MARKET FOR AGENCY COSTS: LOOSING THE COMPETITION BY PROTECTING THE IGNORANT Good rules by Good Governance

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Abstract:
Europe is on the threshold of a campaign of imposing more disclosure requirements and costs through company and securities legislation. The following issues led to this European policy: Firstly, the SarbOx adaptation policy was put in place to protect European companies from the SEC’s filings and protect the European economy from the spill over effects in other to boost confidence; secondly, there was the policy on the creation of a single financial market. It will be contended here that the European Member States’ characteristics do not correlate with the aforementioned campaign. Europe is known for its high concentrations of block holders or a low concentration of sophisticated *active* investors who vigorously and effectively look for influence or control; the latter being on the rise. The new disclosure requirements may affect some efficient European countries and could affect a firm-level of governance. Academicians cried for reforms after financial crises and market players fervently hoped for a bigger market. The regulatory competition between the US and the EU is more replica of *Tom & Jerry’s* cartoon chase. In this instance, European Member States still have not adapted to the US costly audit rules of 2002, the PCAOB and the SEC adapted to the UK cost effective regulation by adopting Auditing Standard 5. (Note that AS 5 was adopted less than a year after the Committee of Capital Markets Regulation issued its 1st wake-up call report.) This discloses the fast pace by the US and remarkably the slow pace of the EU in adapting to new events. Who must bear the costs to disclose or monitor? Who must set the disclosure requirements? What kind of rules is needed in Europe in a globalising world? This thesis attempts to give the reader an insight why one of Lisbon’s goals will not be reached in 2010. Added to that, it shows that Europe in fact needs to revitalise its ‘good governance’. This is needed to improve its law-making process and flexibility of rules that harmonise Europe without harming its champion, the UK.

**Keywords:** Sarbanes, Disclosure, Monitoring, Directives, Regulatory Competition, PCAOB, IFRS 7, 404, GAAP, Turnbull, Europe, Equity market, Competition.

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LIST OF ABBREVIATIONS

AS: Auditing Standard

BIT: Bilateral Investment Treaty

BERR: Department of Business Enterprise and Regulatory Reform

CEO: Chief Executive Officer

CESR: Committee of European Securities Regulators

ECJ: European Court of Justice

ECS: European Securities Committee

EU: European Union

LSE: London Stock Exchange

IFRS: International Financial Reporting Standards

IPO: Initial Public Offering

FSAP: Financial Services Action Plan

GAAP: Generally Accepted Accounting Principles

PCAOB: Public Company Accounting Oversight Board

SarbOx: Sarbanes-Oxley Act

SEC: U.S. Securities and Exchange Commission
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I INTRODUCTION

Throughout the last decade Europe undeniably was in a roller coaster. The reasons stem from globalisation, spill over effects of scandals, the competitiveness of the capital markets\(^1\), and the harmonisation of the European capital market\(^2\). All these issues led to the enacting of over 50 new securities and company law directives. Also there was the designation of several high level committees (Kok Report, Winter Report, Lamfalussy Report), thousands white and green paper debates and hundreds of time-consuming implementation measures at European and national level. It is certainly clear that the rollercoaster, in which Europe found itself, placed Europe in precarious position. Many times Europe stood before two options; to serve the interests of its most efficient commercial jurisdiction (London), or to serve the needs of the European retail investors. The UK struggled as well during the making of the preliminary versions of the FSAP Directives. The UK gave counter pressure against the European parliament members and the European Commission in a bid to safeguard its interests. For instance, during the creation of the Transparency Directive\(^3\), the Rapporteur Skinner\(^4\) made some comments on behalf of UK on very important issues. He pointed out that he supported the European Commission’s objective to provide investors in Europe protection in other to foster confidence. But that the quarterly reporting duty would not serve all the Member States interests.\(^5\) He underlined that the ‘current well-functioning systems’ would be affected.\(^6\) In a footnote he made the Commission aware of the fact that Barclays estimated a cost of at least 1.3 million Euros a year if the quarterly reporting duty would be implemented in the Directive.\(^7\) Eventually all quarterly reporting duties were inserted into interim management statements on half-yearly or annual reports basis.\(^8\) During

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1. Lisbon European Council 23 and 24 March 2000 (Presidency Conclusions), for this thesis relevance, Reports on the Competitiveness of Europe: 5795/00 and 7130/00.
6. Ibid.
7. Ibid.
a dinner speech, Ed Balls (Secretary to the Treasury) commented that the “UK fought and
won the battle against quarterly reporting”.9
It did not go differently during the making of the High Level Group (HLG) company law
directives. The HLG10 endorsed to move away from the shareholder and creditor protection
policy and move towards a policy that would concentrate on business efficiency.11 The
Commissioner Bolkestein decided not to follow this recommendation. Enron negatively
affected the cross-listed European companies and the European economy. Added to that,
the enactment of SarbOx increased the risk of dual-listed European firms in the US to be
accused of malpractice. For this reason, Bolkestein’s response to this situation was to adapt
the European audit standards to section 404 of the US SarbOx12. This section regulates the
audit independency (see the 8th company law Directive on Statutory Audits of Annual and
Consolidated Accounts (2006/43/EC13).

Many of the requirements set out in this Directive are applied through the UK statutory
standards.14 These standards can be adopted voluntarily and the requirements are less
detailed.15 During the UK consultation period, UK market parties endorsed the 8th Company
Law Directive’s goal, which is improving the quality of the annual and consolidated
accounts. In contrast, market players forcefully viewed that the Directive’s light touch
approach was not optimal16 as it would in any case increase costs in their efficient business
community.17 For instance in its response, Deloitte raised its concern on the Directive
because of the damage on the UK corporate governance’s efficiency. Deloitte further states

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9 HM Treasury - Speech by Economic Secretary to the Treasury, Ed Balls MP, at the City of London
Corporation Dinner (2006) [Internet] Available from: <http://www.hm-
treasury.gov.uk/newsroom_and_speeches/speeches/econspeeches/speech_est_251006.cfm>, [Accessed
on October 26th, 2007].
10 Winter, J., High Level Group, ‘Report of the High Level Group of Company Law Experts on a Modern
Regulatory Framework for Company Law in Europe’, p. 27.
11 Idem, ACCF (2006), Topics in Corporate Finance, ‘Corporate Governance Regulation and Enforcement in
the US and the EU’, p. 27
14 URN 07/1239, p. 3. (UK Government Policy Conclusions and Draft Regulation).
15 Ibid., p. 4.
BERR Documents Online. [Internet] Available from: <http://www.berr.gov.uk/files/file40558.pdf>,
[Accessed on October 26th, 2007].
17 Ernst and Young views that the there is need for harmonisation, but that the strict implementation in
primary or secondary legislation harms the UK. See: BERR (2007), ‘Response to the Consultation on the
Implementation of the Statutory Audit Directive’, BERR Documents Online. [Internet] Available from:
that the UK Combined Code is respected throughout the world and thus a strategic advantage. This statement was very remarkable as Deloitte was one of Parmalat’s business partners that were negatively affected by the scandal. Because of the responses, the UK government weighed and tested three options; firstly, not to implement the Directive 2006/43/EC nor to opt-out on all gold plated disclosure requirements of the Directive or to fully implement the Directive 2006/43/EC. Recently, in December 2007, the UK Government selected the second option. The costs of the second option were between 5.8 to 7.6 million Euros annually, eventually moving from 8.9 to 10.1 million Euros (see form 1). UK won the clash of the quarterly reports costs that would raise costs with at least 1.3 million Euros, but it certainly lost a higher stake with 2006/43/EC. The topic on cost effective regulation and disclosure costs will be discussed in paragraph III A.

Having said this, the latest disclosure requirements rose from two different developments. Both cross each other’s path. Firstly, there is the legacy of the FSAP to harmonise the European wholesale and retail markets. This harmonisation comes along with disclosure requirements in the securities regulation. Subsequently, the European reaction to the US’ spill over effects is to adapt the US shareholder protective rules, which results in more disclosure requirements in the 8th company law Directive. Many of the aforementioned debates and advice generally brought to fore two general issues. The first in a nutshell, is shifting risks and costs among shareholders and businesses whilst looking at the trade-offs and possible revenues. The second issue is the European ‘good governance’ practice; on who must have the legislative power or how it will be divided in order to guarantee high quality European rules. This is subject to discussion in paragraph III B.

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20 Ed Balls held that some argued that the UK does not need Europe. Balls disagreed, for there are many political advantages if the UK stays in Europe. Secondly, he underlined that due to the low obstacles among Member States, companies are incorporated in the City. However, he announced he would do everything to secure the UK cost effective regulation. That is why the assessment of option 1 (not to comply with the Directive) is always taken into account.
21 There are many other topics as well, such as the effects on the social policy, employment and nationalistic protective ideas. They can be considered as very important; nonetheless, they are not part of the general topics.
European Member States have always had unique corporate governances and principles that correlate with their national characteristics. Globalisation changes the view on disclosure requirements. Due to globalisation of money raising capital markets, more stock exchanges, legislators and even companies must consider changing their laws and bylaws on disclosure and monitoring. An assumed competition between the US and the EU\textsuperscript{22} should prevent legislators and stock exchanges from becoming less attractive to agents.\textsuperscript{23} In the near future new rules that increase or negatively affect business efficiency will correlate more with global competition than with national characters. Political relations between investors as citizens and their governments will be discouraged. The rise of the NYSE is an illustration of the consequences of competition. The success of NYSE in the US was the consequence of a highly competitive epoch in a new landscape where many national exchanges stopped to exist as a result of being unattractive. They did not adapt well to the changing technology and regulatory milieu.\textsuperscript{24} The collapse of the New Orleans Cotton Exchange, Boston Curb Exchange, the California Stock Exchange and some other US exchanges form part of this illustration.\textsuperscript{25} The NYSE became dominant after aggressively using the stock ticker and telegraph systems to broadcast price information all over the US to attract order flow.\textsuperscript{26} In the present day, improved technology and software provide investors the opportunity to look over the borders. There is no geographical barrier for investors or broker-dealers; a commercial jurisdiction’s liquidity is more relative than before. Added to that, globalization has fostered the already ongoing cross-border IPOs which began in the 1970s. This has strengthened the market players’ incentive to compete even more. The trading platforms

\textsuperscript{22} Asian countries such as India could be heavy competitors in this battle if it were not for their lack of interests to ratify BITs with western countries. Even though it is not sure that BITs protect portfolio investments, it would induce competitiveness. In his book, International Law on Foreign Investment (Sornarajah, M., \textit{The International Law on Foreign Investment}, Cambridge, Cambridge University Press 2005, p. 7-8), M. Sornarajah opines that portfolio investments do not fall within BITs’ scope since the IMF excludes portfolio investments when clarifying the term investment. Other scholars think differently plus in several BITs, portfolio investments are explicitly excluded by States. Probably because of uncertainties on this issue, or States might have implicitly recognized the general inclusion of every type of investment in the BIT.

\textsuperscript{23} There is also competition between large investors. Large investors who trade with capital from their clients have a reputation that must be guarded. If the latter goes wrong, clients seek higher dividends from other competitors.


\textsuperscript{25} Ibid., p. 13.

\textsuperscript{26} Ibid., pp. 8-10.
experienced the globalization as an opportunity for further growth. Among the strategies is to list on the stock exchanges to raise higher and *better* capital. Another strategy is to acquire foreign stock exchanges to broaden horizons. Globalization raises the question on how Europe should look at good governance and how to react to costly disclosure requirements in this new era. Due to the recent developments, the question is, who has to bear the costs and in what shape of equity market? The European market does not have a single shape, it is quite the opposite. It has many shapes of corporate control as every Member State has its own features. Sweden, the Netherlands, Germany, Belgium and many other Member States are known for their high level of shareholder concentrations. Among these Member States there are large sociological, economical and historical differences as well. The market in the UK, on the other hand, is characterised by its outsider’s model. Because of the resemblance with the US outsider model, many immediately take the superficial view that capital markets of the US and the UK are almost similar. Yet, the many, so called, outsiders in London are sophisticated investors (see paragraph II). They use their knowledge, legal power and media aggressively to influence boardrooms’ decisions. As this movement grows in Europe, one cannot decide overnight whether there is need for rigid European rules that impose disclosure duties. These disclosure costs are borne by both large and small sophisticated investors. That is why it is believed that markets with dispersed shareholders need to take shareholder protective measures.
The dissertation’s assumption is that sophisticated investors tend to avoid markets with high disclosure costs. They have their own monitoring mechanisms that are market based and deemed to be more economically. They assess better whether internal and material information are fine and accurate. They assess how much cost they are prepared to abide by comparing these costs with the capital flow returns although bearing in mind the consequences of high monitoring costs that is share value. The fact that the low share price may be perceived as undervalued attracts takeovers. This increases the share value and may partly compensate prior monitoring costs.\(^{27}\) Therefore, market based monitoring

\(^{27}\) The use of Martin Lipton’s poison pills in bylaws (companies’ statutes) is a mechanism that gives the manager power to use the handbrake indefinitely, which is going away from the shareholder oriented model. Scaring prospective buyers away by saying “talk with us or we kill the company” is the wrong message to send out. Current shareholders want their shares to stay liquid. However, there are many situations where the board was able to get a higher price for the shareholders than would otherwise have been obtained because of the board’s ability to prevent the bidder from buying too cheaply. Having said that, what does the board solely know about fair value? Martin Lipton himself uses nationalistic arguments in favour for these pills. Bebchuck promoted the use of a poison pill antidote, which consists of changing by-laws so to prevent managers to use poison pills indefinitely without the consent of the majority of shareholders or the consent of a unanimous board. Lipton finds these amendments pernicious, because under Bebchuck’s plan the board could be rendered voiceless on the most sensitive topic, by the tyranny of one vote against the rest. (See for more on the discussion: Lipton, M and Gordon, M. (2006) Destructing American Business [available from:] <http://www.law.harvard.edu/faculty/bebchuk/Policy/deconstructing.pdf> [Last modified: n.d] [Accessed: September 22\(^{26}\), 2007] and Harvard Law School (2006) Bebchuck files suit in Delaware Court over poison pill
mechanisms have to be considered as very efficient. Added to that, it is common sense that sophisticated institutional investors regard timely non-financial performances measures as very essential; especially in the BioTech-Pharmaceutical sector. For instance why should these investors bear disclosure costs after acquiring very important non-material information a few months or years earlier? They would be harmed twice for either actively searching for non-financial information or for bearing disclosure costs that is imposed by legislation.

