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CORPORATE GOVERNANCE & TRANSPARENCY

ROLE OF DISCLOSURE:

HOW PREVENT NEW FINANCIAL SCANDALS AND CRIMES?

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CG DEFINITION

Corporate Governance History vis-à-vis Governance Today: An Overview

Corporate governance systems have evolved over centuries, often in response to corporate failures or systemic crises.

The first well-documented failure of governance was the South Sea bubble[1] in the 1700s, which revolutionized business law and practices in England. Similarly, much of the securities laws in the US were put in place following the stock market crash of 1929[2].

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[1] Popular name in England for the speculation in the South Sea Corporation, which failed disastrously in 1720. The corporation was formed in 1711 by Robert Harley, who needed allies to carry through the peace negotiations to end the War of the Spanish Succession. Holders of £9 million worth of government bonds were allowed to exchange their bonds for stock (with 6% interest) in the new corporation, which was given a monopoly of British trade with the islands of the South Seas and South America. The monopoly was based on the expectation of securing extensive trading concessions from Spain in the peace treaty. These concessions barely materialized, however, so that the corporation had a very shaky commercial basis. Nonetheless, it was active financially, and in 1720 it proposed that it should assume responsibility for the entire national debt, again offering its own stock in exchange for government bonds, a transaction on which it expected to make a considerable profit. The government accepted this proposal, and the result was an incredible wave of speculation, which drove the price of the corporation's stock from £1281/2 in Jan., 1720, to £1,000 in August. Many dishonest and imprudent speculative ventures sprang up in imitation. In Sept., 1720, the bubble burst. Banks failed when they could not collect loans on inflated stock, prices of stock fell, thousands were ruined (including many members of the government), and fraud in the South Sea Corporation was exposed. Robert Walpole became first lord of the treasury and chancellor of the exchequer and started a series of measures to restore the credit of the corporation and to reorganize it. The bursting of the bubble, which coincided with the similar collapse of the Mississippi Scheme in France, ended the prevalent belief that prosperity could be achieved through unlimited expansion of credit. Legislation was enacted that forbade unincorporated joint stock enterprise.

[2] In the aftermath of the stock market crash of 1929 and the ensuing economic depression Congress enacted the Securities Act of 1933 ("1933 Act"). It was the first major federal legislation to regulate the sale of securities. Prior to that time, regulation of securities were chiefly governed by state laws (which are commonly referred to as "blue sky" laws). The 1933 Act has two basic objectives: require that investors receive significant (or "material") information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities. Congress intended the law to empower investors, and not the government, to make informed investment decisions. To assist with its objectives of informing potential investors and fair dealing in the market place, the 1933 Act requires issuers to disclose significant information about themselves. Disclosure also has the added benefit of discouraging bad behaviour. Supreme Court Justice Louis Brandeis coined the phrase "sunlight is the best disinfectant," which also is part of the philosophy underlying the 1933 Act. Disclosure of relevant information is accomplished through the registration of securities with the Securities and Exchange Commission ("SEC" or the "Commission"). The SEC is the principle federal agency responsible for oversight of the securities market and enforcement of the federal securities laws. The SEC was created pursuant to the Securities Exchange Act of 1934. The 1934 Act is a more comprehensive statute and regulates the secondary markets and many market participants. Provisions of the 1934 provide for the creation of (i) the Securities and Exchange Commission ("SEC" or the "Commission"); (ii) a system for regulating the markets themselves and those who trade in those markets; (iii) a continuous disclosure system for issuers; and (iv) anti-fraud provisions.

There has been no shortage of other crises, such as the secondary banking crisis of the 1970s in the UK and US savings and loan debacle of 1980s[3]. In addition to crises the history of corporate governance also has been punctuated by a series of well-known corporation failures: the Maxwell Group raid on pension fund of the Mirror Group newspapers, the collapse of Bank of Credit and Commerce International[4] and Barings Bank[5].

Most recently, the financial crisis that began in East Asia, and rapidly spread to Russia, Brazil and other areas of the globe, showed that systematic failure of investor protection mechanisms, combined with weak capital market regulation, leads to failures of confidence that spread from individual firms to entire countries.

Insufficient financial disclosure and capital market regulation, lack of minority shareholder protection, and failure of board and controlling shareholder accountability all

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[3] See Kaminsky, G.L. and C.M. Reinhart, 1999 "The Twin Crises: The Causes of Banking and Balance of Payments Problems," AER, Vol. 89 (June), pages 473-500.

4 The Bank of Credit and Commerce International (BCCI) was a major international bank founded in Pakistan in 1972. At its peak, it operated in 78 countries, had over 400 branches, and claimed assets of $25 billion.

BCCI became the focus in 1991 of the world's worst financial scandal and what was called a "$20-billion-plus heist" (Beaty 1993). It was found by regulators in the United States and United Kingdom to be involved in money laundering, bribery, support of terrorism, arms trafficking, the sale of nuclear technologies, the commission and facilitation of tax evasion, smuggling, illegal immigration, and the illicit purchases of banks and real estate. The bank was found to be worthless, with at least $13 billion unaccounted for. Investigators in the U.S. and UK revealed that BCCI had been organized to avoid centralized regulatory review and to commit fraud on a massive scale, with its own intelligence network, diplomatic corps, and shipping and commodities trading corporations. The liquidators, Deloitte & Touche, filed a lawsuit against Price Waterhouse and Ernst & Young, the bank's auditors, which was settled for $175 million in 1998. A further lawsuit against the emir of Abu Dhabi, a major shareholder, was launched in 1999 for around $400 million. BCCI creditors also instituted a $1 billion suit against the Bank of England as a regulatory body. After a nine-year struggle due to the Bank's statutory immunity, the case went to trial in January 2004.

[5] The Barings Bank had a long and storied history. In 1802, it helped finance the Louisiana Purchase, despite the fact that Britain was at war with France, and the sale had the effect of financing Napoleon's war effort. Later daring efforts in underwriting got the firm into serious trouble following the Brazilian revolution, and the bank had to be rescued by a consortium organized by the governor of the Bank of England, William Lidderdale, in 1890. While recovery from this incident was swift, it destroyed the corporation's former bravado. Its new, restrained manner made it a more appropriate representative of the British establishment, and the corporation established ties with King George V, beginning a close relationship with the British monarchy that would endure until Barings' collapse. The Baring family were appointed to the peerage with the title Baron Revelstoke. The corporation's restraint during this period would cost it its preeminence in the world of finance, but would later pay dividends when its refusal to take a chance on financing Germany's recovery from World War I saved it the painful losses experienced by other British Banks at the onset of the Great Depression.

Barings collapsed on February 26, 1995, due to the activities of one trader, Nick Leeson, who lost $1.4 billion by speculating on the Singapore International Monetary Exchange, primarily using futures contracts. Barings was purchased by the Dutch bank/insurance corporation ING after its collapse for the nominal sum of £1 and assuming all of Barings liabilities and no longer has a separate corporate existence. Its name lives on in Baring Asset Management.

supported lending and investing practices based on relationships rather than on a prudent analysis of risk and reward.

In hindsight, the not-surprising result is that corporations over invested in non-productive and often speculative activities, as we can see in the Enron and Parmalat cases.

Historically, each crisis or major corporate failure, often a result of incompetence, fraud, and abuse, has given new elements of an improved system of corporate governance, as we can see today in the new attention given to these matters.

Through a process of continuous change, developed countries have established a complex mosaic of laws, regulations, institutions, and implementation capacity in the government and in private sector. The objective was not to shackle corporations but rather to balance the spirit of enterprise with an improved liability.

This continuous process of change and adaptation has accelerated with the increasing diversity and complexity of shareholders and stakeholders.

Globalization, too, is forcing many corporations to tap into international financial markets and to face greater competition. During the past decades freedom in all aspects of business activities has increased markedly creating more breathing space for entrepreneurs. Cross-borders business relationships have increased dramatically.

New communication, distribution technologies and the removal of trade and investment barriers, have created truly global markets with global competition for goods, services and capital, and even corporate control. A whole new level of economic interdependence is emerging, as evidenced by the European Union (EU) and the North American Free Trade agreement (NAFTA). Deeper and broader cross-border business relationships between nations signal significant changes to all aspects of society, from culture to labor markets and political focus.

But increased freedom means increased responsibility: corporations must show respect for their shareholders as well as for other stakeholders and indeed society as a whole.

Now the business community needs to show that their corporations are ready to shoulder this increased responsibly. Corporations realize that by building better relations with shareholders, employees, customers, suppliers and the general public, many new avenues of business opportunities will open.

Mutual trust between the public and the business community is a key to improved competitiveness and thus to higher living standards.

An important step to ensure that the business community is trustworthy is to improve practices in relations between shareholders, boards of directors and managing directors.

It is essential that the business community accepts its responsibility and adopts good practice working methods and procedures, which will strengthen the infrastructure of enterprises and increase mutual trust between the general public and enterprises.

During the past few years more than 30 countries, international organizations and business associations have brought forward recommendations for good or appropriate corporate governance so the debate on these matters has been quite extensive.

Corporate Governance: A General Definition

Nowadays, CG is a subject of paramount importance and utmost topicality.

It is *important* because good or bad results are very much dependent on the way governance systems operate. It is *topical* because recent scandals have proved that today's ostensibly 'state-of-the-art' mode of governance is indeed inadequate.

In the section on international principles of CG, we quote and comment on several coded definitions of CG, noting their advantages and critical points, which are of course dependent on the institution that supplies the definition and the major objective which that definition intend to pursue.

A shared definition of CG, which is both valuable and consistent, is not easy to find and CG definitions are often unclear, inconsistent, or partial and subjective.

I assume the following definition:

"The set of criteria and tools necessary to assure steady value creation in continuity and guarantee strategic effectiveness and operational efficiency to an organization, in compliance with the rules."

By *rules* I mean laws and corporation values (whether the underlying group/corporation decide to specify any, and codify and translate them into explicit and practical behaviors to be delivered to every member of the organization). There cannot be other rules than those mentioned above, because morality cannot be legislated. Nonetheless, the process for translating values into practical behavior is long and hard.

This definition extends from groups/corporations to all other private or public institutions, and it relies on the following assumptions:

- The purpose of each group/corporation is steady value creation in continuity;
- Value shall not be confused with price, particularly in this age of extreme volatility of the financial markets;
- The purpose of each institution, public or private, is to pursue its mission in an effective and efficient way in continuity;
- The purpose of each true leader is to let the group/corporation mission be coherent and convergent with human dignity of all stakeholders, commencing

from employees. It is not an easy job. It calls for competence, vision of the future, and power to spread the right culture and observance of rules.

For all these reasons, even a well-conceptualized CG system cannot assure a self-adjusting mechanism.

Professionalism and “virtue” of an effective leader make the difference.

These assumptions, on which any notion of good CG rests, should be considered common to every corporation or institution as well as independent from origin or location.

What differs from one country to another, and from one culture to another, is the way CG principles are specified and fine-tuned in order to fit differences in each context and to better reach the objectives expected in its application.

In this sense, each continent and each culture should “learn from itself.” This means that the starting point of this effort should be to clearly understand the value of what has been achieved so far. It is therefore necessary, as a first step, to understand the critical and successful competitive advantages in which the considered country should develop its uniqueness and its competitiveness.

