IRL	Price-sensitive news that is not publicly known: changes in the company's financial condition, the performance of its business, the company's expectations as to its performance
L	Any major developments within the company's sphere of activity not of public knowledge and potentially price sensitive; due to the increased presence of foreign companies listed on the Luxembourg stock exchange, several provisions for ad-hoc reporting allow foreign law (of the country where the company is registered) to apply as complementary or equal to domestic legislation
NL	Price-sensitive information, changes in share rights
AU	Stock options, buyback programmes, changes in major shareholdings
P	Price-sensitive information not of public knowledge
SF	Standard price-sensitive information rules
SW	Price-sensitive developments not of public knowledge
UK	Companies are required to disclose periodic financial information, price-sensitive information, events such as director dealings, and transactions above a certain size, different disclosure requirements for overseas companies, and specific company types such as property companies and innovative high growth companies

ANNEX 4

DISSEMINATION CHANNELS AND INSTRUMENTS

B	Legal minimum 1 national newspaper and 1 electronic news provider (Belga), issuer via email to press .
CH	Minimum 1 electronic information system, plus firms inform investors via internet.
DK	StockWise, owned & operated by CSE.
DE	Periodic announcements: national newspaper (Pflichtblatt).
	Ad-hoc: publication of specialised press (Börsenpflichtblatt) and/or a newswire service, service provider Deutsche Gesellschaft für Ad-hoc-Publizität forwards the information electronically to vendors and publishes it in its website, dissemination by safe link and fax.
EL	Publication of financial statements and ad-hoc information on 2 national newspapers (1 general, 1 economic) while simultaneously sending the information to the Athens SE to be published in its Daily Official List. Listed companies may choose to publish ongoing information on their or other websites.
E	Companies are required to send information to the Commission Nacional del Mercado de Valores (national securities market authority) to be published on its website. Announcements can be sent via fax and email. Investors receive information also via press releases, companies' distribution lists and websites.
F	BALO (Official bulletin for mandatory announcements) for annual three-monthly and semi-annual reports, release of information via the CMF (Conseil des Marchés Financiers) in its monthly Bulletin Officiel du CMF of potentially privileged conditions over stock sales/purchases between shareholders of the same company, information relating to take-overs (the memorandum of response of the target company) has to be published in an economic newspaper (prior to COB approval), Euronext Paris' website, fax, mailing to authorities (for important and sensitive news), email for others; unless stated it is up to the company how to transmit announcements provided that the addressee agrees.
I	The Borsa must receive material information without delay. Each announcement is channelled through the NIS (regulatory news service) to the exchange. The latter then disseminates the information to Consob, which for its part sends it to two press agencies.
IRL	Companies must notify the CAO (Company Announcements Office) of the exchange over periodic and ad-hoc reporting. The CAO releases these announcements on the RNS (Regulatory News Service), which forwards them to information vendors and/or straight to customers. Those firms registered with the RNS send reports directly to the service.

L	At least one newspaper circulating in Luxembourg, simultaneous dissemination in the Lux. SE in French, German or English.
NL	Press releases are sent to Euronext Amsterdam and the National News Agency (ANP) simultaneously.
AU	Newspaper (nation-wide), electronic information dissemination system in German, e.g. Austria Presseagentur, Bloomberg, Reuers etc.
P	All (material, interim) information should first appear on the regulator's website (CMVM) and then be published in the official bulletin of the exchange; announcements to the CMVM are sent via email, safe connection for electronic posting of information in the near future.
SF	Information is sent to the exchange's main filing office and to central news agencies simultaneously. Companies fill in information in the exchange's special data format when sending electronic announcements. News agencies accept announcements in electronic format.
SW	Minimum 2 news agencies plus 3 national daily Swedish newspapers, via email and fax.
UK	Regulatory Information Services (also known as Primary Information Providers) approved by the FSA disseminate immediately and electronically ad-hoc information to Secondary Information Providers (media firms like Reuters, Bloomberg, etc.).