On the other hand, retail investors are not homo economici who calculate their risks and profits. Stout argues that retail investors (unsophisticated investors) seem to be trusted investors who do not behave as if they were rational. “[They make]… themselves vulnerable to persons who have behaved well in the past. As a result, innocent investors are betrayed or defrauded – at least once”. She further concludes that most retail investors in the US are trusting investors. The US Senate reacted tremendously on the adversity that affected some company’s shareholders. The additional disclosure costs after Enron are automatically borne by open companies, where the agent remains with a smaller budget. This negatively affects everybody’s goal. In addition, investors are harmed twice as both their investments and likely dividends are lost. Another focal point is that imposing too much disclosure duties can invite the danger of material information overkill. It does not come as a surprise that unsophisticated investors are not able to handle the data properly. McCahery and Armour noted that before Enron collapsed, there were gaps in the data made available to the public. It was further concluded that not only that the company eventually failed but that the available information was ignored. Unlike sophisticated investors, they do not have the means to assess the information that is broadcasted. Sophisticated investors mostly have lawyers, economists and other analysts who conduct due diligences, look for gaps in data and


have the ability to alert the board using their influential position. Whether the high disclosure costs are entirely legitimate could then be questioned. Section 409 SarbOx requires an easy understandable use of language in the financial reports. Whether this initiative solely is successful or whether this is the first step in helping uneducated investors to recognise the value deviation is not yet clear. What is clear is that sophisticated investors seek other markets where disclosure costs are lower. They seek markets where the monitoring practice is not restricted by economical consequences induced by legal duties.

Fig. 1: Agency costs divided in monitoring costs and disclosure costs

\[ Z = \sum A \cdot B \cdot C \] (more info on B in paragraph 3)

The third box is based on the Jensen and McKling theory (see: McColgan, P., University of Strathclyde, Department of Accounting and Finance, Glasgow: “Agency Theory and Corporate Governance: a Review of the Literature from a UK Perspective”, p.4)

There is no doubt that legislators will want to keep authority on determining the rules in their financial markets. They serve a superior goal, which are keeping the equity market competitive by keeping the capital in the market fluid or ensuring growth and employment. This, in combination with the transatlantic competition cultivates the need for a study that answers the second question, which is: what type of ground-breaking rules is needed? Unlike the UK, that has broadly chosen the risk-based regulation; the US Senate chose its own path by drafting SarbOx. With this Act the agent’s willpower to disclose properly on an ongoing basis was encouraged. By section 302 SarbOx, agents have the duty to sign all financial reports. By signing this, they will be liable for misleading the market if the information is incorrect. The latter statement goes along with the knowledge of the fact that the agent has full internal control. Section 401 of the SarbOx requires that all material information that is disclosed is accurate and not ‘just enough’ to recognise the deviation between the share value and the material information. Off-balance sheet transactions, liabilities and other transactions
have to be included in the financial reports. Section 404 deals with the financial reporting regarding the internal control. The after-effect of SarbOx’ enactment was that the audit costs rose astronomically as disclosed by the Fortune 1000 companies on retail, energy and insurance industries.\(^{32}\) This, in combination with the regular intervals of disclosure, makes SarbOx an Act that demands a high level of compliance, which suppresses the firms’ value. This seems detrimental to the cross-listed companies who seek for more liquidity and deeper markets abroad because they have a duty to submit to an international consolidated account. This negatively affects the share value and the potential dividends. In addition the agent’s remuneration and budget is affected thus determining additional\(^{33}\) goals to keep the firm highly competitive.

As said, strict regulation in essence keeps the capital flow because shareholders who are protected by it will not seek for control or influence. In other words, it is beneficial for the economic development to draft strict disclosure rules.\(^{34}\) The basic argument is that block holders harm the liquidity of firms and capital markets and their influence should drastically be reduced. This much used hypothesis has its trade-offs. According to many studies, it is ridiculous to consider that regulation ensures fair value. Irrational behaviours in the market make different investors to value their shares differently. Furthermore, national legislators only protect public interests. Searing active block holders away could negatively affect retail investors who base their successes from sophisticated investors. Sophisticated investors could provide turn immaterial information into material. Therefore, information becomes relevant earlier and retail investors are better protected because of that. Material information is not only published earlier, but in many occasions the information is filtered out. And lastly, many studies have concluded that it is important to attain the diversity. This will be discussed in paragraph III D.

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33 Aside from the short and long term shareholders’ goal to provide good dividends and to keep the firm healthy respectively, on many occasions the CEO has additional goals to reach, such as innovation, high competitiveness and the personal reputation.

The third question is whether regulators’ interventions are still appreciable? The agency costs and problems on itself is not a novel issue. The reality is that these problems have occurred in private and public companies. These problems have not always occurred in a transatlantic securities trading platform. In other words, the agency problem has always been imminent – evolution has simply shifted and distributed the problem. Legislators have tried to do away with this dilemma. However due to the ever evolving of new unidentified circumstances, again new problems had to be solved and new policies and solutions were needed. In an interview, Lord Goff, member of the House of Lords in England, held that “[the role of law in general is to]…help businessmen [, but]…not [to]…hinder them [,] to give effect to [their] transactions [not to]…frustrate them…”35 Law ought to do its job, but legislators are not really aware of the effect of having quality regulation. Firstly, legislators have no dealings with the consequences of the law’s lacunae or the costs of market failures. They do not instantly sense where failures may be in other to prevent prospective hindrances. For this reason they are incapable of acting after problems have occurred. Legislators and regulatory watchers improved their regulation on financial disclosure after Enron,36 Parmalat, US Foodservice and Ahold.37 New regulation was also adopted after the innovation of the communication technology and globalisation. In so doing, legislators endeavour to create a platform in their commercial jurisdictions that creates, ensures and improve confidence.38

Stock exchanges are highly sensitive markets where the aspiration must not allow any excessive damage to that confidence.39 Berle and Means warned on the agency conflict. Yet, the US kept on trusting agents. In the 1990s, the salaries of the agents were linked with the share prices; agents constantly did positive re-statements that amplified the share value. Hence, their

37 Ahold was accused of false bookkeeping and deceiving on the ownership and control of a subsidiary.
38 According to the Financial Services Act 1986, the Financial Services Authority has the authority – among others – to make rules and give directions with the underlying regulatory objective to maintain confidence in the financial system (see: D Digman, A. and Lowry, J., ‘Hannigan Company Law (3rd Edition)’. London, LexisNexis Butterworths., 2006, p. 66). The Financial Services Action Plan endeavours to foster the investor confidence (see: supra, footnote 1)
salaries were always on the increase.\textsuperscript{40} When the bubble burst, the agents of Enron and WorldCom sought innovative ways to hide the deviations, then it was already too late. After the reactions of the legislator, many studies concluded that “[Pending legal provisions that are heavily scrutinised and] … that have been debated for years [due to their far-reaching policy]… simply would not have been passed without [financial scandals]”\textsuperscript{41} Other conclusions that fit within the critics’ bias are that, it seems that legislators from capital markets with disperse shareholders were merely able to impose more disclosure rules and costs to listed companies. Fourthly, the deficiency of promptness of the process of making new law can harm the interests and negatively affect the position of the market participants. Thus, many scholars conclude that, after Enron, legislators overreacted when drafting excessive stricter rules.\textsuperscript{42} On the other hand, it was important to create investors’ confidence in a competitive global market by taking actions but without imposing costly rules. Another remark is that next to the fact that the SEC enforces the SarbOx, the PCAOB together with SEC have the authority to create new binding standards. The SEC and the PCAOB are able to adopt standards to events quickly and adequately by the combination of the expertise and authority of the two agencies. Europe can learn from the US good governance practice. This will be discussed in paragraph III C.

In paragraph two, the initial schemes and groundbreaking events are identified by analysing history and present. The important historical events that have shaped the US and the UK capital market landscapes are taken into account. By looking at those events, it is feasible to analyse the inspirations and the philosophy of national equilibriums behind the creation of the markets and why regulation is needed. Throughout the assessments on the burdens of the disclosure duties, both securities and company regulation are taken into account. According to many scholars the duties in securities regulation depend on the burden of duties in the company law. It is important to safeguard a balance between both regulations in order to shape corporate govenances that correlate with the characteristics of the States.

\textsuperscript{40} ECGI (2004) – Conference: Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective, Brussels “Presentation by Melvin Eisenberg, Koret Professor of Law, University of Berkeley, California” [Internet] Available from: <http://www.ecgi.org/tegd/launch/eisenberg_speech.php>.


\textsuperscript{42} Ibid.
Paragraph three examines the investors’ incentive to monitor. Also to be discussed is the managers’ incentive to list elsewhere and how Europe has reacted or should react to that. It further assesses what is needed to lower agency costs. This paragraph looks at the cost-effective rules and the drafters themselves. This is analysed by discussing the agency and corporate theories and looking at facts and figures. Paragraph four concludes. This paper attempts to provide a legal based answer which is written from a business lawyer’s theoretical point of view, by means of pinpointing both legal as well as economic determining factors. Corporate governance, as such, is a very complex topic to write on. It has its many dimensions within the areas of politics, economics, law, history and even psychology.

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II THE ASCENDANCY OF CORPORATE GOVERNANCE REGULATION
AND TODAY’S FUTURE

HISTORY
In many commercial jurisdictions, different types of capital markets evolved due to the actions of market players and actions of legislators. The legislators’ decisions were commonly based on social and economic conditions with an emphasis on reallocations of capital and risks. Consequently, many commercial jurisdictions were affected by the effects of new company and securities legislations. As we understand, the equilibrium between both legislations creates unique corporate governances that correlate with the State’s capital market. Hence, the formation of efficient disclosure or monitoring mechanisms in many States was not intended by legislators who look for efficiency or shareholder protection, but as a result from other events in history. US legislators for instance have not deliberately shaped the US equity market that we know today. They reacted adequately to certain events in the past. The following subparagraphs in section ‘History’ indicates how UK and the US legislators reacted differently to important events and scandals in their business community. It will be contended here that the UK formed unique corporate governance in which securities and company law have formed an efficient model while the US corporate governance consists of two extremely different approaches. This will be followed by the section, ‘Present’ where the reaction of the EU to the globalisation and scandals are discussed. It will be suggested that reaction from European legislators negatively affect the UK.

The following subparagraph discusses the relevant events which have distributed the capital and risks within the US and UK capital market and secondly, the legislators’ conducts that have tried to impede the market failures. In the 19th century a number of events shaped the current capital markets and the following paragraphs will examine those events that had great impact on the capital market.
A) THE UK CAPITAL MARKET AND ITS CORRELATION WITH ITS CORPORATE GOVERNANCE

In western countries, such as the US and UK, “… [new-fangled] rail and telegraph systems called for the creation of new type[s] of business enterprise[s]”. In the UK, Acts such as the Gauge of Railway Act of 1846 were parliamentary enacted, which served as licenses that producers needed in other to build railways. Licenses were granted on the condition that producers had sufficient capital. This resulted in many competitive road shows. “… [A] largely untaxed middle class had amassed [n] … amount of wealth over the course of the mid to late nineteenth century which needed a home”. In 1844, England enacted the Joint Stock Companies Act which made it possible for investors to become shareholders of businesses. Middle class people with capital invested in companies with legal frameworks that were provided by the Joint Stock Companies Act. These shareholders did not have the capacity to control the company and others were hired to manage the company. The concern at that time was the loss of a great amount of invested capital due to the time of completion. Each single enlargement or change of the railway needed permission by Act of Parliament (see for instance section 2 and 3 of the Gauge of Railway Act). The work was delayed and it became more expensive as the days rolled by. The Border Counties Railway Act of 1854 entered into force in other to accelerate the time of completion. The goals of this Act were to advance economic development by raising more

47 Ibid., pp. 16-18.
capital and management.\textsuperscript{49} There was indeed more freedom to raise capital, but this encouraged a familiar conduct by managers regarded as window dressing.\textsuperscript{50} Thus, aside from the positive aspects, concerns increased as well because many “…businessmen [were] apt to delude themselves, by expecting impossible results to arise, by natural magic, from mere inactive investments…”.\textsuperscript{51} This concern combined with the above mentioned revolution and subsequent large amounts of invested capital founded a new philosophy of the need for an alignment of interests. It was not until the enactment of the 1855 Limited Liability Act that members of the company for the first time became liable for the share price they held.