This is why the point of departure needs to be international practices and shared definitions of CG

Normative and Management dimension

The achievement of an outstanding CG system can today be considered one of the top strategic priorities for corporations, in emerging and “developed” countries alike. This is especially true after recent corporate scandals such as Enron in US or Parmalat in Italy, which have spurred a new need for transparency, disclosure and certainty of rules and behaviors, in order to enhance corporate efficiency and investors’ confidence.

A good governance system is considered to be as fundamental in finding equity and/or debt capital for a start-up business as it is, although more extensively, in maintaining shared standing among different stakeholders. Primarily for these reasons, the discipline of CG has grown significantly during recent years, with the creation of vast amounts of literature on the matter.

Generally, the discipline of CG can be analyzed with regard to two distinct dimensions: normative/statutory; and management/strategic.

The **normative/statutory dimension** is connected to all the legislative acts (codes, laws, regulations, etc.) of CG, while the **management/strategic dimension** is related to the many ways of implementing the legislative acts that should not only be enforced at the corporate level.

The sections below present a synthetic overview of the international definitions of and the main guidelines for the CG discipline, considering them as a framework for both the normative/statutory dimension and the management/strategic dimension.

Corporate Governance: International Definitions

As a discipline, CG covers various aspects. A unique definition of CG is therefore hard to find. It is hence necessary to primarily consider the main aspects it covers, such as the structures, rules and mechanisms through which the decision-making process of a corporation is guided and monitored.

It is commonly recognized that effective governance, with all other socio-economic conditions (competitiveness, innovation, etc.) remaining equal, allows for the achievement of the following main objectives:

A better level of efficiency for both the corporations and the country's economy;

- An increase of the efficiency of the capital market, especially regarding the allocation of economic resources;
- A stronger corporation focus on the relationship between the objectives and the means (in terms of resources) to reach these objectives;
- More attention on part of corporations with regard to the property structure and the optimal methods of monitoring the entrepreneurial and managerial activities; and
- The identification of the most effective incentives for both the board of directors and the management.

Furthermore, different socio-economic and cultural reference models have a relevant influence on CG.

For this reason, it could be useful to consider the main qualifying elements of CG, analyzing how CG is presented by those countries with a more consolidated experience on the matter.

As a first step, the Organization for Economic Cooperation and Development (OECD) defines CG in the following terms:

Corporate Governance is affected by the relationships among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations, acting through a holding corporation or cross shareholdings, can significantly influence corporate behavior. (…) Corporate Governance is only part of the larger economic context in which firms operate, which includes, for examples, macroeconomic policies and the degree of competition in product and factor markets. The Corporate Governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in *which it operates can also have an impact on the reputation and long-term success of a corporation.*[6]

Furthermore, the following statements outline CG as defined by the codes of a number of individual OECD countries:

Australia (Performance Audit Report):

CG refers to the stewardship of an organization in terms of the way it is directed and controlled (…). It is concerned with the respective roles, powers, responsibilities and accountabilities of the boards.

Belgium (Recommendations of the Federation of Belgian Corporations):

CG is the organization of the administration and management of corporations.

Germany (Berlin Initiative Code):

CG describes the legal and factual regulatory framework for managing and supervising a corporation.

Italy (Preda Code):

CG, in the sense of the set of rules according to which firms are managed and controlled, is the result of norms, traditions and patterns of behavior developed by each economic and legal system and is certainly not based on a single model, that can be exported and imitated everywhere.

The Netherlands (Peters Report):

CG means a code of conduct for those associated with the corporation – in particular directors, supervisory board members and investors – consisting of a set of rules for sound management and proper supervision and for division of duties and responsibilities and powers affecting the satisfactory balance of influence of all the stakeholders.

Portugal (Securities Market Commission Recommendations):

CG is used to describe the system of rules and procedures employed in the conduct and control of listed corporations.

United Kingdom (Cadbury Report):

CG is the system by which business corporations are directed and controlled.

[6] OECD, Principles of Corporate Governance, 1999. These principles are available in full-text at www.oecd.org/daf/governance/principles.htm.

United States of America (Business RoundTable Report)

CG is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation.

Considering all these definitions and following an integrated analysis of the same, we can infer the following main elements as qualifying and defining CG:

- CG concerns the methods (structure) through which defining corporation's goals and the methods for reaching these are monitored periodically (OECD – BRT Report);
- CG manages relations among all corporation stakeholders, each within its role, its characteristics and responsibilities, with the objective of realizing a systemic balance (OECD – Peters Report);
- From the two previous bullet points, it can be inferred that CG aims at defining the complex system of roles, responsibilities and power partition (Performance Audit Report);
- In this way, CG describes not only an objective legislative framework (Berlin Initiative Code), but also a more in-depth and radical code of behavior for every stakeholder (Peters Report); and
- Finally, the CG model adopted in each country is the result of a complex system of rules, acts, norms, traditions and procedures of behaviors developed.

OECD Principles: Creation of a Governance Culture

The capacity of developing an effective model of CG is a fundamental requirement for the development of an advanced economic system, which is able to generate transparently and effectively a long-term value, on the microeconomic side (corporation level) as well as on the macroeconomic level (a country's economy).

As a consequence, international organizations place growing attention on the definition and diffusion of CG principles, especially by promoting them in countries with recent involvement in the international competition.

In 1999, on the wave of the Asian crisis, the OECD endorsed a set of principles, standards and guidelines fostering CG at the international level. Today, this set of principles, revised in 2004, is considered to be the basic framework for a CG discipline.

The OECD report on "Principles of Corporate Governance" has the following objectives:

- To support governments in their process of creation and evaluation of the institutional, statutory and legal framework of CG; and
- To provide guidelines and suggestions to stock-exchanges, institutional investors, corporations, and all other actors participating in the development process of a "good governance culture".

The implementation of the OECD principles mainly refers to listed corporations, in order to ensure the necessary protection of stockholders' interests. Nevertheless, on specific OECD recommendation, the principles should represent a useful tool for ameliorating the governance of all types of corporations, private and public.

The OECD Principles:

- Reflect the broad consensus reached by the 29 OECD member nations with regard to fundamental issues of corporate governance.
- Represent the first inter-governmental accord on the common elements of effective corporate governance.
- Provide significant room to take into account national differences, including differing legal and market frameworks, traditions and cultures.

The OECD Principles build on the four core standards set out in the Millstein Report: fairness, transparency, accountability and responsibility.

Fairness. The OECD Principles expand on the concept of fairness with two separate principles:

- *The Corporate governance framework should protect shareholders' rights (OECD Principle I).*
- *The Corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights (OECD Principle II).*

This Principle recognizes that shareholders are property owners, and as owners of a legally recognized and divisible share of a corporation, they have the right to hold or convey their interest in the corporation. Effective corporate governance depends on laws, procedures and common practices that protect this property right and ensure secure methods of ownership, registration and free transferability of shares.

The Principle also recognizes that shareholders have certain participatory rights on key corporate decisions, such as the election of directors and the approval of major mergers or acquisitions. Governance issues relevant to these participatory rights concern voting procedures in the selection of directors, use of proxies for voting, and shareholders' ability to make proposals at shareholders meeting and to call extraordinary shareholders meetings.

According to Principle II, the legal framework should include laws that protect the rights of minority shareholders against misappropriation of assets or self-dealing by controlling shareholders, managers or directors.

Examples include:

- Rules that regulate transactions by corporate insiders and impose fiduciary obligations on directors, managers and controlling shareholders.
- Mechanisms to enforce those rules (for example, the ability of shareholders to bring a claim on behalf of the corporation in certain circumstances).

Transparency. *The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the corporation (OECD Principle IV).*

This Principle recognizes that investors and shareholders need information about the performance of the corporation (its financial and operating results), as well as information about corporate objectives and material foreseeable risk factors to monitor their investment. Financial information prepared in accordance with high-quality standards of accounting and auditing should be subject to an annual audit by an independent auditor.

This provides an important check on the quality of accounting and reporting. In practice, accounting standards continue to vary widely around the world. Internationally prescribed accounting standards that promote uniform disclosure would enable comparability, and assist investors and analysts in comparing corporate performance and making decisions based on the relative merits.

Information about the corporation's governance, such as share ownership and voting rights, the identity of board members and key executives, and executive compensation, is also important to potential investors and shareholders and a critical component of transparency.

Accountability. *The corporate governance framework should ensure the strategic guidance of the corporation, the effective monitoring of management by the board, and the board's accountability to the corporation and the shareholders(OECD Principle V).*

This Principle implies a legal duty on the part of directors to the corporation and its shareholders. As elected representatives of the shareholders, directors are generally held to be in a fiduciary relationship to shareholders and to the corporation, and have duties of loyalty and care that require that they avoid self-interest in their decisions and act diligently and on a fully-informed basis.

Generally, each director is a fiduciary for the entire body of shareholders and does not report to a particular constituency. As the board is charged with monitoring the professional managers to whom the discretionary operational role has been delegated, it must be sufficiently distinct from management to be capable of objectively evaluating them.

Responsibility. *The corporate governance framework should recognize the rights of stakeholders as established bylaw and encourage active co-operation between* *corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises(OECD Principle III).*

This Principle recognizes that corporations must abide by the laws and regulations of the countries in which they operate, but that every country must decide for itself the values it wishes to express in law and the corporate citizenship requirements it wishes to impose.

As with good citizenship generally, however, law and regulation impose only minimal expectations as to conduct. Outside of the law and regulations, corporations should be encouraged to act responsibly and ethically, with special consideration of the interests of stakeholders and, in particular, employees.

CG FRAMEWORK

Different needs – Different systems

Different governance systems articulate the corporate objective in different ways, depending on which of two primary concerns is taken as the main focus:

- Societal expectations.
- Ownership rights.

Some nations focus on the need to satisfy societal expectations and, in particular, the interests of employees and other stakeholders (variously defined to include suppliers, creditors, tax authorities and the communities in which corporations operate).

This view predominates in continental Europe (particularly Germany, France and the Netherlands) and in certain countries in Asia.

Other countries emphasize the primacy of ownership and property rights, and focus the corporate objective on returning a profit to shareholders over the long term. Under this view, employees, suppliers and other creditors have contractual claims on the corporation. As owners with property rights, shareholders have a claim to whatever is left after all contractual claimants have been paid. This "residual" right is given weight by corporations focusing the corporate objective on shareholder value.

Most often associated with the US, Canada, the UK and Australia, this view of the corporate governance objective is generally justified on the following grounds:

- Accountability to shareholders provides a single measurable objective that avoids the risk of diffusing the accountability of managers and directors. If managers and directors are accountable to a whole range of stakeholders, almost any action can be justified as in the interest of some group of stakeholders, and this gives managers and directors unfettered discretion.
- Focusing on long-term shareholder value encourages investment capital to be put to the most efficient economic used from a market perspective and this should benefit society broadly. In advising clients on how to reconcile the two approaches, in-house counsel should bear in mind that, although much ideological debate has arisen about which of the two descriptions of the corporate objective should prevail, as a practical matter the two concepts do not present inherent conflicts (except when posed in the extreme).

Generally, viewed in the long term, stakeholder and shareholder interests are not mutually exclusive. Corporations do not succeed by consistently neglecting the expectations of employees, customers, suppliers, creditors, and local communities, but neither do corporations attract necessary capital from equity markets if they fail to meet shareholders' expectations of a competitive return. In the extreme situations in which the short-term interests of various stakeholders collide, a clear understanding of who legal duties are owed to assists boards and managers to take necessary, timely, but difficult actions.