Annex 5

Glossary of Abbreviations

ARC	Accounting Regulatory Committee
BALO	Bulletin Officiel du CMF
CAO	Company Announcements Office
CESR	Committee of European Securities Regulators
CMF	Conseil des Marchés Financiers
EDGAR	Electronic data-gathering analysis and retrieval system
EFRAG	European Financial Reporting Advisory Group
FASB	Financial Accounting Standards Board
FRRP	Financial Reporting Review Panel
FSAP	Financial Services Action Programme
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
RegFD	Fair Disclosure Regulation
RNS	Regulatory News Service
SEC	Securities and Exchange Commission
SOA	Sarbanes-Oxley Act
SPE	Special Purpose Entities
SROs	Self-Regulatory Organisations

PARTICIPANTS OF THE CEPS TASK FORCE

The report does not reflect a common position of the members of the Task Force. Accordingly, each member of the Task Force does not subscribe to every assessment contained in this report, nor does the report necessarily reflect the views of the respective institutions to which they belong.

Rapporteurs:	Karel Lannoo Chief Executive & Senior Research Fellow CEPS	Arman Khachaturyan Visiting Fellow CEPS

Ludovic Aigrot
Special Adviser
European Affairs
Euronext Brussels

Elisabeth Alteköster
Head of Office
Volkswagen Liaison Office

Rym Ayadi
Research Fellow
CEPS

Floris Boekholt
Euronext Amsterdam

Nicky Brewster
Manager
Primary Markets Developments
London Stock Exchange

David Brown
Economic Officer
Financial and Monetary Affairs
Mission of the United States to the EU

Philip Buttifant
London Stock Exchange

Asuncion Caparros
Vice President
EU Liaison Office
ABN Amro Bank N.V.

Eve Carpentier
Head of Listing Paris
Euronext Paris

Margaret Cazalet
ECON Secretariat
European Parliament

Paul Chisnall
Director
British Bankers' Association

Clifford Dammers
Secretary General
IPMA

Rudi De Ceuster
Director
Business Wire

Simonetta Di Cagno
Head of Representative Office
Assonime

Carmine Di Noia
Chief Economist
Assonime

Kyriakos Gialoglou
Research Fellow
CEPS

Charles Goldfinger
Managing Director
Global Electronic Finance

Karen D. Haarbo
Deputy Financial Inspector
Finanstillsynet

Mary Hustings
IPMA

Gerhard Imbach
Director
Credit Suisse Group

Oliver Kamm
Business Management
Commerzbank Securities

Philippe Lambrechts
Belgian Banking & Financial Commission (CBF)

Mattias Levin
Research Fellow
CEPS

Henry Manisty
Head
Government & Regulatory Affairs
Reuters

Tine Rau Schiott
Listing and company Affairs
Copenhagen Stock Exchange

Donald Ricketts
Consultant
GPC International

Albena Rousseva
European Savings Bank

Sophia Saridou-Zafiropoulou
General Director
Association of Members of the Athens Stock Exchange

Daniel Schwammenthal
Journalist
Dow Jones Newswires

Kleanthi Seimanidi
Lawyer
Association of Members
of the Athens Stock Exchange

Xavier Tessier
Senior Officer
International Department
COB (Commission des Operations de la Bourse)

Clara Thompson
Economic Specialist
Mission of the United States to the EU

Constantinos Tomaras
DG Market
European Commission

Margot van Noordennen
Amsterdam Stock Exchange

Simon Wilkinson
Head of RNS
London Stock Exchange

Georgios S. Zavvos
Member of the Legal Service
European Commission

INVITED GUESTS AND SPEAKERS

Luk Delboo
Euronext Brussels

David Devlin
Partner
PriceWaterhouseCoopers

Hubert Grignon du Moulin
DG Market
European Commission

Mark Hynes
Director
PR Newswire

Ruben Lee
Managing Director
Oxford Finance Group

Joe A. McCahery
Professor
Faculty of Law
Katholieke Universiteit Brabant, KUB,
Tilburg University

Matthias Meitner
International Finance
ZEW

Howard Miller
London Stock Exchange

Jos Peeters
Managing Partner
Capricorne Venture Partners

Philippe Pele
DG Market
European Commission

Jurgen Tiedje
DG Market
European Commission