Post-war circumstances fostered a dispersed-ownership regime that consists of sophisticated shareholders. Among the small shareholders are pension funds and life insurance companies\textsuperscript{52} and presently hedge funds. The well-known British economist, John Maynard Keynes, advised the government to halt financing war by means of debt and to raise the income tax rate on capital income instead.\textsuperscript{53} This was a change of war funding policy. During WWI, England was not invaded and was therefore able to fund the war “by running down its large stock of private foreign assets against newly issued public debt”.\textsuperscript{54} In contrast, during the WWII, the City of London was bombed for a period of three years. Much was at stake


\textsuperscript{51} Ibid.


and Keynes’ advice piloted a policy that led to the decline of retail investors.\textsuperscript{55} Retail investors invested in pension funds and insurance companies. Consequently, pension funds and insurance companies gained capital due to a combination of a deficiency of tax hindrances and on the other hand high personal income tax rates.\textsuperscript{56} Additionally, these were strengthened by the social policy after WWII. “The inflationary shocks led to major social security programs … [in Pan-Europe]”.\textsuperscript{57} Before WWII, social security programs were intended for soldiers and mineworkers.\textsuperscript{58} After WWII, it became an entitlement for everybody. United Kingdom’s social security program was heavily extended in 1946. This, in accordance with Perotti and Von Thadden’s theory which suggested that the dramatic inflationary shocks that hit during wartime, caused major financial shifts. Major capital streams ran into Pension Funds (see: table 1).

\textit{Table 1: Development of Pension Systems in Various Countries}

<table>
<thead>
<tr>
<th>Country</th>
<th>Year of First Program</th>
<th>Year of First Major Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>1910</td>
<td>1945</td>
</tr>
<tr>
<td>Germany</td>
<td>1889</td>
<td>1949</td>
</tr>
<tr>
<td>Ireland</td>
<td>1908</td>
<td>1952</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1913</td>
<td>1957</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1898</td>
<td>1938</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1908</td>
<td>1948</td>
</tr>
<tr>
<td>United States</td>
<td>1896</td>
<td>1935</td>
</tr>
</tbody>
</table>


\textsuperscript{57} Perotti, E. and Schwienbacher, A., Activists Investors, Hedge Funds and Corporate Governance “Chapter IV: The Political Origin of Pension Funding” p. 6.

\textsuperscript{58} Ibid., p. 23.
Pension funds became financial refined and increased shareholders influence and controlling interests. In addition to that, they acquired great amounts of influential voting shares. As institutional investors attained high blocks of shares, it became apparent that they acquired more control within a company and subsequently determine their own rights in corporate governance statues. During the mid 1970’s and 1980’s, institutional investors started using their controlling power to monitor, hire or sack boards, if need be. The Coase-Williamson theory, explained in chapter III C, instigated this thought of actively monitoring the company (firm level monitoring).

Due to a common law system that provides fair remedies distilled from contractual agreements, minority shareholder rights were already protected from the decision powers of large shareholders\(^59\) and increasingly from boards (see chart 2). In conjunction with the deregulation policy of the 1970s and 1980s, the London Stock Exchange had lesser difficult\(^60\) to find support for the UK corporate governance rules. This is based on the principle of comply or explain, which is the principle of a shareholder oriented corporate governance. When the LSE lists it becomes redundant and it should have had financial interests in regulating the market after listing. The FSA carried out the tasks to regulate the market from 2000.

**B) THE REACTION TO UK SCANDALS**

In the 1980s, the UK market experienced a number of financial scandals. Agents of Poly Peck International Plc and the Robert Maxwell Group were among those held responsible.\(^61\)

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\(^{59}\) Edwards v. Halliwell [1950] 2 All ER 1064. A shareholder has the right to enforce the article of association in order to prevent the company from amending or breaching these articles. Additionally, a shareholder has the right to bring a personal action to prevent a special majority from deviation of the articles of association. (See: Digman, A. and Lowry, J., ‘Hannigan Company Law (3rd Edition)’. London, LexisNexis Butterworths., 2006.)


The agent of the Robert Maxwell Group transferred, without authority, 350 million pounds sterling from a Maxwell Group’s pension fund to a number of private companies.\textsuperscript{62} The agent of Poly Peck International had ‘conflicting interests’ of doing business with two companies he was chairman of.\textsuperscript{63} He was accused of theft and false accounting.\textsuperscript{64} The UK subsequently designated a committee to study on how to deal with the agency problem. The Cadbury Committee’s ambition was not to impose costly rules which would negatively affect the business efficiency. A best financial disclosure practice doctrine was initiated in 1993. According to Sir Cadbury, ex ante monitoring by non-executive directors would improve the efficiency of the agent’s conducts.\textsuperscript{65} This practice was implemented in the LSE listing rules. It was finally enacted in March 2005. Until 2005, listed companies voluntary complied with the rules of the Operating Financial Report.\textsuperscript{66} Therefore, the principle of corporate governance has acquired respect around the world. It does not impose strict and costly rules but it works effectively. This Operating Financial Report was replaced in December 2005 by the Business Review, which lessened the reporting of public listed companies’ burden and costs by 33 million pounds sterling.\textsuperscript{67} The UK Business Review only demands the reporting of analyses of business performance to the extent necessary.\textsuperscript{68} Additionally, the Business Review does not exercise the \textit{one size fits all} principle since the comprehensiveness of the report’s analysis on the business performance depends on the size and complexity of businesses.\textsuperscript{69} This is entirely different than the principle of the SarbOx.

Given that the UK is a member of the EU, the UK has the duty to implement Directives that are drafted by the Commission and the European Parliament. The EU Directive 2006/46/EC, also known as the Company Reporting Directive will be shortly enforced. The Directive is together with the Directive 2006/43/EC on Statutory Audit of Annual and

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\textsuperscript{67} Ibid.
\textsuperscript{68} Ibid, p. 6.
\textsuperscript{69} Ibid, p. 6.
Consolidated Accounts the European light version of the SarbOx. This will be discussed in section ‘Present’ of paragraph II.

C) THE US CAPITAL MARKET AND ITS CORRELATION WITH ITS CORPORATE GOVERNANCE

New England States, Connecticut and New Hampshire adopted the general Act of Limited Liability in 1818 and 1837 respectively. Andrew Jackson, who was then US President (1829-1837), ostracized big companies with shareholders who hid behind its legal frameworks and charters. Additionally, he disliked big banks that were desperate for money. This consequently led to the removal of the Second Bank of America in the US market. Hence, during the Jacksonian Democracy period, these States fell back into the unlimited liability. When this era ended in 1857, the US adopted the limited liability principle once more. During the last quarter of the 19th century and the first ten years of the following century, banks, such as the Chase National Bank and insurance companies gained more economic power. They sat on the boards of many powerful industrial firms due to many mergers and reorganizations since 1890. These reorganizations were part of a scheme to reduce competition amongst producers to stabilize the US economy and its dollar. Large-scale reorganizations were reason for the fact that “… 5,000 previously independent concerns … [united] into … 300 industrial trusts”. The US capital market was before 1915, characterized by the many concentrations of shareholders. This was partly initiated by JP Morgan who “was primary banker to numerous railroads … [and the] … establishe[r] of the Northern Securities Company to control a group of major railroads”. Bankers controlled

75 Ibid.
76 Ibid.
56% of the US gross domestic product. They sat in boardrooms of competitors in same market and this affected the economy. Woodrow Wilson - the US President (1913-1921) ratified the 1914 Clayton Act which prohibited the interlocking of directors (section 18 of the Clayton Act). The Clayton Act was a result of the legislator’s fear of the concentration and misuse of economic power in the internal market. The Federal Trade Commission (1914) received the mandate to supervise mergers in order to protect national consumer’s interests. The action of the legislators was considered to be one of the most influential decisions as it shaped the US capital market. Three years after the 1929 Wall Street Crash, the Glass-Steagall Act was ratified. Section 16 and 21 of the Act prohibited banks and insurance companies to hold equity. Investment and commercial banks were excluded. In contrast, national banks were allowed to purchase securities only up to 10%.

There are other important events in history that had great impact on the US capital market as well. Before 1929, “… investors were introduced to the idea of large-scale collective investments” Investment companies created large liquidity by pooling the resources of individual investors. The inspiration of the managers of investment companies was to pay them selves enormously. According to Armour, this goal can only be reached by keeping the monitoring costs minimal and by enhancing returns of capital without increasing investments by using borrowed money (leveraging). Consequently, investment companies

81 Ibid., p. 28.
82 Ibid.
were at high risk of taking passive investors with antiquated block of shares and debts. Especially, closed-end management companies traded with fixed shares in stock exchanges at discounts from the net asset value. After 1929, a large amount of retail investors lost their trust in investment companies and restrictive rules were now set for investment companies. Subsequently, investment companies were therefore not capable to function as block holder investors as they had no sufficient capital owing to the heavy regulation by the new securities Act.

Professors Berle and Means identified another characteristic that made scholars and legislators aware of the problems within the field of ownership and control. Berle and Means (1932) remarked in their book ‘The Modern Corporation and Private Property’, that, in 1920s, US corporations with dispersed shareholders emerged from family owned enterprises or high shareholder concentrations. As these retail shareholders were neither interested nor experienced in controlling companies, managers took over and moral hazards situations loomed. The realisation of this fact changed the views of many scholars and legislators. A new idea was to try to lower agency costs by making it impossible for decision makers to act unfaithfully. These assumptions ended the laissez-faire philosophy within the securities markets. It led to vast legal acts with corporate disclosure requirements and hard line securities law enforcement. These Acts are laid down in the post-depression Securities Acts of the 1930s in the last century.

The aforementioned acts and events enormously influenced the US capital market. It led to the US capital market being typified as shareholder dispersed. Consequently, this led to a more authoritarian securities law (regulatory-led). The presumption was that dispersed shareholders needed more protection than institutional investors. The other reason was that

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85 Ibid., p. 3.
the crisis of 1929 should not be allowed to happen again. This, in combination with the managerial model, company law of Delaware does not reflect the type of governance in the UK, where its corporate governance principle is shareholder-led and oriented. The US federal securities law is shareholder oriented and the Delaware company law prioritises agent’s interests. Therefore, the corporate governance is affected by the state and federal law.

D) THE REACTION TO US SCANDALS

Many have observed that the race to the bottom, which resulted in the Delaware’s pole position, triggered the agent’s objective to incorporation in the State of Delaware. The Delaware company law on agent (manager) was quite attractive. It led to many international and national companies being incorporated in this State. 50% of all US listed companies and 60% of the Fortune 500 has a seat in Delaware. The Delaware’s company law provides the shareholders with not so many effective rights against boards. Agents benefit from the freedom in the internal corporate affairs as there were opportunities for agents to initiate risky projects without having to deal with the principals (shareholders). In their groundbreaking work, Lele and Siems measured the effectiveness of the shareholder protection in five different countries with a lexicometric approach. (Amongst those countries are the US and UK.) This implied that Lele and Siems ranked all shareholder protective provisions. If the variable equals 1, it means that shareholders have effective rights. If the variable equals 0 it means that there is no shareholder power. (There are also positions between 0 and 1.) By accumulating the variables it is possible to effectively assess the amount

of shareholder protection in the US and/or Delaware and the UK. Chart 2, which is based on their leximetric approach, shows the effectiveness of the shareholder protection provided in Delaware and in the UK.

*Chart 2: A Leximetric Approach to the positions of Delaware and UK Company Law shareholder rights*

Bratton and McCahery viewed that the US Congress, after the Scandals, wanted to compensate the shareholders’ internal affairs rights by enlarging market disclosure duties for managers (see chart 3). This would bring balance back in the US corporate governance. Hence, these scandals have adjusted the equilibrium between state company law and federal securities law by increasing disclosure costs. Furthermore, Eisenberg views that the federal government’s incentive was to attain a strong national market. Added to that, he reasoned that the federal government had a strong interest in an efficient State’s company law, for income tax on a federal level is based on profitability, whereas Delaware’s income is not based on profitability, but incorporation. Eisenberg concluded that a concession between the federal government and Delaware was virtually signed:

“If Delaware law got too bad, the federal government would intervene. If the federal government intervened, Delaware law would be less attractive, because it would matter less where you incorporated.”