Corporate Governance Models in Developed Countries

There is no one-size-fits-all blueprint for CG. Several models of GC have evolved that highlight the relative weight given to shareholder value or protection of stakeholder rights.

Most notable are the *US*, *UK*, *German* and *Japanese* systems.

The US and UK models are often described as based on outside control and widespread ownership. Shareholder rights are relatively secure, and shareholders increasingly include institutional investors such as pension funds. There is one board per corporation, and directors are often drawn from outside of corporate management. Banks play no direct role on boards but are influential in their role as creditors. In the United States and in United Kingdom, the board members' legal duties to the corporation are delineated by law.

The German model relies on a two tier board of directors, one executive and one supervisory, which includes representatives from labor. This is an insider model in which shareholders, banks and representatives from labor appoint those who will monitor management.

The Japanese model of one board per corporation also emphasizes insiders. The board normally includes representative of management. Such insiders as suppliers, customers, and main banks exercise informal influence through extensive cross-holdings.

In *Italian model*, (after the reform of corporation law in 2001), three new governance structures are now available: one reflecting the structure presently in force, which consists of a board of directors and a board of statutory auditors (in addition to external auditors auditing the corporation's accounts); another reflecting the German two-tier structure, however adapted to the Italian context; and a third one inspired by the Anglo-Saxon unitary board, with a majority of independent directors and a mandatory audit committee. The possibility to choose between these three different systems is intended as a substitute to regulatory competition, as the choice, for example, of the unitary board might work functionally as a (partial) equivalent to the choice of U.K. Law.

Despite their differences these models operate in the same basic external environment, that of a well regulated system, and all have common internal elements.

Globalization has made it especially important to harmonize the main aspects of corporate governance to reduce the risks and transactional costs in international capital markets.

Thus, while there may be many models and no fixed blueprint, there are commonly agreed elements of framework for corporate governance.

Corporate Governance and Developing Countries

The market-based model, like the US model of corporate governance, is not feasible for developing countries.

First, developing countries lack most of the formal and informal institutions that make workable a market-based corporate governance system characterized by an enabling corporate law with few mandatory shareholder protections. Put simply, developing countries lack the advanced markets that are essential for a market-based governance system to work.

Indeed, the whole point of ongoing corporate governance reform efforts is to create securities markets. Developing economies also lack important second-order institutions (e.g., experienced investment bankers, lawyers, securities analysts, accountants, money managers) that enable markets to monitor.

In fact, there might be few experienced managers to run corporations, a fact that challenges a basic presupposition that it is efficient for ownership and control to separate with dispersed shareholders hiring expert managers.

Perhaps the single most important institution in the U.S. system is the Delaware judiciary. Developing countries often lack an effective judicial system, let alone a highly regarded expert judiciary like the Delaware courts. More fundamentally, judges in civil law countries may be reluctant to exercise the kind of discretion required to apply fiduciary duties. The law of fiduciary duties is ineffectual if judges are not willing to exercise their discretion or if judges are not respected enough for their decisions to have legitimacy.

Second, private ordering is not easy. One cannot simply turn an economy loose and instruct the parties to organize their affairs as they see fit, even if the formal corporate law provides a general governance framework. Rather, successful private ordering depends on a variety of important preconditions that, for the most part, do not exist in developing economies.

The parties need to know how to organize a corporation’s internal affairs, how to implement a governance structure, and how to evaluate various governance practices. The parties need a textured understanding of the issues as well as insight into what a reasonable allocation of rights, duties, and risks might be for a particular corporation given its management team, financing needs, operating history, financial condition, future prospects, and capital structure.

Formal training is not enough. Bankers, lawyers, investors, and other market players need the kind of sophistication and experience that only come from on-the-job training. In a market-based system, it is important that market actors draw from a similar set of experiences and a shared mental model of business dealings and corporate governance because this reduces transaction costs by ensuring that everybody is “on the same page” with common understandings and similar expectations.

Third, for a model of corporate governance that depends on relatively few legal mandates to work well, the future has to matter. That is, the long-term payoff for insiders of cooperating and refraining from exploiting shareholders must exceed the short-term payoff insiders receive when they act opportunistically.

The future matters more when a person expects to engage in a series of repeated transactions for which his reputation for cooperation and honest dealing is essential. The social, political, and economic instability found in many developing countries means that future prospects are heavily discounted and are worth less than the immediate benefits of shirking, looting, self-dealing, and other disloyal behavior. Further, it is hard for those who are "cooperators" to commit credibly by contract or otherwise to cooperate if courts and other enforcement institutions are not well-established.

The challenge for these countries is to adapt systems of corporate governance to their own corporate structures and implementation capacities, public and private, to create a culture of enforcement and compliance. They need to do so in a manner that is credible and well understood both internationally and cross borders and they need to do it far more quickly than did developed countries before them.

Corporate Governance: Other Key Issues

Identification of effective CG criteria means to focus the attention on the very essential needs of corporation, with the aim to improve his functions.

Every corporation is asked to manage several potential conflicts of interest, while keeping in mind that its mission is to create value, in full compliance with rules (laws and corporation values, where present).

Therefore, it is necessary to:

- Identify potential conflicts of interest;
- Identify those which are relevant; and
- Draw practical, applicable policies for each conflict of interest.

In short, a solid corporate charter is built on three pillars:

- Legislative/rules;
- Ethical/behavior; and
- Strategic/management.

An efficient CG system builds on these three corporate charter pillars and must assure optimal solutions to the following matters:

- Ownership structure and shareholders agreements
- Corporate structure
- Top management structure

- Mission.
- Values: definition and application.
- Business definition criteria and strategic structure.
- Vision of the future and related objectives.
- Criteria for the measurement of corporation value and its conversion into objectives and responsibilities.
- Strategic planning system (phases, timing, responsibilities and processes)
- Macrostructure (people – key positions) at the group level and for each legal entity, providing appropriate allocation of responsibilities.
- Criteria for defining roles and responsibilities/target parameters, compensation and rewarding system.
- Strategic control, managerial control and operating control (it also includes information/reporting system).
- Mechanisms for integration, coordination and optimization; committees, regular meetings (e.g. management committees), and critical processes.
- Policies concerning key resources:
- Policies concerning key operating functions:.
- Policies concerning cross factors:
- Policies concerning relevant conflicts of interest

Effective Corporate Governance results

No matter what view of the corporate objective is taken, effective governance ensures that boards and managers are accountable for pursuing it.

The role of corporate governance in making sure that board and management are accountable is of broad importance to society for a number of reasons.

In fact, effective corporate governance:

- Promotes the efficient use of resources both within the corporation and the larger economy. Debt and equity capital should flow to those corporations capable of investing it in the most efficient manner for the production of goods and services most in demand, and with the highest rate of return. In this regard, effective governance should help protect and grow scarce resources, therefore helping to ensure that societal needs are met. In addition, effective governance should make it more likely those managers who do not put scarce resources to efficient use, or who are incompetent (or, at the extreme, corrupt), are replaced.
- Assists corporations (and economies) in attracting lower-cost investment capital by improving both domestic and international investor confidence that assets will be used as agreed (whether that investment is in the form of debt or equity). Although managers need to have latitude for discretionary action if they are to innovate and drive the corporation to compete successfully, rules and procedures

are needed to protect capital providers, including: independent monitoring of management; transparency as to corporate performance, ownership and control, participation in certain fundamental decisions by shareholders

- Assists in making sure that the corporation is in compliance with the laws, regulations and expectations of society. Effective governance involves the board of directors ensuring legal compliance and making judgments about activities that, while technically lawful in the countries in which the corporation operates, may raise political, social or public relations concerns
- Provides managers with oversight of their use of corporate assets. Corporate governance may not guarantee improved corporate performance at the individual corporation level, as there are too many other factors that impact on performance. But it should make it more likely for the corporation to respond rapidly to changes in business environment, crisis and the inevitable periods of decline. It should help guard against managerial complacency and keep managers focused on improving firm performance, making sure that they are replaced when they fail to-do so.
- Is closely related to efforts to reduce corruption in business dealings. Although it may not prevent corruption, effective governance should make it more difficult for corrupt practices to develop and take root, and more likely that corrupt practices are discovered early corporations to have wholly independent audit committees with at least three members, each of whom are financially literate. At least one member must have accounting or related financial sophistication or expertise.

TRANSPARENCY IN DOING BUSINESS

Transparency in Corporate Governance

Transparency, it seems, has taken on a life of its own. It has moved over the last several hundred years from an intellectual ideal to center stage in the drama being played out across the globe in many forms and functions.

An older, passive view of transparency has given way to a new vision of transparency; transformed from a mere intellectual curiosity to a real-life, real-time requirement that engenders a range of emotional responses.

It has touched off an international debate on morals, ethics, privacy, politics and personal responsibility.

The new view of transparency implies several important characteristics:

- An inevitable trend toward more transparency rather than less
- More intense scrutiny from more groups or individuals around the world
- More comprehensive demands for new kinds of information
- More complex requirements in gathering, analyzing, and reporting information
- More proactive attention by both the observer and observed
- More debates about what information should be public

Today, after many scandals and financial crises, the transparency in corporate governance is the debate du jour.

Transparency lies at the intersection between the public's right to know and corporation's right to privacy.

The public's right to know, means the stakeholders interest in obtaining corporation information about management and strategy

Stakeholders includes employees, unions, and governments at various levels, media, customers, suppliers, financial institutions, various nongovernmental corporations with broad or narrow agendas, and the even the public at large.

The stakeholders have a legitimate claim to know vast quantities of information about corporation's actions and intents.

The corporation's right to privacy means the corporation's right to control the collection, use and disclosure of all information and management strategies related of the corporation.

Defining a New Concept of Transparency

Transparency, as currently defined, is letting the truth be available for others to see if they so choose, or perhaps think to look, or have the time, means and skill to look. This implies a passive position on the part of the corporation under consideration. In today's broader public context, however, transparency is taking on a whole new meaning: active disclosure. The old transparency (being open and forthright, should anyone happen to ask) has given way to a new transparency, more active in calling attention to deeds, both intentional and unintentional. In other words the new concept of transparency includes action or motion, putting new responsibilities on the corporation.

Even though the discovery of corporate misconduct has grabbed most of the headlines in the past few years, transparency is not a new issue for corporate governance. It is, and was, high on the agenda of every corporation and organization.

The difference is the attention that it has received from the public and the evolution of this concept.

Most media articles about business, in fact, concern transparency: more specifically the conduct of public traded corporations. They explore how the corporations conduct their businesses: their accounting methods, earnings, insider trading, conflict of interest, executive compensation and the independence of their boards of directors.

In the simplest term, all stakeholders in the corporation want to know all the facts about a corporation's financial health and structure, including whether each officer and board member is acting in the interest of the shareholders, employees, customers and the public.

Transparency extends to every face of business and can both affect, and be affected by, the conduct of employees at all levels. For most businesses, success results from the ideas and actions of employees. A transparent corporation will attract the best and retain the best. An opaque corporation will continually deal with turnover or a disgruntled workforce. Transparency has also impact outside the corporation, on customers, suppliers, international trade, and adherence to government regulations.

Lack of transparency and Opacity Spiral

There is no magic formula that makes some corporations thrive while other fades away. History proves, however, that those corporations that continually hide the truth merely postpone the inevitable. Transparency may not lead to immediate success, but lack of transparency can surely lead to a swift failure.

In a capitalist market system or a democratic government, transparency is not a luxury, but it is now a fundamental requirement of the system of governance.

An opaque event can damage a corporation or even destroy it. We talk about a downward spiral; one event leads to another until the public exposure or castigation.

Opacity, the opposite of transparency, is defined as the state of being hard to understand. Not clear or lucid. When information is not clear, it's not trusted. When information is hidden, it's natural to believe there's truly something to hide.

Over and over corporations get trapped in opacity predictable pattern. In the figure above, a corporation commits a dangerous act in secret. Word leaks out. Denials follow. More information leaks out. Denials continue. Irrefutable evidence comes out. Eventually, the corporation is damaged or destroyed by the unrelenting spiral of media exposure, public pressure and many times, litigation. Most transparency scandals, both historic and recent financial markets (i.e. Enron or Parmalat), follow these patterns.

As graphically demonstrates, no important event, big or small, can forever avoid being sucked into its gravitational pull. Opacity is inevitably eliminated by the vicious cycle of public exposure. Transparency has become own self-fulfilling prophecy.

The Information-Transparency Cycle

The Information-Transparency Cycle can be used to describe the situation caused from true and efficient disclosure of information. In fact the need of information multiplies itself when it is started.

The information transparency cycle is simultaneously an industry, an economy and a way of life. The I-T Cycle, in its endless gathering, manipulating, storing, disseminating, archiving, retrieving of information has created the new transparency imperative. The public's right to know is steadily and inexorably eroding the secret, opaque lives of corporations.

The transparency imperative unleashes a perverse mechanism: the more we know, the more we demand to know, the more there seems to be disclose. The cycle seems endless.

While increasing transparency means that market mechanisms operate closer and closer to true efficiency, shareholders and stakeholders have more power, the privacy right of corporations slips slowly away.

A Good Background for a Better Transparency

Media stories on transparency often focus on what's wrong at the top: chief executive officers (CEOs) who report misleading, or fraudulent financials, secret pacts between high-ranking military officers, or backroom deals among politicians.

While some leaders are culpable, creating a transparent corporation is the responsibility of the entire corporation. To be a truly transparent corporation, four key elements are required:

- A culture dedicated to openness and a commitment to transparency from a corporation's most senior leadership

- Programs and processes that encourage and ensure openness at every level, that reward transparency and meter out quick and decisive punishment for opacity, obfuscation and fraud
- Well-trained workers, managers, and administrators at all levels of the corporation with the wisdom, integrity, confidence, and security to do and say what is right and to recognize and act when the corporation or individuals are not doing things that should be done and
- Established means of proactive communication to the corporation's important stakeholders

A Culture of Transparency

A corporation's board of directors bears direct responsibility for creating a culture of transparency. Truly independent boards establish policies that ensure and reward transparency. They diligently monitor implementation, decisively intervene to ensure completeness, ensure that facts are not obscured and that conflicts of interest are eliminated.

Senior management's responsibility is to create the programs and processes to see that these policies are properly executed. In best practice corporations, top leaders are diligently committed to a culture of transparency. Not given to edicts from the top or just mechanical processes of auditing, accountability permeates the corporation and real commitments are made for collaboration and sharing information.

Leaders create programs and processes that institutionalize transparency and make it an essential function and trait of the corporation.

When top management has done its part, individual actions of employees make a transparent culture real. Those in the trenches are often most aware of how the corporation is really functioning at the operational level, and as such, they bear equal responsibility for organizational transparency.

No corporation in the world can claim victory when it comes to transparency. Like safety and quality programs, transparency is a journey, not a destination. Transparency requires constant refinements in response to new market requirements and increasing organizational competencies.

Guidelines for corporation's transparency:

Leadership commitment. A corporation's leaders are committed to the principles and spirit of transparency. They embed this commitment into the corporation's communications with stakeholders, its information-gathering processes, and its systems of metrics. Commitment is demonstrated by the standards to which senior leadership holds itself, the documentation and communication of governance processes and metrics, and walking the talk with swift and steady enforcement of transparency and ethics guidelines.

Formalized processes. Transparency requires frequent, abundant, and accurate information. Clear responsibilities for compiling and reporting of information metrics is assigned and automated where possible. Each relevant metric carries a reporting mechanism or process.

Training programs. Top management's commitment to transparency is enhanced by comprehensive training programs that communicate this commitment and demonstrate avenues available to pursue it, including independent channels to report fraud. Managers are taught to collect, analyze, and report information that is decoded, that is, stripped of the jargon of the particular industry, corporation, or profession, in an accurate but understandable way for no technical audiences. Employees are shown how to look beyond today's transparency requirements and attune themselves to the evolving demands of the marketplace. Training goes beyond the teaching documentation and reporting competencies, to the development of critical thinking and decision-making skills, and the encouragement of true understanding and commitment to transparency and ethical behavior.

Communication with stakeholders. Today, transparency goes beyond just allowing interested stakeholders a look inside the corporation. Transparency demands active disclosure, including communicating essential information in a timely and convenient fashion and providing fast, easy, and inexpensive means of getting feedback. Transparent communication with stakeholders involves focusing on more than just the traditional numbers, such as financial data, customer statistics, and operational metrics. It requires venturing into accurate and understandable discussions of the stakeholder value drivers, the things that mean the difference between success and failure for the corporation. Frequent communication to stakeholders is essential. Feedback from stakeholders (employees, customers, constituents, shareholders, and community leaders) tells the corporation what it is doing well and what it needs to work on.

Transparency's Impact on the bottom line

No matter what an organization's purpose, function, or structure, the finance department's role is to accurately and completely portray its financial affairs. Financial reports include filings and documents required by law, as well as those expected by lenders, investors, employees, donors, or board members.

Unfortunately, the insatiable demand for financial information, the speed at which it's required, and the increasing sophistication of financial tools, often sidetracked the finance department from its core responsibility: clear and accurate reporting and analysis for shareholders.

Nowhere, therefore, does transparency get more problematic than in financial reporting for public corporations.

Going back as far as the 1600s, financial reporting scandals have been the most visible and far-reaching examples of hidden information and outright fraud.

In the twentieth century financial reporting scandals were a key component of financial collapses ranging from the Great Depression, to the Asian currency crisis, to the stock market meltdown at the turn of the millennium. Along the way, plenty of executives made the journey from business media star to inmate, and thousands of employees lost their jobs due to greed and fraud at the top.

The recent cases of opaque and fraudulent reporting are far too numerous to mention here.

In the United States, new regulations have made CEOs and board members bear more responsibility, with signatures required on financial statements and a legal assumption that the CEO and chief financial officer (CFO) can attest to the accuracy of financial reports.

Intervention of SEC in US CG

The public's growing, and in some quarters, seemingly insatiable demand for information requires that boards and senior administrators embrace the spirit as well as the law of transparency.

The Securities and Exchange Commission (SEC) argued as much itself:

"The SEC strongly encourages corporations to adopt codes [of business conduct] that are broader and more comprehensive than necessary to meet the new disclosure requirements." Understanding the law is decidedly easier, although far from perfect, however, than coping with the moving target of the spirit of the law.

But even within the law, uncertainty rules. Corporate reporting of financials frequently defaulted to volumes of information in an attempt, depending on the politics of the observer, to either comply or confuse. Regardless of intent, the result has been a growing mass of almost indecipherable data.

In fact, the same SEC argued that the route to more and better corporate disclosure lay in simplified, shortened reporting that clarified and communicated public corporation accounts in a few pages.

So, it is also possible to have too much transparency. Too much disclosure produces a white noise effect, making it difficult to know what is significant or even to have the time to sort through all the data.

Indeed, in a cynical view, if you really want to hide information, the best thing to do is to bury it in a flood of data. Moreover, disclosing information requires time and effort, and it can be hard to keep up with all the demands.

For example, firms are increasingly being bombarded with calls for transparency on their environmental and labor practices, often paired with demands to permit third party certification of their compliance with "voluntary" corporate social responsibility standards.

We can identify there the reverse of the Opacity Cycle. Every attempt by regulators to clarify information has had the opposite effect, touching off a high-stakes game of increased obfuscation.

If transparency is to be used successfully, it will also have to be used judiciously, with careful attention to minimizing the burden created by the demand for information and to formatting information in user-friendly ways that minimize the white noise effect.

The history of regulatory reporting throughout the twentieth century is a "less than virtuous cycle" of accountants and lawyers finding loopholes or devising a creative path around virtually every new law, regulation, or accounting standard, often as quickly as they were put in place. But if corporate leaders embrace the spirit of transparency as a matter of principle and routine action, they'll give stakeholders the information they really want.

For business, the Sarbanes-Oxley Act of 2002 removed much of the choice and some of the confusion of corporate reporting (although it created much more confusion in some areas). New regulations eliminated many conflicts of interest: off-balance sheet financial trickery, personal loans for executives, and the slow reporting of insider stock trades. It also established jail time for those destroying evidence of wrongdoing.

Federal and individual state governments are using both civil and criminal courts to go after violators, most often those at the top, for example, board directors and senior management.

DISCLOSURE IN CG

Role of Disclosure in facilitating and enhancing CG

Disclosure to the shareholders and to the market has long been a key mechanism in corporation and capital market law. Milestones, in corporation law were the Gladstonian reforms of 1844 and 1845. One hundred years later the U.S. American securities regulation of 1933 and 1934 gave to the world the blueprint for using disclosure in securities regulation.

Brandeis' dictum of the sun as the best of disinfectant already had an early precedent in 1837 from the famous Prussian reformer Hansemann, who said: "Among the means by which the management of a large corporation limited by shares can be kept law-abiding and efficient, is to be counted that it must be exposed to a certain degree to the public. This is the most effective control."

Disclosure is an issue that is highly regulated under the securities laws of many countries. However, in many instances, corporations may voluntarily disclose beyond what is mandated by law.

Most countries generally agree on the need for directors to disclose to shareholders (whether in an annual report or in another document) their own interests, as well as the financial performance of the corporation. Generally, this is required by law, regulation, or listing requirements, but some guidelines and best practice documents also address the issue.

Similarly, even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, a number of codes from both developed and developing nations describe the board's responsibility to disclose, before the annual general meeting of shareholders accurate information about the financial performance of the corporation and agenda items.

Many codes also itemize the issues reserved for shareholder decision at the annual meeting of shareholders.Generally, guidelines and codes of best practice place heavy emphasis on the financial reporting obligations of the board, as well as board oversight of the audit function.

Again, this is because these are key to investor confidence and the integrity of markets. While some guidelines and codes specify the key points that the directors must comment on, others do not go into this level of detail. However, because securities laws often heavily regulate disclosure, the distinction is not necessarily substantive.

Disclosure is also a powerful tool for improving corporate governance in Europe and in US. First and foremost, this type of regulation is most compatible with a market economy because it interferes least with freedom and competition of enterprises in the market. This is particularly relevant when there is considerable uncertainty and difference of opinion on what the right rules for efficient corporate governance are.

It is true that there is considerable theoretical controversy as to the effectiveness of disclosure in efficient capital markets. Yet in reality, capital markets may not be that efficient; otherwise, Enron could hardly have happened the way it did.