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93 Ibid.


95 Ibid.
The goal eventually was to provide shareholders more protection by means of enhancing federal securities law. The idea was to provide retail investors more reliable material information in order to make them able to assess whether selling their shares is appreciable if they do not like the boards’ performances. Many scientists state that the reaction of the US federal legislator has put the US capital market in danger. This will be discussed in the next subparagraphs.

In all, the Delaware company law did not react to the scandals as can be seen in chart 2 and 3. The above-mentioned enhancements of the ruling and disclosure costs in the national securities laws are the result of the national regulator’s efforts to reach out to retail investors. The US capital market is typified by its regulatory-led securities law with high federal shareholder protection. The US Committee on Capital Markets Regulation published the ‘wake-up’ reports one and two. (These reports will be handled in the following subparagraphs.) The reports mirrored the Committee’s concerns on the competitive position of the US capital market. One of these concerns was that there were too many burdens for public companies. Hence, one can undeniably advocate that as the company and securities law are interrelated, that the gains of the Delaware State could mean the loss of the US national exchange in a global competitive market. The next subparagraphs discuss the competitive position of the UK (EU) and the US by looking at the disclosure mechanisms in general.
PRESENT

E) EUROPEAN REACTION TO GLOBALISATION: COMPETITION OR HARMONISATION

Both in the US and the UK, regulatory positions or events influenced the allocation of wealth and capital. Due to these events, the UK and the US attained equity markets with dispersed shareholdings. However, there were differences between the US and UK equity market. For instance, the US Clayton Act and the Glass-Steagall Act took away the right of banks to hold considerable amounts of equity and market power, and the 1930s Securities Acts fostered liquidity even more. On the other hand, the UK post-war policy, combined with the jurisprudence that protects the notion of the contract brought another difference between UK and US market. Many small investors in the UK, such as pension funds, hedge funds and insurance companies became very sophisticated. Whereas the US retail investors are in general the working class who use their returns for their educational expenses and other household expenditures. Legislators drafted new rules while considering the public interests of the nation, such as social security, war funding, shareholding and consumer interests. Legislators delineated the financial markets by making new rules and adapting to new local requirements making no room for globalisation. This has established a strong correlation between corporate governance rules and State features.

As globalisation continues, the stock exchange houses listed and forayed into other borders. There was gradually elevation of companies and such came with its attendant problems. The rules on disclosure and audits practice were not synchronised. However, the latest US Federal SarbOx Act has not bothered with the globalisation of markets. On the other hand, the European Commission adopted almost a decade ago a competitive action plan that would ‘modernise’ company law and enhance corporate governance.96 Added to that, the Lisbon Agenda indeed took the globalisation in consideration by mentioning the competitive position of the European Union. The Financial Services Action Plan’s goal was to harmonise the European capital market. Additionally, the High Level Group of Company Law Experts (HLG) that emanated from the Lisbon accord received the mandate to observe the very

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implications and to recommend for the upcoming company law Directives outline. The HLG viewed that the Action Plan had to be in concurrence with the Lisbon Agenda’s goals, which was to form a competitive European commercial jurisdiction that is able to stand against the upcoming powers in the east and US in the west. To achieve this, a new European company law legal framework had to be created that is open, transparent and importantly business efficient. Winter, the HLG’s chairman, concluded that “indeed… [the European] company law [needed to]… catch up with…recent developments”. The HLG further decided to step away from the stakeholder primacy policy, which was broadly used by Europe to harmonise the European company legislation. This stakeholder policy resulted in nine company law directives; those are, the 1st, 2nd, 3rd, 4th, 6th, 7th, 8th, 11th and the 12th Directive. Accordingly, the HLG’s recommendation was to construct company law Directives that are more efficient for businesses and investors so as to increase the market’s competitiveness with the rest of the world. The agenda set for the forthcoming company law Directives was the protection of business efficiency and European’s most efficient capital market (UK).

The HLG’s recommendation to create a European company law based on the principles of efficiency and competitiveness of businesses did not become its legacy, as the European Commission did not follow the HLG’s proposals. Bolkestein suggested that Europe should adopt the US SarbOx. Europe urging the UK to implement these additional standards (2006/43/EC) in their primary and secondary regulation. These additional standards do not correlate with the UK legislative features, but more with the US features. It was thought that it could negatively affect the attractiveness to the City of London. There is no correlation between these new European rules (2006/43/EC) and the features in the UK capital market. This is because the very last English scandals dated back to 1980s and early 1990s. Secondly, the UK legislators reacted differently to scandals, compared with the US legislators, by composing risk-based regulation. Since the 1980s the UK started eradicating all inefficient rules. The Cadbury and the Turnbull guidance, of which the latter is the UK version of the execution of section 404 SarbOx, were as a result of the deregulation policy. They were not

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97 Ibid, p. 2.  
99 Ibid.
imposed but rather assimilated by the companies.\textsuperscript{100} Urging the UK to adopt the US securities law because of the globalisation could be pernicious. Chart 4 shows that the security regulations in the UK and the US are not the same. The security regulation in the UK consists of listing rules and best practice standards, whereas the US has strict regulation and listing rules. The US has taken much effort for advanced shareholder protective measures in the securities regulation since 2000. Between 1995 and 2000 there was even a noticeable decline in disclosure duties. As these enhancement are tailor made for the US capital market, it must be questioned whether these rules would be suitable for the UK capital market.


Many economic scientists put question marks to the Sarbanes-Oxley Act which became law in 2002. It led to a decrease in IPO’s (see: table A at section tables and figures), a decrease in share value trading in the US capital market (see: chart 5), an increase in delisting\textsuperscript{101} and an


increase in competition by European stock exchanges, especially the LSE (see: chart D at section tables and figures).\textsuperscript{102} This means that the competitive position of the US capital market is in danger. The raison d’être is that article 302, in conjunction with article 404, of the Sarbanes-Oxley Act has a great impact on the disclosure costs. Every data that may consider being material information and every record that may affect the share price need to be taken into the financial report. This may even lead to material information overkill. Additionally, it is expected that public firm disclose on a continual basis. In contrast, the UK Business Review only demands the reporting of analyses of business performance to the extent necessary.\textsuperscript{103}

*Chart 5: Index Growth Equity Trading Value*

The total of shareholder protective measures (in both company and securities regulation) is shown in chart 6. Romano’s empirical study shows that in the US the increasing shareholder activism has not led to better firm performance.\textsuperscript{104} Shareholders in the US have used internal

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\textsuperscript{102} Many scholars opines that the enactment of Sarbanes-Oxley was not the cause for the reducing of the emissions in 2002, they blame 9/11 and the improved communication technology. The latter makes it for investors possible to buy shares in foreign exchanges.


controls that were provided by the law such as the Exchange Act Rule 14a-8 (proxy fighting) and submitted proposals. Romano therefore recommends institutional investors to step up and implement new effective internal monitoring mechanisms as institutional investors have little to say in the US. Additionally, Bebchuck claims that it is a myth that shareholders are able to even threaten the boards of US public companies. His much criticised study because of its hard-line of anti Delaware Corporate Law approach, observes that UK company law provides shareholders more protection than US Delaware company law. The removal of boards is indeed an existent threat to boards of UK public companies. That is what makes them more responsible, whereas the Delaware provides shareholder protective rules that are not effective. This difference is crucial as can be seen in the UK and the Netherlands, where not only the block holders, but the ‘influential holders’ as well, are able to effectively threaten boards with legal instruments and open letters. See for instance the Dutch case of British shareholder TCI a major share holder at ABN Amro and HSBC and its activist Knight Vinke who openly criticises the wages and performances of the board.

*Chart 6: UK v. US: Overall Shareholders protection v. Boards*

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Reactions of the US federal regulator after Enron, demonstrates the incapability to provide shareholders with more active rights in the internal corporate affairs without the help of the Delaware State. The federal government’s message was that misconduct by agents and auditors should cease forthwith. The incapability to make effective rules without the States’ participation resulted in the fact that shareholders did not obtain more effective active rights in internal corporate affairs. Merely more disclosure duties were imposed to agents’ and auditors. When critically looked at, it can be concluded that there was a balance being sought between primarily the agent’s duties and, secondarily, the shareholders’ rights. However the agent’s duties could be looked at from the view of national financial reasons as explained in subparagraph II D.

*Chart 7: The Equilibrium between the UK Company and Securities Regulation*

Globalisation has affected Europe in the new equilibrium between the US Federal Securities Law and Delaware’s Company Law. Europe tries to keep up with globalisation by means of modernising European Legislation. It has therefore drafted new harmonizing Directives. The UK, as a Member, has the duty to implement these European Directives into their National Corporate Laws (see table 2 and figure 6).
Table 2: UK and US Corporate Governance Principles

<table>
<thead>
<tr>
<th>Shareholder-led</th>
<th>Regulatory-led</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder Oriented</td>
<td>UK (Comply or Explain)</td>
</tr>
<tr>
<td>Manager Oriented</td>
<td>US (strict regulation laid upon managers)</td>
</tr>
<tr>
<td></td>
<td>US Delaware (no effective shareholder rights)</td>
</tr>
</tbody>
</table>

Fig. 2: Effects of a Globalizing Market: The Equilibriums (in Dots and Red Lines) that Preserve the Political, Economical and Financial Balances

There are many reasons for Europe to draft these new Directives. One of those was to protect international cross-listed European companies, specifically those listed in the US. During his dinner speech, Bolkestein noted the interdependence of the US and EU economies. He stated that “the transatlantic economies employ 12 million employees, [and] that [the] US and EU capital markets amount to 50 trillion dollars and 60% of the world trade are in commercial services […]”. What is done in the US affects the EU and therefore Bolkestein concluded that the regulatory spill over effect of SarbOx was “[…] not an exception, but the rule.” There was need for taking control over the regulatory spill over. Hence, Bolkestein conferred with the PCAOB and the SEC on 2006/43/EC. Therefore the 2006/43/EC is not only a result of globalisation, but an international political concession as well.

109 Ibid.
All said, as Bolkestein waived his sceptre and decided to slightly adapt to US standards, he designated Winter as chairman of the High Level Group of Company Experts who concluded that Europe needed business efficient ruling. Bolkestein did not tag along. Europe liaised with PCAOB and the SEC on the preliminary draft of Directive 2006/43/EC. The motivation was to react to the scandals, global convergence of markets and its spill over effects. The next paragraph demonstrates the other ‘spill over effect’ of the global convergence of markets, which is competition.

F) THE UK (EU) VS. US COMPETITION

For hard liners it is difficult to comprehend that globalisation and global competition can go along with harmonisation. For instance, Professor Hoffman opined on international politics and commitments that:

…even if representations did agree; behind the ‘veil of ignorance’ on standards of international justice, in a milieu where self-help is the rule and where force can always be used by each agent, there is no guarantee whatsoever that those principals would ever stick for very long. In other words, when you are dealing with a domestic order, the gap between what Rawls calls the original position’ and reality is often no more than a normative gap – if you prefer, an inspiration.111

Harmonisation can protect markets from dreadful volatility and spill over effects, but a competitive policy improves the competitive position. As said, Europe responded to the globalisation by slightly adapting to US federal rules; that is, to concentrate on shareholder protective legal frameworks as characterised by the SarbOx. During the UK consultation period, market players argued that the implementation of Directive 2006/46/EC and 2006/43/EC can only negatively affect the efficiency of the current UK corporate governance.112 The Directive requires from the UK to enhance its efficient regulation by implementing costly disclosure mechanisms. Directive 2006/43/EC, for instance, demands audit firm or partner rotation. Additionally, according to 2006/43/EC the group of auditors have to bear full responsibility for the disclosure, even for the work of other audit firms (see:  

MARKET FOR MONITORING COSTS: LOOSEING THE COMPETITION BY PROTECTING THE IGNORANT

table C at section tables and figures)). This means that there is greater risk for auditors, which will be reflected in the auditor’s malpractice insurance and therefore in the disclosure costs. Recent developments show an increasing popularity for European exchanges, especially the LSE. Conglomerates are rescheduling their future plans. Data confirms that decision makers are influenced by disclosure Acts (see: chart 1). Especially after the SEC’s adoption of new rules for deregistration under the Securities Act in March 21st 2007,113 many conglomerates initiated a delisting process (see: table B at section tables and figures)). Additionally, the IPO benchmark demonstrates interesting results. In table 2 the IPO benchmark is shown (see: table 2 at section tables and figures).

Chart 8: New Listed Companies

The independent US Committee on Capital Markets Regulation issued a first wake-up call report (the Interim Report) in November 2006. The document proclaims that the “competitive position of the US equity market is eroding”.114 It relies its conclusion on many factors, such as the decline of the world’s share in amounts of IPOs (in 2000 from 37% to 2005 10%), the decline of the world’s share in IPOs value from 50% in 2000 to 5% in 2005.

and the preliminary development of US public companies that issue their shares abroad.\textsuperscript{116} On August 30\textsuperscript{th} 2007, the Ahold concern announced their intention to delist from the NYSE. The boards’ goal was ‘to improve cost-effectiveness by reducing complexity’.\textsuperscript{117} On September 4\textsuperscript{th} 2007, Bayer decided to de-list from the NYSE and to deregister with the SEC thereby terminating the formal reporting obligations. The board expects to save €15 million annually.\textsuperscript{118} Without a doubt, an increasing amount of European and international conglomerates leave the NYSE because of the high disclosure costs caused by rules that require more audit costs.

The reaction of the US is interesting. Nearly a year after the ‘first wake-up call’ report, the SEC decided to reconcile with foreign businesses in the near future by allowing them to only comply with the IFRS.\textsuperscript{119} Both the US GAAP and the IFRS standard will be recognized. Subsequently, in November 2007, the Public Company Accounting Oversight Board (PCAOB) adopted, jointly with the SEC, the Auditing Standard 5. This new standard replaced AS 2. This new standard is principle based and tailored to the complexity and size of the company.\textsuperscript{120} It eliminates unnecessary procedures and it concentrates only on the important issues, which falls entirely within the UK cost-effective regulation principle.\textsuperscript{121} The Financial Times headed ‘the US looks at London for regulatory model’.\textsuperscript{122} The Committee
on Capital Markets Regulation published its ‘second wake-up call’ report in December 2007. It concluded that not enough effort was taken by the federal regulators. It further stated that it will issue quarterly reports on the developments.

All said, it must be questioned what principles Europe then should bear in mind when making rules to facilitate a highly competitive EU market without forcing its Members to implement laws that are originally drafted for a bull market that protects retail shareholders’ interests by demanding high federal disclosure standards due to a federal policy of keeping Delaware State highly competitive. This will be discussed in the following paragraph.

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III MOVING TO LOW DISCLOSURE COST PROVISIONS

In subparagraph II E it has been contended that the competitive position of the UK is harmed by the European conducts. This paragraph will look at the opportunities for Europe that lie ahead. In the past, Europe already looked for better ways to draft and implement European rules. In 1999, the Lamfalussy group held that there was need for a fast law making process and in 2004 the Doorn Report advocated that there was need for regulatory impact assessments. The Lamfalussy process is broadly used for FSAP Directives and all rules are indeed assessed on their impact. Regardless of the aforementioned initiations, this paragraph argues that there is need for better governance and better rules.

In order to address this issue properly, starting from the basics will be helpful. The following subparagraph argues that the old and most recent European cost effective approach is not yet optimal. The approach lessens the administrative burden (red tape) but it still imposes obligatory disclosure mechanisms. The subparagraph III B challenges the suitability of the European governance to adapt efficiently and adequately to new events. In order to make better rules there is need for better governance. Then, it will be analysed on (subparagraph III C) basis of how the theory on the nexus of contracts fits within the disclosure and monitoring rules today. The subparagraph III D discusses, as a last remark, the new philosophies that are needed to attain a competitive position in a globalising market.

In subparagraph III A attention will be given to the cost effective regulation. How has Europe tried to protect investors while at the same time giving answer to the powers of global competition?

A) COST EFFECTIVE REGULATION

Due to the competitive equity market, the PCAOB initiated in 2004 the cost effective regulation policy, which is featured in the Auditing Standard (AS) 5. The AS 5, drafted by the PCAOB, takes only effect if approved by the SEC. The SEC chairman, Christopher Cox, stated that the Commission unanimously approved this new auditing standard in November 2007 because of the deficiency of AS 2 and, thus, the improvement of cost-effective
compliance with s. 404 SarbOx.\textsuperscript{123} The new AS is principle based, less prescriptive for auditors,\textsuperscript{124} it is audit scalable (duties dependant on size and complexity of the firm) and it focuses only on data that matters most,\textsuperscript{125} which is much like the UK Turnbull Guideline of 1999 and its 2004 revision. Next to this, the SEC recognised the IFRS as accounting standard that is used by foreign private issuers. This is a piece of evidence that the PCAOB and SEC adapted to globalisation and competition; i.e. only five years after the enactment of SarbOx. This was due to the fact that international private issuers announced they would delist and leave the market. On top of that, two-thirds of the US retail investors attain shares of foreign private issuers, which is an increase of 30\% in five years.\textsuperscript{126} While the US is adapting its strategies and laws to the UK’s principle on regulation and cost-effectiveness, the EU is urging the UK to implement costly rules based on the aftermath of Enron and Parmalat debacles. The EU is clearly slower in adapting to events than the US. That could have an effect on London in attracting foreign liquidity and IPO’s; as will be discussed in subparagraph 3 C.

Sir Nigel Wicks endorsed in 2004 that Europe should be obliged to regularly assess the regulatory impact of EU rules.\textsuperscript{127} Many rules that raise the administrative burden, or ‘red tape’, affect the competitiveness of companies. More than 60\% rules on financial and economic issues come from the EU.\textsuperscript{128} The Doom Report reflected that European costly\textsuperscript{129} rules that impose business enterprises to disclose information have a price tag of 4 to 6\% of

\textsuperscript{125} Ibid.
\textsuperscript{129} Later in the report the writer remarks that national and regional rules produce costs as well.
the Member States’ GDP. Member States have suggested removing or simplifying more than 330 European rules. During the public hearing of May 3rd 2006 on the review of the EU Action Plan of 2003, conclusions were taken that resulted in the initiation of a simplification plan. The European Commission initiated an EU regulatory simplification program within the field of company law, audit and accounting regulation. The simplification measures are “simplification of disclosure requirements” and “reducing reporting and auditing requirements” for SMEs so to lower administrative costs for European companies. A remarkable detail is that the guidelines of the Doorn Report were utilized to draft Directive 2006/43/EC. As seen in subparagraph 3 A, this Directive still does not come up to the expectations of market players in the City of London. For instance, Directive 2006/43/EC contains rules that give Member States the discretionary power to exempt SMEs for instance from publishing corporate governance statements. This is a result of the policy to reduce and simplify new rules in order to reduce administrative burdens on a macro economical level. Listed corporations are not exempted and, hence, this will affect the competitiveness of the City’s equity market. In order to attract companies and investors in an equity market in a globalising market it is important to reckon that aside from listing rules, language, punitive threats, reputation and liquidity, disclosure costs can make a

notable difference. To lower the disclosure costs, as part of the total agency costs, it is important to lower the auditor’s costs. Balachandran and Ramakrishnan\textsuperscript{137} viewed that that disclosure costs resulted from unobservable audit effort, uncertainty in the audit process and risk aversion of the auditor. Thus, constituting an oversight board would reduce the audit costs. They also concluded that risk-sharing reduces the auditor’s costs. The European Commission constituted the European Group of Auditors Oversight Bodies\textsuperscript{138} that “ensure[s] effective coordination of new public oversight systems of auditors and firms”.\textsuperscript{139} Balanchandran and Ramakrishnan further viewed that if a firm is monitored by different auditors it would foster a lack of knowledge and hence, it would raise the costs and insurance fees. In the 26\textsuperscript{th} consideration of Directive 2006/43/EC, the European Parliament and Council provide Member States autonomy to impose firm rotation.\textsuperscript{140} In addition to that, article 42 imposes partner rotation every six years while all liability is passed on and shared among the auditors thus increasing the insurance fees as well. It is of note that the SarbOx does not mention firm rotation. Another example that is related to the firm’s efficiency is Directive 2006/46/EC on company reporting, which imposes large corporations apart from the duty to publish corporate governance statements but also to disclose off-balance sheet arrangements. The latter includes the financial position of the whole group which includes the possible special purpose vehicles abroad.\textsuperscript{141} According to the UK Department of Business Enterprise and Regulatory Reform (BERR), the Companies Act 1985 already regulates such matters, but the Directive goes further.\textsuperscript{142} The additional costs for the new duties are 42.17 million pounds (over 59 million Euros).\textsuperscript{143} Further, the implementation will

\begin{footnotesize}
\textsuperscript{141} See the considerations 8 and 9 of Directive 2006/46/EC (OJEU 1006, L 224/1).
\end{footnotesize}
have a considerable shock on the competition as confirmed by the BERR.\textsuperscript{144} The mentioned provisions of the Directives are an example of the extra costs imposed to listed firms. The rules impact analysis is needed and it should be therefore remain, but the policy that is used does not entirely eliminate the problem. This is due to the fact that the guidelines of the Doom Report and underlying simplification’s objective are not to change Directives’ goals, which in this case is imposing more duties to listed companies and auditors in the EU. Presumably, listed companies will never, unlike SME, be exempted from corporate duties. Conclusively, the EU must therefore have the opportunity to either measure whether new rules should be incorporated, firstly, in regulation (slow implementation) or, secondly, in European best practice ‘handbooks’ (fast implementation and flexibility) after having assessed the impact of these rules. Thirdly, the EU must have the opportunity to implement new rules with opt-out options more often. Hertig and McCahery view that opt-out options that are provided to Member States, investors and companies are, on the long run, advantageous for Europe\textsuperscript{145} as these rules become tailor made and even market based even if after consideration of the market, companies or investors decides to opt-in. These alternatives will increase regulatory flexibility, so to give Europe the opportunity to react in an immediate and adequate manner to events and costly rules.

As we have seen that the European cost-effective regulation policy is based on macro economic considerations and not on market parties’ efficiency, the next question to be answered in part C is: who drafts and measures these cost effective rules?

\textbf{B) DELEGATION TO EUROPEAN AGENCIES; THE STARTING POINT TO \textit{PLAIN, PERFECT AND FAIR BALANCES BETWEEN CORPORATE DUTIES AND SHAREHOLDER RIGHTS TO REDUCE AGENCY COSTS AS PART OF B}}

The corporate governance of listed companies is regulated by company law and securities law. (Quasi-law, company statues and listing rules do not exceed the scope of the aforementioned.) The securities law basically deals with disclosure and auditing standards, requirements and duties so to provide shareholders the opportunity to get hold of current

\textsuperscript{144} Ibid.

reliable material information.\textsuperscript{146} Company law regulates the internal powers and liabilities of shareholders and agents. In order to attain an efficient equilibrium between the agent and the principle, it is fundamentally important to spread risks and costs between both parties on a good manner. The intensity of the risks or level of costs that are to be borne by one of the parties depends on many factors, such as the shape of the equity market, the private contracts, tax and social policy. As there are many solutions, an outsider (one who does not deal with market issues and who is not able to conduct complicated economic assessments), will find it impracticable to assess whether one must bear more, less or no costs at all.

The US has a deep sophisticated equity market where the level of liquidity is high. After Enron, the US Senate drafted the SarbOx that aims to protect weak minority shareholders. Consequently, in order to serve the shareholders’ interests well, the US equity market’s supervisor agency\textsuperscript{147} (SEC) has the right to enforce and make binding rules to address situations adequately. As for Europe, the European Commission designated a commission chaired by Lamfalussy. One of the Commission’s tasks was to improve the law-making process (European’s good governance). The Wiseman Committee recommended speeding up the law-making process by setting up two specialised not entirely independent European agencies; those are the ESC and CESR. This recommendation came along with the intention not to harm the institutional balances between EU and its Member States.\textsuperscript{148} As a result, the

\textsuperscript{146} The US securities law provides the shareholders the opportunity to proxy fight, which is a power as well. In contrast, the effectiveness of this power is disputed by Romano (see: Romano, Roberta, (2000) ‘Less Is More: Making Shareholder Activism A Valued Mechanism Of Corporate Governance’, Yale Law & Economics Research Paper No. 241 and Yale ICF Working Paper No. 00-10 [Internet] Available from: <http://ssrn.com/abstract=218650> [Last modified: n.d] [Accessed: March 25th, 2007]).


Wiseman Committee, chaired by Lamfalussy, did recommend the EU to designate an agency with authority to make binding rules in a good pace and above from any interference by European, national and regional political considerations. Added to that, the CESR has been given the model of a European parliament, where governmental representatives take seat, debate and vote on guidelines, reports and recommendations. Hence, the European agencies can unquestionably not be compared with the SEC. The lack of political independency combined with the deadlines could harm the adequacy and efficiency of the rule making process.