There is no need to go into the various forms of the efficient capital market theories here and to argue why the strong form may be less convincing. It suffices to record that a modern theory justifies mandatory disclosure by its function of facilitating and enhancing corporate governance.

According to this theory, corporate governance provides the most persuasive justification for imposing on issuers the obligation to provide ongoing disclosure (via shareholder voting, shareholders enforcing management’s fiduciary duties, and capital allocation).

General Principles of Disclosure

There have been repeated attempts in economics literature to establish a body of "principles of orderly capital market information”.

This attempt is also occasionally referred to in texts on the regulatory aspects of information to be disclosed on the capital markets.

Materiality

Information has a facilitating function. Information facilitates investment decisions, i.e., the decision to buy, hold or sell listed securities. Information is "material" if it is capable of causing a reasonable investor to take a different decision than he would have made in the absence of the information.

Both demonstrable facts and statements that are not capable of demonstration ("soft information"), such as management projections regarding business plans, can be material.

At least three policy considerations arise in connection with material information:

- all material information, as defined above, should be disclosed in its entirety to the capital markets;
- exceptions to this rule of disclosure should be strictly limited, such as for the protection of trade secrets;
- immaterial information should not be disclosed to the capital markets. Optimum disclosure, not maximum disclosure, is the goal. Publication of immaterial information is not only expensive and unnecessary, but can even be counterproductive if it works to distract interested persons from material information.

Clear Disclosure

Article 22(1) of the EC Listing and Reporting Directive (2001/34/EC) requires that listing particulars present information in as easily analyzable and comprehensible a form as possible, and Article 5(2) of the proposed EC Prospectus Directive (COM (2001) 280 final) would reinforce this requirement ("The information…shall be presented in an easy analyzable and comprehensible form").

A similar position has been promoted by the U.S. Securities and Exchange Commission ("SEC") through its "plain English rule" (see Rule 421(d) under the Securities Act of 1933, as amended), which presents six, basic principles regarding the language used in prospectuses.

Current Information

In the SEC. 409, the Sarbanes Oxley Act provides “Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer”. Disclosure shall be easily transferred from year to year, or from corporation to corporation.

A similar position has been promoted by EU by the EU Parliament and Council with the Directive of December 2004 **(**2004/109/EC), where it is provided that current reports and reports regarding changes in shareholdings must be made "promptly

Standardization

One requirement of standardization is that all issuers must present the required information in the same format. Like the prospectus, the balance sheet and income statement must follow a standard format, which reduces the costs incurred by interested persons in obtaining corporation data. Standardization also presents another characteristic. Because investors are interested in making comparisons between various corporations, it could be advisable under certain circumstances to disclose a negative piece of information that would not reach the threshold of materiality if the corporation were viewed in isolation.

Forward Looking Information and Cautionary Statements

As a general matter, information in the capital market is forward looking. It is necessary to put potential investors in a position to assess the results of the corporation's operations, including the corporation-specific risks involved, on the basis of the disclosed data.

If the occurrence of specific events is expected, but they have not yet occurred, this must be clearly stated. Investors are also particularly interested in knowing how the management assesses the future earnings and risks of the corporation

Equal Treatment of Investors

Legally required corporate disclosure creates equal treatment of investors with regard to the information disseminated pursuant to law, provided that appropriate media of dissemination are used.

If certain groups of persons are privileged in the disclosure of information, other groups will be prejudiced, and these latter groups will either withdraw from the market or demand a compensating risk premium on those markets where such activity is allowed.

Provisions on insider trading make it a criminal offense for members of the management board to communicate inside information to persons who enter into related securities transactions on the basis of such information.

EU vis-à-vis US: an overview

In EU, the Expert Commission has recommended that listed corporations be required to fully disclose their capital and control structures, in particular possible defensive structures established in the corporation, in order to enable the market to react by discounts and a higher cost of capital.

The Expert Commission has gone further and recommended that listed corporations should be required to briefly describe the key elements of their governance structure and practices, whether they arise from mandatory law, default provisions, articles of association, or whether they are based on particular codes.

In the answers to this need, there was overwhelming consent on using disclosure for improving corporate governance.

Examples for what could be disclosed in this context include the following: major shareholders of the corporation; shareholders rights, especially minority rights; appropriate information on the board and the auditors, in particular as to their independence and remuneration; risk management system within the corporation, etc. Disclosure should not be restricted to financial information, but should be extended to qualitative disclosure.

A checklist of what to disclose should be developed, and presentation in one comprehensive statement could be required in order to help shareholders compare and evaluate corporations all over the internal market based on their corporate governance system.

Of course, non-disclosure and, even more, false disclosure must have consequences for the directors.

In US, the Sarbanes-Oxley Act provides for drastic sanctions, both criminal and civil. As mentioned before, there are considerable doubts about the sections on criminal accountability.

The Facilitating Function of Disclosure

Corporate disclosure aims not only at investors, but also at creditors, employees, regulatory agencies, and the public at large. As a rule, disclosure performs a facilitating function: it is designed to facilitate, assist or enable the decision-making of the persons to whom it is addressed.

This applies, in particular, to disclosure directed to persons making decisions whether to contribute capital, general investors, and existing shareholders, who are the primary addressees of the disclosure.

An initial, important distinction is that between disclosure requirements designed to provide information to persons who purchase to shares in an initial or secondary public offering (*ex ante disclosure*; primary market information) and the continuing disclosure requirement of listed corporations (*secondary market disclosure*).

As a general matter, *ex ante disclosure* seeks to give the investing public all material information regarding the financial condition and results of operations of the corporation, including the risks regarding such operations, that they require to make a reasoned investment decision.

The primary tool for disclosure in this regard is the *securities prospectus*[7] which is used in various forms both in connection with listing securities on an exchange and for other public offerings of securities.

The *ex ante disclosure* of corporate information is, of course, not only important for initial public offerings and secondary offerings.

Ex ante disclosure may also play a role in the much larger secondary market for securities, where a potential investor would not purchase shares from the corporation, but from a shareholder who desires to sell. The information for the primary market thus mixes with the information that is continuously disclosed to the secondary market.

An investor who has already subscribed shares in the context of an initial public offerings or a secondary offering, or purchased them in the secondary market (shareholder) will be

[7] There is a well-known controversy in Europe about this document. Here it appears enough here to say that these controversies concern, among others, the issuers concerned (exceptions for small and medium enterprises), the form and content of the prospectus (choice between one or two prospectus documents, information to be disclosed, continuous disclosure, etc.), and the prospectus regime of the supervisory authority of the state of origin or of the place where the securities are issued and a possible choice of the issuer as to this supervision

interested in information ex post in order to make a decision whether to hold or sell the securities.

This information is referred to “ex post” or "hold/sell" information. Similarly, the potential buyers in the secondary market will require similar information in order to make their decision on whether to buy. This information, taken together with ex post or hold/sell information, is referred "secondary market information." Secondary market information consists of a number of elements and follows general principles that are similar to those underlying ex ante information.

Traditionally, a shareholder of a stock corporation obtains the bulk of his information regarding the corporation's financial condition and results of operation from the annual shareholders' meeting.

Because of the defects in the shareholders' meeting as a source of information, regulatory requirements and developments in information and communication technology have led to an increased flow of information apart from the shareholders' meeting.

Such information consists of number of elements and serves two functions: first, to enable shareholders to make a decision regarding their investment on a continuing basis, including when a material change occurs in the corporation's situation, and second, to promote the development of an efficient secondary market, i.e., to facilitate the decisions of investors interested in acquiring shares that are publicly traded on the secondary market.

Thus, at least in the case of a publicly listed stock corporation, the shareholders' meeting has failed to perform one of its traditional tasks: to provide market-relevant corporation information to the capital markets.

Secondary market disclosure consists of a number of types of information, and has developed to meet market needs over the years.

The aforementioned examples are only those types of information that are required to be disclosed by law, but it should be noted that information that is freely disclosed to the capital market is taking on increasing importance.

Such information has come to be disclosed in the context of investor relations and the pursuit of shareholder value, and includes voluntary interim reports, shareholder (news)letters, meetings with analysts and institutional investors, and postings on the corporation's website.

Financial asset pricing in fact requires not only disclosure of accurate financial statements but also disclosure of the main corporate objectives, standards and practices. Conveying this information to the market is an essential aspect of transparency.

Thus we need here to remark the OECD Principles of Corporate Governance that call for regular, timely and accurate disclosure not only operating and financial results but also of information on commercial objectives, ownership structures, boards of directors and key executives and their remuneration, related party transactions, governance structures and internal controls. Additionally, information about policies towards stakeholders and corporate social objectives is also a desirable element of transparency.

Transparency relates to the critical issue of trust. Alan Greenspan[8] said "It is hard to overstate the importance of reputation in a market economy….Rules cannot substitute for character."

When markets lose confidence in the integrity of information provided by a firm, the negative effects are likely to be dramatic.

OECD: Empirical evidence

Empirical work has produced strong evidence that transparency and corporate governance do indeed matter for both OECD and non-OECD regions and at both the country and individual corporation levels.

High levels of transparency, as measured by indices of opacity, are found to be associated with lower country risk premium and costs of capital and higher trading volumes or liquidity[9]. Similarly, corporations with less demanding corporate governance standards have been shown to experience higher capital costs and also to pay greater risk premium on their bonds[10].

Governance deficiencies have been shown to be associated with an increased probability that takeovers will not be successful and with a greater fall in the share price of the acquiring firm[11].

Moreover, the quality of corporate governance appears to have an effect on the ability of corporations to manage risk and react to macroeconomic shocks.

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[8] Alan Greenspan, *Corporate Governance*, at the 2003 Conference on Bank Structure and Competition, Chicago, Ill, May 8, 2003

[9] PriceWaterhouseCoopers, Investigating the costs of opacity: Deterred foreign direct investment, April 2001;and.Bhattacharya, et al, The world price of earnings opacity, forthcoming, Journal of Financial Economics,2003

[10] For example, one study focuses on the effect of takeover barriers which vary between US states. P. Gompers, J Ishii and A Metrisk, "Corporate governance and equity orices", NBER Working Paper, 8449, 2001; and a study for Germany looked at overall indices of corporate governance finding that it indeed did influence the cost of capital in the expected direction. W. Drobetz et al, Corporate finance and expected stock returns: evidence from Germany, ECGI Woking paper in Finance, 11/2003

[11] B. Hermalin and M. Wesibach, "Boards of directors as an endogenously determined institution: A survey of the economic literature", NBER Working Paper, 8161, 2001

Corporations with good corporate governance arrangements in Asia, especially Korea[12], for example, weathered the financial crisis better than those with less developed governance structures in place.

In conclusion, transparency is a key factor contributing to financial market efficiency and for providing the information necessary for market discipline to be effective.

Market discipline and transparency, in turn, are of central importance to the provision of the robust corporate governance necessary for stable markets and investor confidence.

The challenge for policy makers is to establish a framework within which transparency, market discipline and corporate governance can interact in a positive, coherent way that strengthens market integrity and economic performance.

[12] S. Johnson et al, "Corporate Governance in the Asian financial crisis", Journal of Financial Economics, 58, 2000

RECENT REGULATORY CHANGES IN THE US AND THE EU

Sarbanes-Oxley Act

The 2002 enactment of the Sarbanes-Oxley Act (SOX) marked a significant milestone for corporate governance in the U.S. The Act, which was the legislative response to a series of high-profile financial scandals, was intended to rebuild investors' confidence in the capital markets.