Fig. 3: Lawmaking policy

There are certainly low standards that are broadly accepted because fairness and justice compliance and equally goals of national interest that have to be satisfied, such as safeguarding the market’s liquidity. Though supplementary blind spots subsist for policy makers and legislators, it ought not to be regulated from an iron tower solely. It is the foremost important concern to assure that policy makers, legislators and regulators keep law as efficient as possible. The achievement of drafting cost effective regulation can not purely be the result of a policy of keeping law as efficient as possible. Tailor made rules must also be drafted or endorsed by the right parties. Further, it is imperative to attain a clear understanding among policy makers, regulators, and legislators and market parties. In that
case, they could all react adequately to further enhancements, adaptations and shifts within the global economic and legal arena. For that reason it is essential, certainly in the case of a union, such as the European Union or a federal union, to have a clear separation between tasks and duties of regulating or legislating within the field of company and securities law. As pinpointed in paragraph two, the US federal regulators and legislators broadly defined the features of the national (federal) securities law, despite the fact that States have had the authority to regulate and to enforce within this field as blue sky laws. The States have delineated the many different company laws. As for the European Union, the red line that separates the discretionary power among the national or European government and private regulators within the field of securities and company law is non-existent. Both European Union Member States and their regulators and legislators have set new rules for their nationals. The result is the incapability of making good rules that are suitable for each and every Member State. Regardless of that, the intention of the EU is not to harm these Members when setting out to implement rules that could be the foundation of loosening ground in competition. Seeing that there is need for fast adaptations, better rules and improved economic assessments on the impact of rules, there is need for better governance. In his EU/US comparative study, Gerardin advocates that Europe must learn from the positive movements and the flaws in the US. Gerardin reflects that the creation of agencies in Europe is a new occurrence and though increasingly accelerating but still infantile compared to the US. Gerardin’s suggestion is to allow Europe to discard the Meroni doctrine, which prohibits (or excessively restricts) the delegation of law-making power to


150 First Gerardin identified the imperfections within the delegation power, and then he looked at “the lack of homogeneity” and lastly, “the…compliance with good governance principles”. Gerardin conducted his study in three steps: EU and the current state of European Agencies, secondly, the US experience and inspirations, considerations and recommendations. (See: Gerardin, D., ‘The Development of European Regulatory Agencies: What the EU Should Learn from American Experience’, p. 6-10. Columbia Journal of European Law (11) December 2004-1.

151 Ibid, pp. 9-10.


specialised agencies. The Interstate Commerce Commission was the first US commission (agency) to be constituted in 1889. The US Federal Trade Commission was one of the pioneer-agencies in. 1914.\textsuperscript{154} After the 1929 crash and Enron debacle, the SEC and the PCAOB, respectively, were given the authority to enforce, promote, supervise and regulate.\textsuperscript{155} The authorities were delegated by means of the Securities Act of 1934\textsuperscript{156} and SarbOx.\textsuperscript{157} These agencies form part of the regulatory model,\textsuperscript{158} whereas the European ESC CESR agency that conduct under the Lamfalussy level II and III process falls under the comitology and supervisory approach.

As said, the PCAOB and the SEC reacted quickly and adequately to events after Enron, as experts who have the authority to prescribe rules to market players. For example the SEC and PCAOB promptly adapted to the rising proportion of US investors attaining shares in foreign companies listed in New York. By providing these agencies the authority to enforce and to make law, a time-consuming democratic cooperative approach is bypassed. Thus, there is need for ‘knot-cutting’ agencies with expertise. Some Member States have these independent non-governmental bodies with relatively broad scopes of rule-making, enforcing and monitoring discretionary powers; e.g. the FSA\textsuperscript{159} that is constituted in 2000. The FSA outlined its own policy on making new rules. This was set out in the FSA’s paper entitled ‘A new regulator for the new millennium’.\textsuperscript{160} The core principle is creating cost effective guidelines. The FSA is merely constrained by the four statutory goals outlined in FSA Bill enacted in 2000, which are maintaining market confidence, promoting public

\textsuperscript{154}Ibid.

\textsuperscript{155}The PCAOB can only adopt new rules if approved by the SEC.


awareness, protecting consumers and reducing financial crime. The Dutch AFM (comparable to the FSA) has the authority to make rules if not constraint by the minister of economic affairs’ orders in council. This is an illustration of the considerable differences between Member States, apart from the principles used in national corporate governance principles. The Dutch agency has clearly a reduced amount of discretionary authority when compared with the FSA. These differences might raise awareness on a possible creation of a European agency that does not absolutely need to enforce but at least assure that all disclosure performances are recognised and comprehended well. Secondly, it should have the authority to write soft guidelines when new circumstances arise. Think of new situations like the use of new technology or economic shifts. Thirdly, this European agency should network with local watchdogs and governments. It should monitor regulators and legislators to assess whether they act according to European principles and guidelines. This is achievable if these guidelines and principles do not impose specific provisions, but respect the different balances in corporate governance among the Member States. Added to that, it ought to have the right, as being the expert, to counsel the Commission as well. This would create, firstly, a custom-made European harmonisation channelled by regulatory competition and, secondly, it would induce speed, agility (or high level of pro-activeness) and flexibility of new soft and hard law. Many of these suggestions are already realised as these tasks are described in article 4 of the Charter of the Committee of European Securities Regulators. In contrast, firstly, the CESR’s tasks are outshined by the slow and burdensome lawmaking process of the chief EU legislator. Secondly, the proposed tasks are divided into two European agencies of which the CESR is independent. The other agency is the European Securities Committee (ESC).

161 Ibid., p. 5.
The CESR is a self-governing body that chooses its own chairperson (article 2 of the CESR charter), raises its own budget (article 8) and assigns its own secretariat (article 7). However, even as independent advisory body, as illustrated, it has according to article 5.7 the duty to democratise its decisions if working under Lamfalussy level III.\textsuperscript{162} In addition to that, it does not do anything without the consent or a report sent to the European Commission; see article 1.3 (duty to inform the European Securities Committee (ESC)), article 3.1 and 3.2 (European Commission’s right to active participation in debates and meetings), article 6.1 (annual report to the Commission), article 6.2 (maintenance of strong links with the ESC) and the ESC’s chairman right to observe meetings\textsuperscript{163}. This dissertation’s proposes to delegate powers to a European agent tallies with the provision of the European Commission’s authority to (heavily) regulate securities law in Europe. The Lamfalussy process was set so to make it possible for the European Commission to understand what is happening in the markets, to provide the European Commission the technical knowledge and to speed up the

\textsuperscript{162} Unanimity is required if at least one member wishes so.

lawmaking process by setting deadlines. These were a few of the arguments of the Wiseman Committee chaired by Lamfalussy.\textsuperscript{164}

The flexibility of law is outlined by awarding CESR the authority to draft guidelines and to give recommendations to the Commission after conferring with the market players. The recommendations are not solely based on the exchange of ideas with market players. Before voting on the recommendation and submitting the report, these issues are heavily discussed with other CESR members. The ESC was formed to counsel the European Commission on the technicalities. Hence, both the CESR and the ESC have the ability to react according to national considerations. Nonetheless, the European Parliament wanted to safeguard “the inter-institutional balance…to respect…the democratic processes at both national and European level.”\textsuperscript{165} Hence, tasks are divided in such a manner that the Commission attains control over the European agencies and the decisions within the CESR are only legitimised if reached by consensus, the majority or by a unanimous vote between the Member States’ representatives (see articles 5.5, 5.6 and 5.7 of the CESR Charter).\textsuperscript{166} Thus induced by the deadlines, arguments are put forward to support resolutions which would reflect national political concerns such as macro economic considerations. Not on the basis of the listed firm’s efficiency or the interests of market players. This ought to be the incentive of an independent agency.

It is noted that Europe is currently pursuing the agenda of imposing more disclosure requirements and costs through both company and securities laws. The EU, led by the former EC Commissioner Bolkestein, decided to adapt the European’s audit rules in accordance with SarbOx audit provisions through the 8\textsuperscript{th} company law Directive. He conferred with the PCAOB and the SEC on its eventual provisions. This was needed because of the globalisation and its spill over effects (see the arguments in form 1 in the appendix). The implication is that European Member States have markets with high ownership concentrations, which are broadly considered to have the ‘substitute governance

\textsuperscript{164} Ibid.


\textsuperscript{166} CESR/01-007c, (CESR-Charter).
mechanism for weak minority shareholder laws’. Added to that, Member States with high ownership concentrations do have national shareholder protective laws as well (echoed by the independent directors and two tier boards), and jurisprudence (Scandinavian countries, Germany and the Netherlands). Even the dispersed minority shareholders in the UK are sophisticated due to their cash flow entry. Also they are protected as well by common law. In sum, there is not a reception awaiting for these new disclosure requirements.

Fig. 5: Centralisation of Power

The next paragraph discusses the non-macro economic conditions for companies to list in a specific commercial jurisdiction. These conditions are based on broadly accepted theories.

C) INCENTIVES OF INVESTORS AND DECISION MAKERS

Alchian and Demsetz’s (1972) disputed the Coase’s study’s legitimacy on the managerial power to coordinate the nexus of contracts, which formed the firm, or as they say; the marketplace. Coase was against the Dodd’s corporate realism, where the assumption is that a firm is a person with its own interests which includes social responsibility interests. Coase’s theory reduced the firm as a person to a nexus of contracts embodied in a market place where employees and third parties are protected by contracts and financiers. This writer

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168 Note that the UK is the only European market with no high level of controlling shareholders.

opines that the upcoming of the need of the market place’s legal personality is merely to give authority to co-ordinators to let them to do business on behalf of the market place. Scholarships extended the Coase theory and concluded that investors were only protected by the right to monitor the nexus of contracts and its co-ordination as they had no contractual provision where profit maximisation was guaranteed. Many concluded that the theory of the corporate social responsibility would only harm the investors’ position in the market place because this principle is inefficient as all the needs would be met, except the investors for their need is only served if efficiency is upheld.\textsuperscript{170}

Coase concluded that entering the (imperfect) capital market\textsuperscript{171} included transaction costs, since uncertainty of information forms part of the many contracts. The growth of the business is “equals the additional amount of contracts included to be co-ordinated by one management”.\textsuperscript{172} This “growth is guaranteed until the firm’s co-ordination costs are equal to the market’s co-ordination costs”.\textsuperscript{173} Alchian and Demsetz state that the managers’ role, given by Coase, to co-ordinate these contracts is not efficient if there is no monitoring agent enabled by shareholders. Shareholders risk not enjoying the reserves or riches of the business but they have all the incentive to monitor.\textsuperscript{174} Jensen and Meckling supplemented in the late 1970s that the shareholders, as principals, incur agency costs because they do not have all the material information.\textsuperscript{175} Rational investors invest in jurisdictions where they are able to acquire the best information for the lowest price. These rational investors can broadly be divided into investors, who seek for block holdings, influential blocks of shares or retail investors. The question then becomes what the best monitoring execution might be? The presumption is that investors are prepared to bear monitoring costs as long as the returns are superior to those costs. If the costs are higher than the returns, the market re-adjusts the value and the price of the shares. Because of the fact that investors bear the costs that rise from concessions between disclosure duties and monitoring, investors look for bespoke

\textsuperscript{170} Ibid.
\textsuperscript{171} According to the efficient capital market hypothesis all the material information reaches the investor so that the latter is able to determine the share value. Thus, the presumption is that all information is out there and within the investor’s reach. As investors do make costs to acquire missing information to assess the share’s value one can not conclude other than that there must be spoken of an imperfect efficient capital market.
\textsuperscript{174} Ibid.
\textsuperscript{175} Ibid.
monitoring and disclosure rules in different markets and companies where liquidity is high. Investors who seek to acquire corporate influence have a different way of seeking good platforms to monitor than investors who seek for corporate control or retail investors. The latter seek for capital markets where regulatory disclosure provisions are strict.

In his work, John Armour explains what factors affect the rational investor to decide on his strategy to actively look out for influence or control in open companies. Rational investors, who seek for control, look at the costs to acquire the undervalued pile of shares (B) which have to be lower than the benefits accumulating to the stockholders after taking over control (C). Acquisition theoretically then takes place when:

\[ B < C \]

Rational investors who seek for influential piles of shares look at the costs of exercising influence (A), the benefits for all shareholders that may be acquiesced by the exercise of influence (B) and the proportion of the acquired shares (where \( 0 < C > 1 \)). Taking active part in influencing the company is attractive when the following is satisfied:

\[ A < B C \]

Retail investors do not seek to attain influence or control over a company. They invest in commercial jurisdictions where their monitoring costs are low and disclosure costs are high. The stricter the disclosure provisions are, the less an investor uses his own costly monitoring mechanisms. Institutional sophisticated investors may consider these provisions as a negative aspect because high disclosure costs harm their returns as it affects the firm’s value. Secondly, institutional investors mostly have more efficient monitoring equipments as mentioned in paragraph 1. In the pharmacy industry for instance, and presumably in many

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176 For more information on investors who act in the market for corporate influence please read: “The market for Corporate Influence: Activists Hedge Funds and their Antecedents” Armour, J and Cheffins, B.

177 “The market for Corporate Influence: Activists Hedge Funds and their Antecedents” Armour, J and Cheffins, B.


179 Ibid. In practice there are free-riders who have to be sold out, shareholders who have to be squeezed out, not mentioning that the share price always goes up when a party acquires a pile of shares.

180 Ibid., p. 12.

181 Ibid.
other industries as well, institutional investors mostly value their information when it is still considered to be non-material for ‘outsiders’. If these large shareholders react following to their findings, retail investors are warned before the material information is officially disclosed. It is therefore important not to frighten away institutional investors by heavily protecting retail investors. In Europe listed companies have a relatively high concentration of institutional investors. Also many European Member States already provide small shareholders solid internal legal mechanisms especially where influential people effectively threaten boards with legal instruments and letters.

Aside from examining the considerations of (prospective) shareholders, it is important to observe the concerns of decision makers because they could decide to list their shares elsewhere. Decision makers in companies tend to move their base to other States where company law is less stringent in attracting managers. As for the decision making on cross-listing or listing elsewhere, decision makers choose deep equity markets with high liquidity. These markets are dominated by stringent shareholder protective rules. This does not necessarily mean stringent auditing rules because it does not automatically come parallel with high disclosure costs. The presumption is that decision makers avoid high agency costs that are caused by strict regulation, which is a consequence of fostering small shareholder protection and high capital costs for companies. Decision makers do not want to enter markets with too many influential players. They neither have a preference to list in an equity market with restrictive rules that threaten agents with imprisonment. Due to high disclosure costs, it provides less liberty for decision makers to initiate new innovative risk-full projects that affect internal control as they are held responsible for the internal control. That is for an agent to decide. But facts show us that at this point of time there is a lot of movement between stock exchanges, even though Doidge Stulz and Karolyi view that the shift is not necessarily bad for the US competitiveness. It was viewed in the last five years that first-class

184 Ibid.
companies listed in New York and LSE has attracted companies that would not even have been admitted to be listed at NASDAQ.\(^{186}\) They further conclude that the SarbOx does not necessarily negate the US stock exchanges. Nevertheless, in the new millennium the London Stock Exchange has attained fine reputation, international liquidity and international IPO’s. It is so that the innovative AIM forms part of the movement. The new product attracts new IPO’s, companies that delist from first tier markets and companies that especially look for listings with low entry requirements.\(^{187}\) However, the London Main Market has indeed flourished as well. Therefore, Europe must reflect and look out for regulation that harmonises and sets European standards without affecting the equity market in London.

Managers want to reach their own goals in addition to the shareholders’ goals. For a decision maker to decide to leave a commercial jurisdiction for another, the agency costs (B) have to be disproportional high to such an extent that the competitiveness of the business is in danger (Y) in comparison with competitors in the same relevant market. Delisting is not an option if capital injections (C) are needed to keep the business ongoing. Decision makers leave the commercial jurisdiction to list on another stock exchange if:

\[
(Y < B) \text{ AND } (C = \infty)_{188}
\]

During the history of the US corporate governance, events and legislation shaped the commercial jurisdiction. The decision makers were attracted by enhancing State’s company law and liquidity by federal securities law and acts such as the Clayton Act that prohibits banks from attaining a block holder position (see paragraph 2). Pan-European fragmented regulatory framework details a relatively high concentration of block holders where private contractual agreements are made between decision makers and shareholders. Moreover, it is characterised by its local and European legal instruments that protect small shareholders.

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\(^{186}\) Doidge Stulz and Karolyi observations are not entirely correct as can be seen in table 3. Among the companies that have delisted and that have announced they would delist are high-tech companies, large companies that invest in R&D and large companies with well-known branches.


\(^{188}\) There are also other factors that influence decision makers in their assessment for moving to other jurisdictions. One of those factors may be policies that restrict high managers’ remunerations or high penalties. The current writer decided not to include these factors for it is not relevant in this dissertation. The presumption in this formula is that decision makers do everything to keep agency costs as low as possible and yearn for total control over the businesses.
against large shareholders and decision makers. Such protection ranges from judicial decisions to acts of implementation of the ‘company law’ Shareholders Rights Directive. All said, to attain a good balance within the corporate governance without lacking any competitiveness, Europe should look for more managers attracting securities regulation. On other hand through its ‘securities law’ Directives, Europe chose to protect retail investors while keeping audit costs low. This was explained in sub paragraph 3A. London because efficient regulation to the judicial decisions that goes approximately 200 years back and its well-known cost-effective policy in the past century. UK market players such as the LSE exchange view that any disruption in the UK securities and listing rules would be unhelpful to the position of the most cost-effective regulated European stock exchange.\textsuperscript{189}

\textbf{D) ADAPTING OUR PHILOSOPHY TO GLOBALISATION}

Europe and its Member States will want to keep control on the financial markets. There is no incentive yet known that will compel them to distribute their law making power to independent agencies. Therefore, there is need for stimulation of consciousness on the need for initiating a new philosophy with regards to setting new policies in Europe. This new policy must serve the needs of the market players and both European and national political interests. The former sub paragraphs discussed the importance of flexible cost effective rules composed by law makers who are able to react adequate and promptly. The theory is that there is need for rules that place the European market on a more competitive position without harming Member States. This is in accordance with the Lisbon and the FSAP objectives. The objectives are to create one European financial market and to increase competitiveness in the global market. Concentrating on the European harmonisation by drafting detailed provisions that protect retail investors (within the field of securities law and company law) in Europe does not entirely satisfy both goals. Internal rights of minority shareholders are relatively well protected by company law.

From another standpoint one will realise that a State’s liquidity is more virtual or relative than ever because of the technology and the globalisation of markets. Nowadays, apart from

professional investors, retail investors have foreign shares in their portfolio as well. Hence, studies need to analyse whether there is need for more European regulation that enhances that level of liquidity in the capital markets. Different commercial jurisdictions in Europe encourage small and large sophisticated investors to forums if need be. There are different ways to harmonise different types of markets other than imposing strict shareholder protective rules. The EU chose to draft the Prospectus Directive with a full harmonisation objective. Markets need a diversity of investors. It is good for both market players as well as other national macro economic interests. The liquidity of a market depends on the balance between sellers and buyers.\textsuperscript{190} Hence, a market needs a diversity of investors. A market becomes antiquated as objectives, measurements and methodologies become homogenous.\textsuperscript{191} The diversity among investors depends on several factors. Eatwell opines that investors in a financial market must have a variety of financial objectives, different methods to assess data, different investment time horizons and institutional structures. Additionally, investors must have different types of access to information. He views that even if their goals might be homogenous, their reaction would be divergent.\textsuperscript{192} This brings stability in the market. But in the past, as we have seen in paragraph II, legislators have fragmented market parties by implementing new strict rules such as the Glass-Steal Act.\textsuperscript{193} According to section 16 and 21 of the Act, banks and insurance companies are prohibited to hold equity. Overly protecting small shareholders may have that same fragmentation effect, which could destabilize the equity market as all investors (of the US and the EU) become homogenous. This new philosophy serves the needs of all market participants, Member States and the Union. The philosophy creates space that invites flexible innovative rules. An additional philosophy is that Europe should attach importance to the competitive position of London. The US regards London as a direct competitor. The LSE attracts companies in London and the European market may benefit from that on condition that Europe recognises this philosophy. The Action Plan to move forward by modernising company law and corporate governance in the European Union ignited the process of enhancing securities


\textsuperscript{191} Ibid.

\textsuperscript{192} Ibid.

\textsuperscript{193} Ibid.
law as well as company law. It is very complicated to determine the results of every Member State after drafting the Directives, as there is no end-to-end ‘service’ conducted.

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CONCLUDING REMARKS: MOVING FORWARD

Prior to globalisation the common practice was that the legislator would implement new costly disclosure rules or let the market deal with the issues. It has always been the choice between firm level and country level mechanisms. Therefore, the question always asked was: do we have to regulate this issue or shall we let the market deal with it? In other to answer this question, the legislator would consider only the features of the market within his geographical jurisdiction. The scope of this assessment changed after the powers of the Europeanization and the globalisation materialized.

The globalisation experience gives the national legislators the gut feeling that they have to produce better and more efficient regulatory “products”. This is needed in order to attract more businesses into their jurisdictions. However, the policy of Europeanizing the segmented public equity markets comes along with harmonisation, which is regulated by European institutions. Due to the scandals and the spill over effects, Directives come with disclosure duties that damage the current condition of the City’s high level of business efficiency. These disclosure rules are needed in other to form a single competitive market and to protect foreign European investors as well. Although the Europeanization does impose rules that restrict Member States, it does not entirely withhold the many Member States from competing against each other. A few Member States stopped implementing gold plated European rules into their primary and secondary legislation, because others did as well. The Europeanization comes along with more disclosure costs in both company and securities law. These rules may harm the competitive position of some of the European public equity markets. Many have questioned whether Member States should use their discretionary power laid down in the EC Treaty to regulate their markets. This policy keeps


195 During national parliamentary debates on the implementation of European Directives, parliament members occasionally compare their implementation measures with other Member States. For instance, the Netherlands recently stopped gold plating the European rules in their national legislation, as the legislator spoke of the Danish and British efficient implementation tactics.

196 These rules do not harm the SMEs, since Member States many times opt out SMEs from new disclosure rules.
the market fragmented, and it should therefore not be followed. Part of the answer to the aforementioned question is that the securities law should be regulated on European level. Member States especially the UK have to safeguard their competitive positions in the world’s public equity market. However, the options that are provided by European Directives are in many cases not appropriate. The UK, the Netherlands197 and others instinctively complains that the European rules should be less costly. This was one of the objectives which led to the publication of the Doorn Report. Not quite surprisingly he concluded that the European rules should be less costly. He recommended that there must be a slim process that scrutinises the cost impact of new rules. Directive 2006/43/EC, which was scrutinised by the Doorn process, did not come up to the expectations of the UK market parties. The European cost-effective regulation policy is based on macro economical considerations and not on market players’ efficiency. This is entirely different from the UK cost-effective approach due to the usage of agents. A popular comment is that although the Directive 2006/43/EC provided four options, it does not do but oblige the UK to enhance its primary or secondary legislation. The UK regulates many of the imposed rules of this Directive in less stringent ways (best practice instructions). The Directive would have been optimal if it would have provided the option for Member States not to amend the primary or secondary legislation to implement the European rules. In other words, the Directive would have been optimal if it would leave the option to Member States to incorporate the European rules in their flexible national best practice codes. Public firms would have the options to comply or explain.

There is need for smarter or innovative, flexible European rules that keep the market transparently open and enforceable where eligible. Not only is it important to make rules that are suitable for the purpose, these rules ought to be available all time. The quality of European rules can be measured by effectiveness. Firstly it is notable that after new events, new rules are produced; it is good to look at how the US and the UK deal with the rule-making process. We can learn from them that there is need for a European authority that serves the business efficiency.

197 Both the Netherlands (Centraal Plan Bureau) as well as the UK have special commissions that assess the impact of new rules.
Secondly, the rules in the Member States do not necessarily need to be implemented in primary or secondary legislation in regard to European principle on legislation. The rules must form a European platform to reach the European Lisbon goals. Thirdly, the rules must be drafted promptly after important events in the global market. These goals can be reached by giving permission to Member States to use their discretionary power to regulate their national issues that do not need to be regulated on the European level. However, if there would not be a European legislator that would serve the European interests, it would negatively affect the efficiency of the European market as the Member States’ markets would stay fragmented. Therefore, it may be concluded that in order to make better rules, better European governance would be needed.

Table 3: Good Governance Needed in Europe

<table>
<thead>
<tr>
<th></th>
<th>Efficient Rules</th>
<th>Costly Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher Liquidity</td>
<td></td>
<td>Good Governance needed</td>
</tr>
<tr>
<td>Lower Liquidity</td>
<td><strong>Firm level monitoring mechanisms</strong></td>
<td>Costly disclosure requirements</td>
</tr>
<tr>
<td>Virtual Liq. (high and low)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
OBSERVATIONS

Educate retail investors
There is nothing better than sound education. This makes retail investors less stupid and in many occasions it might even make them read prospectuses as well.

Having a certain amount of active block holders in your capital market is good.
You do not want to scare active block holders away: Retail investors can travel with their successes. Immaterial information is materialised and therefore relevant within shorter periods. Material information is not only published earlier, or with a big yell, but in many occasions the information is filtered out. If you leave the little children home alone, you might want to have some big brothers who are sometimes bullies but continuously look after the little ones.

Not only do we have to free ourselves from the traditional thinking of keeping national blue chips national, but there is also need for taking the interests of foreign shareholders in consideration.
Concentrating on the many block holders in Europe is not enough if the goal is to be competitive in a globalising market. Therefore, there is need for more flexible innovative rules. Looking out of that conservative box will make one realise that a State’s liquidity is more virtual or relative than ever because of the technology and the globalisation of markets.