At its core, the historic Sarbanes-Oxley legislation is about promoting corporate transparency by ensuring full, fair, timely, and accurate disclosures. Sarbanes-Oxley, for example, mandates a host of new disclosures relating to, among other things, off-balance sheet transactions, insider stock transactions, internal control systems, and pro-forma financials; enacts tough new penalties for securities fraud; requires CEOs and CFOs to certify the financial statements of their corporations; requires the SEC or, at its direction, the National Association of Securities Dealers or the stock exchanges to adopt rules to remedy conflicts of interest among securities analysts; regulates auditor conflicts of interest; and grants the SEC additional authority to regulate the professional conduct of attorneys practicing before the Commission.

The approach of Sarbanes-Oxley is to reduce, if not eliminate, much of the board's discretion to permit the firm to operate with a financial structure that is opaque to securities markets.

Title IV (SOX): Enhanced Financial Disclosures

1. Corrective disclosure. Title IV of Sarbanes Oxley, section 401(a) requires the SEC to issue rules calling for the disclosure in quarterly and annual reports of

"all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

This has been put into action by the SEC through recently publicized rules that require extensive deliberation in the "Management Discussion and Analysis" section of quarterly and annual reports of the various off-balance sheet arrangements, targeting especially "the means through which corporations typically structure off-balance sheet transactions or otherwise incur risk of loss that are not fully transparent to investors."[13]

[13] SEC. Rel. Nos. 33-8182; 34-47264 (Jan. 27, 2003), available on the SEC website, www.sec.gov. (Section 401 Implementing Release). The rules will be reflected in amendments to Regulation S-K, Item 303. See also the proposing release, which gives an account of the SEC's general regulatory objectives with respect to off-balance sheet arrangements. SEC Rel. Nos. 33-8144; 34-46767 (Nov. 4, 2002) (Sec 401 Proposing Release).

The objects of disclosure, include, in addition to standard off-balance entities, (i) certain guarantee contracts, (ii) retained interests or contingent interests in assets transferred to an unconsolidated entity, (iii) derivative instruments that are classified as equity, and (iv) material variable interests in unconsolidated entities that facilitate financing. The disclosure threshold is whether the off-balance sheet arrangement has or is “reasonably likely” to have a current or future material effect.

These Section 401 rules (which will be reflected in amendments of Regulation S-K, Item 303), require extensive disclosure for these off-balance sheet arrangements.

In particular the Management Discussion and Analysis must address the business purpose of the off-balance sheet arrangements, their importance to the financing of the firm and otherwise, the revenues and cash flow that arise from the arrangements, and the events that would trigger the loss in their availability.

These new disclosure requirements desirable because they correct some of the probable monitoring shortfalls of the board of a public corporation.

2. Price perfecting disclosure. The SEC has also gone beyond the off-balance sheet financing problem to require disclosure of the financial obligations associated with firm’s various other contractual obligations. The SEC is also contemplating further “real time” disclosure of material business developments that go well beyond financing-related disclosure.

The SEC’s stated objective is “to improve the delivery of timely, high-quality information to the securities markets to ensure that securities are traded on the basis of current information,” what might be called “price-perfecting” disclosure[14].

Quite remarkably the Section 401 rules require corporations to make extensive disclosure about the amount and timing of various contractual obligations. The MD&A must include in tabular form a summary of contractual obligations maturing over various time periods: less than a year, one to three years, three to five years, and more than five years.

The covered contractual obligations include long term debt, capital leases, operating leases, purchase obligations, and other identified long-term liabilities.

The hook to Sarbanes-Oxley’s principal concerns is that such disclosure “would improve transparency of a registrant's short- and long-term liquidity and capital resource needs and demands. It also would provide appropriate context for investors to assess the relative role of off-balance sheet arrangements with respect to liquidity and capital resources.”[15] It would give investors “pertinent data to the extent necessary for an understanding of the

[14] SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002). (8-K Release).
[15] Proposing Release.

timing and amount of the corporation's specified contractual obligations."[16] There is no doubt that this amounts to significant disclosure of firm specific information.

Although bits and pieces of this information are disclosed elsewhere in an issuer's public filings, this comprehensive summary is ordinarily the kind of information provided to a bank lender or indenture trustee under loan covenants or perhaps to a credit rating agency. Not only does it forewarn investors about potential cash flow crunches or vulnerabilities, but also capital suppliers and merchandise suppliers, who will now have earlier warning of potential financial distress, and competitors, who will be able to infer the terms of various business relationships and also to determine the firm's ability to respond to particular competitive moves. It could well change how firms are financed and managed.

Another disclosure provision, section 409 of Sarbanes-Oxley, captioned "Real Time Issuer Disclosures," obliges issuers "to disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest."

This section is not self-effectuating and has not yet been implemented by SEC rulemaking, since rule issuance is not under the six-month time limit as for Section 401 and other key provisions. Nevertheless the section seems very much in the spirit of the SEC's proposed expanded disclosure under Form 8-K, put forth in June 2002.

The SEC's theory is that the speed-up in communications generally means that investors and securities markets "demand and expect more 'real-time' access to a greater range of reliable information concerning important corporate events that affect publicly traded securities."[17] As mentioned previously, this disclosure is said to be in service of "ensuring that securities are traded on the basis of current information." The SEC added 11 items that would trigger a Form 8-K filing and shortened the filing deadline from five business days (or 15 calendar days in some instances) to 2 business days. Some of these items are hardly controversial, such as a "conclusion or notice that securities holders should no longer rely on the corporation's previously issued financial statements or a related audit report." But the projected new triggers include:

- Entry into a material agreement not made in the ordinary course of business (and any subsequent termination)
- Termination or reduction of a business relationship with a customer that constitutes 10 percent of the corporation's revenues
- Creation of a direct or contingent financial obligation that is material to the corporation

[16] SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002). (8-K Release).
[17] 8-K Release.

These disclosures related to sensitive business issues where in the past managements have had significant caution with timing. For example, in the acquisition context, firms apparently would be required to disclose letters of intent and other non-binding agreements, and the required disclosure would include description of the agreement, the parties, and material conditions to execution. Yet in the past, the recognition of the desirability from the shareholder point of view of giving management flexibility in deciding when to release information about an impending transaction has made courts and the SEC reluctant to impose an affirmative disclosure obligation. For example, the U.S. Supreme Court recognized in *Basic, Inc. v. Levinson*[18] the difference between a false denial or other misrepresentation and a "no comment."[19] On this understanding firms have developed a catechism of "we do not comment on rumors about such matters." Such an approach will often protect shareholder interests.

Compelled disclosure of a non-binding agreement can disturb negotiations in at least two ways: first, by injecting publicity, including responses by competitors, into negotiations that have not gelled, and second, in anticipation of this effect, by changing the course of negotiations, for example, by avoidance of useful progress-markers such as non-binding letters of intent. Moreover, the increase in the expected failure rate of sensitive negotiations will reduce the likelihood that certain transactions will be undertaken.

"Real time" disclosure of a negative change in an important customer relationship also brings decidedly mixed blessings. Immediate disclosure of a cancelled contract usefully signals to prospective shareholders that a firm has new business problem, to be sure, but also to customers, suppliers, and rivals.

This disclosure could not bring advantages to existing shareholders, who might prefer that management be given some time to try to arrange existing capacity free of the exposed vulnerability, which could unfavorably affect the very terms on which substitute arrangements are negotiated.

Moreover, this negative disclosure impact will give the counterparty additional leverage during the course of performance, especially in circumstances where the contract is material to the firm but not to the counterparty. In other words, the requirement of immediate disclosure in this domain is likely to reduce the value of the firm.

Why would the diversified shareholder want that? The driver of this expanded, quicker disclosure is a disclosure philosophy that seems to be a version of "the board reports; you, the investors, decide." The goal is more accurate prices and less space for insider trading. The Commission's focus is not simply more accurate and reliable information (i.e., less prone to fraud), but *more* information.

[18] 485 U.S. 224 (1988).
[19] The SEC's prior guidance on premature disclosure of merger negotiations is consistent with *Basic*, as reflected in Section 501.06.d of the Commission's Codification of Financial Reporting Policies, 7 Fed. Sec. L. Rep. (CCH) 73,197.

What's missing in the analysis, however, is the articulation of a basis for such a potentially far-reaching disclosure vision. Reducing the risk of insider trading is a fine objective but there is no evidence of a current insider trading problem so pervasive that it should shape the content of the disclosure system in this way. Undoubtedly more accurate prices improve allocative efficiency, meaning the better deployment of scarce economic resources, but the real Enron-era problems in this regard were fraud, not the absence of speedy disclosure.

The disclosure question might profitability be cast in terms of board capacity. The case for "corrective disclosure" is strong because market monitoring over financial strategy seems a necessary adjunct to the board's monitoring effort, especially given present executive incentive compensation packages and the reasonable limits on board activity.

The case for "price perfecting disclosure" seems less powerful because it trenches on areas where board discretion over the information timing release question has been thought to serve shareholder interests and where board competence has not been called into serious question. Indeed, as classically recognized in *SEC v. Texas Gulf Sulphur*[20], there is a legitimate space for timing disclosure in light of the board's business judgment. The prospective mining strike in that case exemplifies a series of instances in which the exercise of the discretion not to disclose a material development is desirable from the shareholder perspective. Public market monitoring may be an element of corporate governance but not its entirety.

3. Potential governance changes. There are many ways in which Sarbanes-Oxley straightforwardly works significant changes in corporate governance of public corporations. Section 301 requires firms to have an audit committee and charges this committee with responsibility for the "appointment, compensation, and oversight" of the firm's auditors.

Sections 303 and 204 emphasize the direct reporting relationship between the auditors and the board committee and take managements out of the loop. Section 407 requires disclosure about whether at least one member on the audit committee is a "financial expert." Section 305 expands the SEC's power to bar individuals from service as officers or directors of a public corporation.

Section 402 bars personal loans to officers and directors, despite explicit permission for such loans in the corporate laws of many states.

The Commission's implementation of the disclosure provisions of Sarbanes-Oxley would, in more subtle but perhaps more important ways, also change corporate governance by significantly affecting management's relationship to the market. This is because the new rules reduce the information disparities between managements and shareholders which have been the basis for management prerogative in many important settings. As management's decisions and strategy become more transparent it becomes

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[20] 401 F.2d 883 (en banc), cert. denied, 394 U.S. 976, n.12 (1969)

harder for management to resist shareholder pressure on alternative strategies. In particular, institutional investors might well insist on more influence and a greater role.

As prices become more accurate – as they more precisely reflect the firm's actual business prospects – it becomes harder for managements to claim that shareholders receiving a takeover bid suffer from "substantive coercion." That is, insofar as the new disclosures required by or stimulated by Sarbanes-Oxley reduce management's informational advantages, then it becomes harder for state courts to employ the traditional grounds to sustain target management defense tactics. The crystal ball is inevitably cloudy about long run effects of some of these regulatory interventions, but vigorous SEC "price perfecting" pursuit of the invitation in Section 409 for "real time issuer disclosure" would have far-reaching implications well beyond the Enron-related problems that set the legislative process in motion.