Give Europe the authority to make rules on an innovative manner, so to make Europe more adequately in reacting to important events.
Europe should be able to draft best practices handbooks for Member States. This would reduce the incapability to react adequately and/or quickly to events. Added to that it would provide the Member States the opportunity to comply with the European standards and principles or explain that complying with such rules would be perilous for the national capital market in the global competition. The argument, that if merely an opt-out rule (with no explanation requirement) is drafted, all Member States opt-out would be well evidenced.
Exempting European champions from complying rules that would not add value to their markets is a remarkable step to one of the Lisbon goals.
TABLES AND FIGURES

**Table A: Newly Listed Companies**

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Total Companies</th>
<th>Domestic Companies</th>
<th>Foreign Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE Group</td>
<td>128</td>
<td>100</td>
<td>28</td>
</tr>
<tr>
<td>London SE</td>
<td>576</td>
<td>544</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>146</td>
<td>127</td>
<td>19</td>
</tr>
<tr>
<td>London SE</td>
<td>626</td>
<td>605</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>2004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>152</td>
<td>132</td>
<td>20</td>
</tr>
<tr>
<td>London SE</td>
<td>423</td>
<td>413</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>107</td>
<td>91</td>
<td>16</td>
</tr>
<tr>
<td>London SE</td>
<td>201</td>
<td>194</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>151</td>
<td>118</td>
<td>33</td>
</tr>
<tr>
<td>London SE</td>
<td>201</td>
<td>193</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>144</td>
<td>93</td>
<td>51</td>
</tr>
<tr>
<td>London SE</td>
<td>245</td>
<td>236</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>122</td>
<td>62</td>
<td>60</td>
</tr>
<tr>
<td>London SE</td>
<td>399</td>
<td>366</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>1999</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>151</td>
<td>123</td>
<td>28</td>
</tr>
<tr>
<td>London SE</td>
<td>187</td>
<td>161</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>205</td>
<td>162</td>
<td>43</td>
</tr>
<tr>
<td>London SE</td>
<td>202</td>
<td>169</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>273</td>
<td>210</td>
<td>63</td>
</tr>
<tr>
<td>London SE</td>
<td>254</td>
<td>217</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>278</td>
<td>219</td>
<td>59</td>
</tr>
<tr>
<td>London SE</td>
<td>397</td>
<td>347</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>1995</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NYSE</td>
<td>173</td>
<td>138</td>
<td>38</td>
</tr>
<tr>
<td>London SE</td>
<td>330</td>
<td>285</td>
<td>45</td>
</tr>
</tbody>
</table>

Table B: Select Foreign Companies that Voluntarily delisted from the NYSE in 2007 or announced they planned to.

<table>
<thead>
<tr>
<th>Announcement of Delisting</th>
<th>Select Foreign Companies that voluntarily delisted from the NYSE in 2007, or announced they planned to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 25</td>
<td>British Airways</td>
</tr>
<tr>
<td>April 26</td>
<td>Group Danone</td>
</tr>
<tr>
<td>May 14</td>
<td>Ducati</td>
</tr>
<tr>
<td>July 25</td>
<td>BG Group</td>
</tr>
<tr>
<td>July 26</td>
<td>BASF</td>
</tr>
<tr>
<td>July 26</td>
<td>Metso</td>
</tr>
<tr>
<td>July 27</td>
<td>Rhodia</td>
</tr>
<tr>
<td>July 31</td>
<td>Fiat</td>
</tr>
<tr>
<td>Aug 2</td>
<td>Lafarge</td>
</tr>
<tr>
<td>Aug 21</td>
<td>E. On</td>
</tr>
<tr>
<td>Aug 23</td>
<td>Westpac Banking</td>
</tr>
<tr>
<td>Aug 29</td>
<td>Suez</td>
</tr>
<tr>
<td>Aug 30</td>
<td>Ahold</td>
</tr>
<tr>
<td>Sept 4</td>
<td>Bayer</td>
</tr>
</tbody>
</table>

Table C: Comparisons between 2006/43/EC and SarbOx

<table>
<thead>
<tr>
<th>Issue</th>
<th>8th Directive (2006/43/EC)</th>
<th>Sarbanes-Oxley</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Committee</td>
<td>Mandatory for listed companies. Must be independent and have at least one financial expert. Appoints or dismisses the auditor</td>
<td>Also requires procedures for complaints from whistleblowers and others</td>
</tr>
<tr>
<td>Internal Controls</td>
<td>Requires audit firm report on key matters arising from the audit, particularly material weaknesses in internal controls related to financial reporting</td>
<td>Requirements are more detailed</td>
</tr>
<tr>
<td>Public Oversight of Auditors</td>
<td>28 EU members/accession states to appoint oversight boards for auditors, register firms and establish investigative/disciplinary systems; European Group of Auditors’ Oversight Bodies (EGAOB)*</td>
<td>Public Company Accounting Oversight Board (PCAOB) oversees audit of public companies; establishes standards for auditing, registration, quality control, ethics and independence of audit firms</td>
</tr>
<tr>
<td>Auditor Independence</td>
<td>Raises the possibility of “total prohibition” on non-audit services</td>
<td>Proscribes specific services and requires audit committee pre-approval for other non-audit services</td>
</tr>
<tr>
<td>Firm v. Partner Rotation</td>
<td>Provides for either audit firm or key audit partner rotation, audit firm at seven years and audit partner at five years</td>
<td>Requires lead and concurring audit partner rotation every five years; no requirement for firm rotation</td>
</tr>
<tr>
<td>Group Auditor Responsibility</td>
<td>Group auditors bears full responsibility for the audit of the consolidated accounts; responsibility extends to the work of other audit firms</td>
<td>None</td>
</tr>
</tbody>
</table>


Table D: Leximetric approach (Lele-Siems Leximetric Approach)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>and NYSE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>14.5</td>
<td>15</td>
<td>17.125</td>
<td>17.125</td>
<td>17.875</td>
<td>19.875</td>
<td>23.125</td>
<td>24.625</td>
</tr>
<tr>
<td>Company Law</td>
<td>3.75</td>
<td>3.75</td>
<td>3.75</td>
<td>4.75</td>
<td>4.75</td>
<td>5.75</td>
<td>5.75</td>
<td>5.75</td>
</tr>
<tr>
<td>UK</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rules</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>19.5</td>
<td>19.5</td>
<td>20</td>
<td>21.25</td>
<td>21.125</td>
<td>22.79</td>
<td>22.58</td>
<td>25.91</td>
</tr>
<tr>
<td>Overall</td>
<td>17.75</td>
<td>18.25</td>
<td>21.125</td>
<td>22.125</td>
<td>22.875</td>
<td>25.875</td>
<td>28.375</td>
<td>29.875</td>
</tr>
</tbody>
</table>
Chart C: Equity Trading Value between 1995 and 2006

Chart 3 shows the growth of the value of the trades in the Decembers of 2000 until 2006.198

Chart D: Trading Volume and Number of Trading (not liquidity)

This chart shows the reported trading volume. This chart shows the interrelation between trading volume and spread (spread is the volume stretched in the amounts of trades). The determinant of the trading volume is negatively related, as can be seen in the chart. The chart shows that the LSE liquidity is increasing. Source: London Stock Exchange, Available from: <http://www.londonstockexchange.com/en-gb/about/Newsroom/Market+Reports/>.
MARKET FOR MONITORING COSTS: LOOSING THE COMPETITION BY PROTECTING THE IGNORANT

Form A: Policy Form on the Implementation of Directive 2006/43/EC

<table>
<thead>
<tr>
<th>Policy Option</th>
<th>Option 2: Implement the Directive by building on the existing UK framework and taking advantage of the flexibilities provided in the Directive, where these are considered to be the preferred policy choice.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ANNUAL COSTS</strong></td>
<td></td>
</tr>
<tr>
<td>One off (Transition)</td>
<td></td>
</tr>
<tr>
<td>£8.9-10.1 million</td>
<td></td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td></td>
</tr>
<tr>
<td>£5.8-7.6 million</td>
<td></td>
</tr>
</tbody>
</table>
| | Public register – up to £4.5 million (one off)  
| Audit reporting – up to £10,000 (per annum)  
| Cooperation between oversight systems – up to £30,000 (per annum)  
| Dismissal and resignation – up to £215,000 (per annum)  
| Transparency reports – up to £1 million (per annum)  
| Audit Committees – £2.3 - £3.5 million (one off) and £3.5 - £5.3 million (per annum)  
| International provisions – up to £3 million (£2 million one off, £1 million on-going) + £650 per instance  
| Cooperation between third countries – up to £100,000 |
| | Total cost (PV) (over 10 years)  
| £58.4-75.1 million |
| **Other key non-monetised costs** | None |<br>|
| | |<br>|
| **ANNUAL BENEFITS** | Not possible to quantify. |
| One off | Yrs |<br>|
| |<br>|
| **Average Annual Benefit (excluding one-off)** |<br>|
| |<br>|
| |<br>|
| |<br>|
| **Other key non-monetised BENEFITS** | It is difficult to monetise the benefits of the Directive. The aim of the Directive is to raise the standard of, and public confidence in, the audit function across the European Internal Market. Greater confidence should reduce investor costs and have a favourable impact on the cost of capital. It should also give greater confidence in corporate reporting systems that underpin capital markets. Companies involved in corporate scandals lose significant market value and are often forced to restructure, with consequent job losses. It has been estimated that the loss in stock market wealth in the US, as a result of the Enron and Worldcom scandals, has been at least 9% or 0.36% of Gross Domestic Product (GDP) - $36.2 billion in the first year. |
| **KEY Assumptions/Sensitivities Risks** |<br>|
| **What is the geographic coverage of the policy/option?** | UK |
| **On what date will the policy be implemented?** | 6 April 2008 |
| **Which organisation(s) will enforce the policy?** | FRC (PGB and APB), FSA. |

Form B: Summary of Competitiveness Measures

<table>
<thead>
<tr>
<th>Measure</th>
<th>Historical Average</th>
<th>2006</th>
<th>2007</th>
<th>Change Since 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Share of Equity Raised in Global Public Markets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WFE</td>
<td>2002-2005: 26.9%</td>
<td>16.8%</td>
<td>19.2%</td>
<td>Better</td>
</tr>
<tr>
<td>Thompson Financial</td>
<td>1996-2005: 33.2%</td>
<td>22.0%</td>
<td>22.0%</td>
<td>Same</td>
</tr>
<tr>
<td>Global IPOs by Foreign Companies (By Value)</td>
<td>1996-2005: 30.3%</td>
<td>6.6%</td>
<td>7.7%</td>
<td>Slightly better</td>
</tr>
<tr>
<td>Largest Global IPOs</td>
<td>1996: 8 of 20</td>
<td>1 of 20</td>
<td>0 of 20</td>
<td>Slightly worse</td>
</tr>
<tr>
<td>Rule 144A IPOs by Foreign Companies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>As a Percent of the Total Value of Global IPOs in the U.S.</td>
<td>1996-2005: 61.9%</td>
<td>85.7%</td>
<td>84.9%</td>
<td>Slightly better</td>
</tr>
<tr>
<td>IPOs of U.S. Companies Abroad</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percent of U.S. IPOs Listed Only Abroad (By Value)</td>
<td>1996-2005: 0.1%</td>
<td>1.1%</td>
<td>4.3%</td>
<td>Significantly worse</td>
</tr>
<tr>
<td>Equity Raised by Foreign Issuers via Rule 144A ADRs</td>
<td>2000-2005: $9.3 bn</td>
<td>$9.9 billion</td>
<td>$4.4 billion</td>
<td>Significantly better</td>
</tr>
<tr>
<td>Equity Raised by Foreign Issuers via Rule 144A ADRs as a Percentage of Equity Raised by Foreign Issuers in the U.S Public Market</td>
<td>2000-2005: 6.8%</td>
<td>80.8%</td>
<td>31.2%</td>
<td>Significantly better</td>
</tr>
<tr>
<td>Cross Listings in the U.S. by Foreign Companies</td>
<td>2000-2005: 21</td>
<td>6</td>
<td>4</td>
<td>Slightly worse</td>
</tr>
<tr>
<td>Foreign Delisting Rates on the NYSE</td>
<td>1997-2005: 5.2%</td>
<td>6.6%</td>
<td>12.4%</td>
<td>Significantly worse</td>
</tr>
<tr>
<td>U.S. Share of Global Market Capitalization</td>
<td>1990-2005: 43.6%</td>
<td>37.9%</td>
<td>35.2%</td>
<td>Slightly worse</td>
</tr>
<tr>
<td>U.S. Share of the Value of Global Share Trading</td>
<td>1990-2005: 50.7%</td>
<td>49.0%</td>
<td>41.2%</td>
<td>Worse</td>
</tr>
<tr>
<td>ADR Trading Volumes in the U.S. as a Percentage of Trading Volumes of Ordinary Shares in the Home Market</td>
<td>2001-2005: 17.2%</td>
<td>20.0%</td>
<td>20.1%</td>
<td>Same</td>
</tr>
<tr>
<td>M&amp;A Advisory and Equity/Debt Capital Market Underwriting Revenue by Client-Parent Nationality</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. as a Percentage of Global Total</td>
<td>1996-2005: 50%</td>
<td>42%</td>
<td>42%</td>
<td>Same</td>
</tr>
</tbody>
</table>

* Red indicates same or worse; black indicates better.

**Fig. A:**

- Duties and enforcement
  - Board's motivation to disclose properly
    - Influencers (<5%)
    - Blockholders (>5%)

**Fig. B:**

- Monitoring Costs
  - Shareholders' motivation to monitor
    - Imposed disclosure costs by legislation
    - Capital Returns
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