In conclusion, Sarbanes-Oxley intervened in many important areas of capital markets accountability and reliability. It's most famous provisions pertain to accountants, to lawyers, and to its determination to use criminal sanctions to deter securities fraud. But the information disclosure provisions are important. They change the received model of corporate governance in protective or corrective ways, but also in ways that may be overly intrusive. These provisions also will become part of the minuet between federal and state law that has been a distinctive feature of the governance of the large public firm in the United States.

Directive 2004/109/EC

The European Union's main goal is to provide a genuine Single Market. "Efficient, transparent and integrated securities markets contribute to" that goal. Hence, the European Union has focused on improving the Community's securities markets during the last few years. Working on the transparency issue EU-wide is one way of providing such enhanced securities markets. Providing more and improved transparency leads to a cutback of information asymmetry among market participants and hence reduces surprises which are harmful for an integrated market, which is mainly based on investors' confidence. Additionally, due to mergers between European stock exchanges further evidence for the need of EU-wide, almost real-time information is provided[21].

The existing legislation was about twenty years old[22]. In order to respond to the evolution of the markets an update was urgently required. By enacting the Transparency Directive[23] the action plan, including 43 measures, was finalized 17.

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21 See the First Consultation Document of the Services of the Internal Market Directorate General on transparency obligations of issuers whose securities are admitted to trading on a regulated market from July 11, 2001, at 3., available at
http://europa.eu.int/comm/internal_market/securities/docs/transparency/consultation1/euregime_en.pdf.

22 In particular these are the Directives 79/279/EEC (supra note 77), 82/121/EEC (supra note 77) and 88/627/EEC (supra note 77). With the Directive 2001/34/EC (supra note 77) each of those three Directives were repealed, involving no substantive changes (see the press release IP/01/1861, *available at*

The main focus of this Directive is the provision of amplified and harmonized disclosure requirements for publicly traded corporations. Therewith the information standards should be tightened and thus a genuine Single Market for financial services finally enabled.

The necessity of highly qualitative and comparable financial statements was also pointed out by the European Council in Lisbon in March 2000 and by the European Council in Barcelona[24] two years later[25].

The Transparency Directive entered into force after two consultations[26] on January 20, 2005[27]. It must be implemented by the Member States within two years.

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ttp://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/01/1861&format=PDF&aged=1&language=EN&guiLanguage=en

23 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390, 12/31/2004, p. 38).

24See the presidency conclusion of the Barcelona European Council 15 and 16 March 2002, available at http://www.europarl.eu.int/bulletins/pdf/01s2002_en.pdf (last visited May 6, 2005).

25 See also Recital 3 of the Transparency Directive

26 The first consultation was launched by the Commission in July 2001 (see supra note 168) and the press release IP/01/999, available at
http://europa.eu.int/rapid/pressReleasesAction.do?
reference=IP/01/999&format=HTML&aged=1&language=EN&guiLanguage=en. Thereby the Commission made for the first time ever use of an open consultation process on the Internet upon the recommendation of the Lamfalussy Committee (see the final report of the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Alexandre Lamfalussy. Therewith it was ensured, that contributions could be made by a huge amount of interested parties, covering a broad variety of interests. Consequently, this open consultation process lead to 90 responses from the entire European Community (see the Summary of the replies received to the Consultation Document of 11 July 2001 for details, available at
http://europa.eu.int/comm/internal_market/securities/docs/ transparency/consultation1/trans_en.pdf, , as well as the press release IP/01/1861 Nearly one year later, in May 2002, the second and final consultation, focusing on several aspects rather than on general statements, was launched (see the Second Consultation Document by the Services of the Internal Market Directorate General of the European Commission, available at
http://europa.eu.int/comm/internal_market/securities/docs/transparency/consultation2/2ndconsultcover_
en.pdf, with a detailed outline in Annex 1, available at http://europa.eu.int/comm/ internal_market/securities/docs/transparency/consultation2/2ndconsult-details_en.pdf. Again the European Commission received various inputs, which all together resulted in the proposal for the Transparency Directive, COM(2003) 138 final.The proposal was then approved by the European Parliament in March 2004 (see press release IP/04/0398, available at
http://europa.eu.int/rapid/pressReleasesAction.do?reference=P/04/398&format=PDF&aged=1&language=
EN&guiLanguage=en. In May 2004 a “fast-track” agreement was reached between the Council and the European Parliament.
Therefore, without a second reading the Transparency Directive could have been signed in December 2004 (see press release IP/04/1508, available at http://europa.eu.int/rapid/pressReleasesAction.do? reference=IP/04/1508&format=PDF&aged=1&language=EN&guiLanguage=en,).

Until the transposition of the Directive into national law the Directive does not have any direct impact on the Member States, its issuers and investors. The impact is only indirect as in the future these upgraded disclosure rules will have to be observed by the issuers. Hence, they have to make themselves familiar with these rules soon and instruct their accounting departments and employees accordingly. In some cases, an adoption of the operational procedure might be necessary.

Spirit and Purpose of the Directive

The main focus of the Transparency Directive is the improvement of securities markets through increased transparency. This goal is sought to be achieved by increasing the information flow between issuers and investors. Investors should be kept informed periodically, even in regard to major shareholdings of corporations to facilitate a reasonable evaluation of the issuer's situation, including the voting structure. Hence, the Transparency Directive provides a minimum standard of disclosure requirements.

With the directive investors should be provided sufficient and appropriate information in order to protect them highly. The better investors are protected the more they trust the issuers of the securities and the better their capital will be allocated by reducing capital costs. This again has a positive impact on the effectiveness of the market, economic growth, and job creation. However, in order to achieve these positive effects it has to be assured that all investors are in possession of all the required information within a reasonable time. Therefore, any kind of media, which can be reasonably relied on being capable of reaching the entire Community, has to be used for notification. Only thereby can financial reports be compared and the best possible protection provided.

Scope of application

The Transparency Directive appeals to "issuers whose securities are already admitted to trading on a regulated market situated or operating a Member State." The term securities is determined in Article 2 of the Transparency Directive and shall include all classes of securities which are negotiable on the capital market such as "(a) shares in corporations and other securities equivalent to shares in corporations, partnerships or other entities, and depositary receipts in respect of shares; (b) bonds or other forms of securitized debt, including depositary receipts in respect of such securities; (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures", excluding money-market instruments[28], with a maturity of less than 12 months and national legislation applicable.

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[27] According to Article 34 of the Transparency Directive the Directive shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union. The Directive was published in this Journal on December 31, 2004

[28] Defined in Article 4 (1) point 19 of Directive 2004/39/EC (see supra note 86) : "Classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payments."

According to that very broad definition the European Union opted for a "one size fits all approach" to create a common level playing field for equity and debt issuers. As issuers of equity and debt securities are put under a uniform disclosure regime, their equal treatment not only leads to more consistency but also ensures that "certain issuers, such as start ups and high tech corporations, mainly traded outside the official listing segment", are now on file too.

For issuers who are not yet admitted to trading on a regulated market or operating, investors are protected by the Prospectus Directive. They have to meet the requirements set up in the Prospectus Directive in order to be admitted. After the admission of their securities to trading on a regulated market they are subject to the Transparency Directive.

Periodic information

In its Chapter II the Transparency Directive specifies several periodic disclosure requirements that have to be fulfilled in the first instance by the issuer as the main addressee in order to provide investors with the proper and current information they need for the issuers' rating. Exemptions to these obligations are only available very rarely[29].

Annual financial reports.

The first periodic report mentioned in the Transparency Directive is the "annual financial report". It has to be disclosed within four month after the end of the financial year30. Moreover the report should be made publicly available for five years194. This assures that information can also be tracked back. Therewith it should be ensured that the investors receive all the information they need to make appropriate appraisals about the financial situation of the issuer and its offered securities, which also requires taking the corporation's past activities and their future development into account.

The elements of the annual financial report are listed in Article 4 Z 2 of the Transparency Directive: It consists of 3 sections: (i) the audited financial statements, (ii) the management report and (iii) a statement by the responsible person.

Accordingly the annual financial report should include a financial statement. It has to be audited in accordance with the Fourth Council Directive 78/660/EEC[31] and the Seventh

[29] See Article 8 of the Transparency Directive (supra note 170). Accordingly only States, its local authorities, certain public international bodies, national central banks and the ECB are excluded form the obligation to provide all this contemporary information. The same applies to certain issuers with a denomination per unit of at least EUR 50.000. In Article 8 Z 2 and 3 the Transparency Directive grants the possibility for home Member States to set aside further exemptions for the provision of half-yearly financial reports for credit institutions (under certain circumstances) and issuers of debt securities, who have already existed prior to December 31, 2003.

[30] Article 4 (1) of the Transparency Directive (*supra* note 170). Until then the deadline for the publication of the annual financial report has not been harmonized. As a result it varied among the Community's Member States as the Directive 2001/34/EC (*supra* note 77) only stated in its Article 67 (1) that the publication has to take place "as soon as possible", without further defining that deadline

[31] Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of corporations (OJ L 222, 08/14/1978, p. 11). Directive last amended by Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC,

Council Directive 83/349/EC; the latter just in the case the issuer is subject to the Seventh Council Directive and therefore has to provide annual consolidated accounts. Therefore, the authorized auditor, whose name has to be publicly disclosed too, has to confirm, that the financial statement is conforming to the annual or consolidated accounts for the same financial year.

The annual financial report must also include a management report. This report – again – has to be prepared in accordance with the Fourth and Seventh Council Directive. Therefore, the management report should give fairly detailed information about the corporation's past development and its future prospects. Moreover the management report should inter alia provide data on the corporation's research and development activities.

In the end, the person responsible has to affirm that the financial statements have been prepared in all good conscience and according to the accounting rules, giving a true and fair view of the issuer's present situation and future development, including the existing risks and uncertainties2.

***Half-yearly financial reports*.**

Besides preparing an annual financial report the issuer is also required – according to Article 5 – to draw up a half-yearly financial report. It has to be published as soon as possible, but in any case no later than within 2 months after the mid-year ending. It too has to be kept public for five years too.

Again, the reports consist of three parts, very similar to the ones required for the annual financial report: (i) the condensed set of financial statements, (ii) an interim management report and (iii) a statement by a responsible person. The summary of the financial statements' set should draw up the financial situation of the issuer by providing a balance sheet and a profit and loss account including some notes.

The interim management report should provide information on relevant events having taken place in the first half of the financial year, including their impact on the financial statements. Furthermore, future risks and uncertainties relevant for the second half of the financial year should also be reported as well as – if shares are issued – major related parties' transactions.

Again, the statement by a responsible person should affirm that the documents have been set up with best knowledge, according to the rules, providing a true and fair view, especially with regard to the interim management report.

***Interim management standards*.**

83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of corporations, banks and other financial institutions and insurance and undertakings (OJ L 178, 7/17/2003, p. 16).

Besides these two statements, the Transparency Directive sets up a third mandatory statement, which can only be waived by providing quarterly financial reports in accordance with the respective national law. If this is not the case, the management has – according to Article 6 Z 1 – to draw up an interim management statement twice a year if the issuer's shares are admitted to trading on a regulated market. The statement has to focus on the period, starting 10 weeks after the beginning and closing 6 weeks before the ending of each of the 6 month periods. All relevant events and transaction during this period, including their influence on the issuer's financial situation, have to be reported among with information on the issuer's financial situation itself.

This increased frequency of regular reporting is – according to the European Commission – essential in order to stay competitive. Without a harmonization in this field some issuers within the European Community would face an enormous competitive disadvantage as some investment firms do not consider purchasing securities, whose issuers are not preparing quarterly financial reports, and some EU stock exchanges already require this kind of reporting frequency. On the other hand, one also has to take into account that an advanced frequency of reporting statements is not only very costly and time-consuming (even for the investors to process the data) but might also lead to a focus on a short instead of a long term view of the corporation's performance.

Responsibility and liability.

Concerning responsibility and liability issues the Directive does not include any detailed rules. It only clearly points out in its Article 7 that it's the Member States duty to provide legal rules, which assures that the issuer or it's administrative, the management or the supervisory bodies are going to be held liable for their mandatory provided periodic information. Without these liability provisions the quality of the information provided cannot be guaranteed and hence investors' confidence could not be restored.

Ongoing information

According to the Transparency Directive issuers are not obligated to just provide periodic and hence contemporary information. Rather, Chapter III of the Transparency Directive includes provisions stating which information is material and as such have an enormous impact on the investors' estimation of the issuers' securities and its value. That asymmetry has to be cut back by disclosing too, even beyond the periodic statements, on an ad-hoc basis.

Information about major holdings.

One issue the European Union was especially concerned about is related to major holdings. Major holdings have an impact on voting structures.

The existence of major holdings might lead to a blockage of the minorities, which reduces the value of minority shares. Besides, even a change in the identity of the controlling shareholder might have an effect (positive or negative) on the shares' value.

Hence, investors should be provided information related to any such changes as soon as possible, which is warranted by making it public within four trading days.

Waiting for the next periodic report might not be sufficient, especially with regard to the detail that the reports have to be published two or rather four months after the specific period ending. Information symmetry has to be restored as soon as possible. Thus, an immediate notification of material changes in the corporation's ownership structure is required.

Regarding this issue, Article 9 provides an obligation of the shareholder to notify the issuer whenever his voting rights change due to an acquisition or disposal of major holdings. With regard to any reaching, exceeding or falling the threshold values vary from 5% to 75 %.In addition, the information is also required to be published if major proportions of voting rights are acquired or disposed of in accordance with Article 10.

Therewith it should be ensured that even changes of the voting structures by e.g. contracting on a voting agreement, temporary transfers of voting rights, or similar cases are recorded since the effect is the same. Furthermore, a notification is required in the case of the issuer acquiring or disposing its own shares as soon as the threshold value of 5 % or 10 % is reached, exceeded or has fallen below. Again, the information has to be provided within four trading days. In addition, the public has to be notified, without delay, of any changes in the rights that various classes of shares are entitled. The same applies to any modification of security holders' rights or any new loan issues.

Information for holders of securities admitted to trading on a regulated market.

Another issue the European Union focused on was the information that has to be provided to share and debt holders, especially regarding to their voting rights. It clarifies that all share and debt holders have to be treated equally. Hence, no information asymmetry should exist on the horizontal level by providing more information to some share or debt holders than to others. This especially refers to information that is required to exercise the rights by proxy. Only thereby it can be guaranteed that voting rights are exercised uniformly.

Therefore is has to be ensured that all the information related to the meeting such as time, place and agenda, is known by the share and debt holders. Moreover, the proxy form has to be made available, either in hard copy or electronically to each elective share and debt holder as well as all the necessary information concerning the payment of dividends and the issue of new shares. As a result it should be ensured that every elective share and debt holder can make use of their primary rights by participating in meetings.

General obligations

Control by the home Member State.

Aside from the issuer's duty to keep the public informed concerning the information in the Transparency Directive required, he also has – at the same time – the duty to notify the competent authority of its home Member State. This additional filing has more the purpose of overseeing whether the disclosure requirements are respected than controlling. It has more the effect of making sure that the required information is provided in time, which could not be verified that easily if the information would only be provided for the public.

They are in charge of making the decision of whether to put the information on their Internet site as well. The same applies if an issuer intends to amend its instrument of incorporation or status. Such a proposal has to be handed over to the competent authority as well as to the regulated market. Moreover any information related to an acquisition or disposal of major holdings or major proportions of voting rights has to be deposited at the competent authority of the home Member State as well.

Language provision.

At present, each Member State can insist on disclosing the information in its official language(s). Hence, the Transparency Directive makes a distinction in Article 20 concerning the language issue with the purpose of being more forthright with the world of international finance.

With reference to the language the information has to be disclosed. The Transparency Directive distinguishes in Article 20: If the information is related to securities, which are only traded in the home Member State, the language accepted by its competent authority has to be used. If a host Member State is also involved the information has to be additionally provided either in the language accepted by the competent authority of the host Member State or in the language being used in the field of international finance.

The choice is up to the issuer. In case, the securities are only admitted to trading in the host Member State, but not in the home Member State the language provision concerning the home Member State no longer applies. With this various language provisions it should be ensured that everyone, for whom the information is important and intended for also receives it, in a less costly and less burdensome way; this also with the intention of attracting more investors from third countries. Otherwise the whole disclosure requirements would be senseless if the target group is not capable of turning the information to account.

Third countries.

In case the issuer's registered office is situated in a third country, the competent authority of the home Member State has the power to waive certain disclosure requirements if the third country provides equal ones. This might likely be the case where the United States is the third country, as stricter disclosure rules apply there. Thereby the high disclosure standards are not put at risk and costs for providing the information can be reduced. Hence, the Directive removes senseless burdens by providing an equivalent standard.

***Penalties*.**

The Member States have to ensure, by setting up penalty provision in accordance with their national law that the responsible persons comply with the disclosure requirements provided in the Transparency Directive. As the Transparency Directive entered into force in January 2005 no proposal set up by the Member States to meet their obligations are yet available.

Further European enforcing provisions

The Transparency Directive represents a "framework Directive" according to the agreement with the European Parliament on improving the regulation of EU securities markets from February 2002[32]. Therefore the Transparency Directive itself only sets up general conditions, without dealing with technical minutiae. The further details have to be provided according to the Lamfalussy procedure by the Commission assisted by the European Securities Committee (ESC)[33].

This four-level approach has to be finished within the two-year period as well. Such further rules are e.g. requested for obligations relating to keeping publicly disclosed information available, for the filing of the information in the home Member State, for the dissemination of information and for several definitions such as one for disclosure by electronic means. As the Transparency Directive entered into force in January 2005, no documents related to the Level 2 to 4 are published yet.

[32] See the press release IP/03/436, at p. 3, *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/03/436&format=PDF&aged=1&language=EN&guiLanguage=en

[33] This Committee has been established by the Commission Decision 2001/528/EC of 6 June 2001 (OJ L 191, 07/13/2001, p.45) and only acts consultatively

CONCLUSIONS

The future of Transparency

Chapter 3 showed the importance of transparency in doing business and how this concept evolved from an old passive view to a new active role in the life of a corporation. Nowadays transparency is a real need for all economic communities as the recent regulatory changes in the US and the EU prove.

So what is the role of transparency in future efforts to manage corporate problems and prevent other financial crimes?

A response to this question depends on two things: whether the demand for transparency continues to grow, and whether a culture of transparency can be cultivated, to help counterbalance incentives for continued opacity.

For several reasons, the calls for transparency seen to date are probably only the beginning of a tidal wave of such demands. Part of the reason is globalization, as people become more interdependent they need to know more about each other. But transparency is growing for other reasons as well: technology and democratization and the development of civil society at both the national and global levels

Technology: Thanks to the information revolution, the cost of being transparent has plummeted. This revolution encompasses technologies that produce, process, and convey information, including microelectronics, computers and telecommunications. Not only are surveillance systems, broadcasting systems, data processors, and telecommunications technologies all becoming vastly and rapidly cheaper and more capable, but they are increasingly able to interact.

While no one of these technologies guarantees market success, the pattern is clear: the quantity and scope of data being transmitted, the capacity to manipulate the data, and the number of people connected are all skyrocketing. All this technology does more than reduce the costs of transparency, it also facilitates global integration and, by decentralizing information, empowers civil society, thus contributing to the outward shift of the demand curve.

Democracy and Civil Society: The spread of democratic ideals and democratic forms of government has contributed greatly to demands for transparency. Newly empowered stakeholders want to know what the managing directors are doing in a corporation. Newly elected managing directors have greater incentives than their predecessors to keep the stakeholders informed.

As civil society grows more vigorous around the world, its demands for transparency will escalate. None of these factors seems likely to diminish anytime soon. The information revolution is accelerating everywhere, albeit unevenly. Civil society is both growing and becoming more demanding in virtually all regions of the world. Calls for transparency will outlast the current financial crisis, and if anything are likely to grow.

The dark side of the Corporations

Discussion up to this point has assumed good intentions on the part of economic actors, though not good performance.

But illegal activities, such as frauds or other financial crimes, can also threaten the stability and efficiency of the corporation and the market architecture. Illicit activities are inherently very difficult to measure, but frauds and embezzlement are the most relevant.

One of the main ways fraud affects business is *false accounting*. Often this will not mean that there has been physical theft from the business, but that executives will falsely report results in order to delete their own poor performance and perhaps to protect bonus payment based on reported corporation performance.

The most straightforward form of fraud involves *deception* to conceal theft and its effects. There are many examples, frequently reported in local newspapers, but since the sums are small, this form of crime is so common it is not thought to be newsworthy for the national papers.

A typical example is purchase fraud, where payments are made to a phantom supplier. Checks are issued and paid into an account controlled, perhaps through an alias, by the fraudster, who might typically be in the accounts or purchasing departments of the corporation. A variation on this approach is where a real supplier is prevailed upon to over-invoice. The payment is authorized by the fraudster and the surplus is divided with the supplier.

Role of Transparency in preventing financial crimes

When self-interested behavior veers into outright criminality, transparency still has a role to play. True transparency would cast a light on these activities causing a change in behavior.

If evidence of such activities can be gathered, the guilty can be held accountable through criminal prosecution. And in the case of fraud, even when criminal prosecutions do not occur, revelations of fraud can force the tainted from office. But it is equally clear that unethical executives and managers have overwhelming incentives to resist disclosure of information about their activities.

Activities, as a result, those calling for transparency must target a very broad range of actors and hoping not only to eliminate the shadows in which the unsavory lurk, but also spotlighting the innocent as well.

In short, increasing transparency will be key to the future success of corporate governance. Only with transparency will it be possible to deter frauds, embezzlement and financial scandals, and foster efficiency in the allocation of investments across corporations and countries.

Increasing transparency will be no easy task. Transparency comes up against obstacles ranging from the legitimate corporation's right to privacy to the desire of rent seekers to hide their ill gotten gains. When a corporation is generating externalities by, for example, lying about its financial reserves (thus risking a financial crisis that would prove costly to others) or secretly dumping toxic substances, it has obvious incentives to try to hide the problem

To do so will require sustained effort toward entrenching a norm favoring transparency among these many actors. It often requires power to induce disclosure, either by coercion or by restructuring incentives, and the information thus revealed can shift power from the former holders of secrets to the newly informed.

Rules, regulations, laws, concepts, structures, processes, best practices, and the most progressive use of technology cannot ensure transparency and accountability. This can only come about when individuals of integrity are trying to 'do the right thing,' not just what is expedient or even necessarily what is permissible.

What matters in the end are the actions of people, not simply their words.

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