

TRANSPARENCY OBLIGATIONS DIRECTIVE

Summary: The Transparency Obligations Directive is another key element of the Financial Service Action Plan, designed to improve the timeliness and disclosure of share issuers throughout the reporting cycle. Current practice varies across the EU, and certain elements of the proposed Directive will require significant changes in some Member States.

The Transparency Directive is due to be implemented in 2005, the same year in which International Accounting Standards will be introduced. This latter will be a significant change for companies, but also for their investors and analysts, who will have to work to understand the changes to the presentation of accounts. The timing of the Transparency Directive could therefore be problematic for companies and their shareholders.

In the wider policy context, there are aspects of the Transparency Directive also contained in the Commission's Action Plan on Corporate Governance and Company Law, for example regarding directors' liability. A further issue is the application of the Directive to third country issuers, and the question of equivalence of requirements, particularly regarding accounting standards.

The key provisions of the draft Directive relate to annual, half-yearly and quarterly reports, where the Commission sets out detailed requirements for the frequency and content of reporting. Regular and ad-hoc dissemination of price-sensitive events is an important part of a company's relationship with the market, but this is not fully addressed in the proposals. **It is important to provide** a sensible disclosure regime for major shareholding in order to avoid confusion of the markets and unnecessary red tape.

Investors should have easy access to the information which they require, and in a format which is useful to them, both in terms of quality and frequency. The Commission proposals explore dissemination of information by electronic means, which has the potential of developing into an efficient method of communication by companies.

1. Background

The Commission published its proposal for a Directive on transparency requirements with regard to issuers whose securities are admitted to trading on a regulated market in March 2003, following two rounds of consultation. The Directive is due to be implemented in 2005, as part of the Financial Services Action Plan.

The aim of the Directive is to improve the information made available to all investors about companies whose shares or debt is publicly traded on regulated securities markets within the EU – by reducing information asymmetries it aims to combine investor protection with market efficiency, and thus giving European firms the best chance to compete globally.

The objectives set out by the Commission are:

- To improve the timeliness of annual financial reporting
- To improve periodic disclosure of share issuers by introducing a requirement for quarterly financial information
- To introduce half-yearly financial reporting for issuers of only debt securities, currently not subject to interim reporting requirements
- To improve on-going disclosure of major shareholdings in some member states
- To update EC law on information provided to security holders in general meetings through proxies and electronic means.

Disclosures will have to be filed with the home Member State's competent authority. A home Member State may impose more stringent requirements for notification or disclosure than in the Directive, but a host Member State may not.

2. Key issues

Implementation timetable

As an important part of the FSAP, the Transparency Directive should be adopted by April 2004 if it is to meet its implementation target of 2005. International Accounting Standards will also come into effect in 2005, which will therefore require companies to report using new standards in the same year. It should be noted that the international standard on interim reporting (IAS 34) is subject to change as part of the IASB's desire to converge to US standards. With the amount of uncertainty faced in converting to international standards, there is an argument for effective transitional provisions for 2005 reporting.

The Commission proposes that Member States could be allowed to exempt security issuers from the application of IAS in the half-yearly financial report due in 2005.

Annual financial report – reporting deadlines

The proposal requires the annual financial report to be disclosed within 3 months of the end of the year. The Commission is concerned that longer reporting periods would cause uncertainty and would increase the risk of selective disclosure. On the other hand, some are worried that shorter reporting deadlines could increase the risk of needing to restate, with unhelpful effects on investor confidence in financial reporting. There is also an argument that smaller companies in particular may find it difficult to meet this deadline, given a relative lack of resources and an increased and concentrated demand for audit services.

Quarterly reporting

The Commission proposes mandatory quarterly reporting in the first and third quarters, which would provide information on key historical data (net turnover, profit & loss, explanatory statement), but which would not be based on IAS34. The Commission gives the following reasons for introducing quarterly reporting: it already exists in eight Member States, and has been required in the US since 1946; it should provide better investor protection; the more frequent availability of information would increase market efficiency and competition (through better allocation of capital); it will help persuade international investors to diversify their investments across world markets. Some think that quarterly reports should be established according to IAS 34 as it represents an established standard but this is by no means a uniformly held view.

However, there is concern that this approach would lead to increased stock market volatility, and may encourage short-termism in markets where quarterly reporting would be a new requirement. A greater frequency of reporting would also take up valuable management time and would incur significant additional costs, as companies would wish to provide high quality financial information and would therefore need to produce a balance sheet. Although auditing would not be mandatory, companies in the UK wishing to ensure that the information that they provide to investors is of the highest possible quality may feel obliged to seek audits. There is

also an argument that the new mix of reporting requirements could reduce the effectiveness (and frequency) of the ad hoc reporting regime and would not represent an increase in the quality of information available to the market, and would therefore not improve investor knowledge.

Half-yearly reporting

The deadline for this will be two months. This report is designed to be an update of the annual report. The Commission proposal does not require a mandatory auditor's review, but where such exists, it must be fully disclosed. Issuers of debt securities will have to produce a half-yearly financial report for the first time.

Directors' liability

The Directive will require responsible persons to state within the half-yearly and annual reports that these are in accordance with the facts and make no significant omission. This is similar, although not identical, to the requirement introduced by the 2002 US Sarbanes-Oxley Act. The issue of liability risks remains however very complex. Who decides who is accountable and to whom, for a company which is listed in more than one Member State? Companies may decide to exclude certain Member States from issues if the civil liability implications become too complicated.

This issue is discussed in the Commission's recent Action Plan on Corporate Governance and Company Law. Indeed, several suggestions in the document relate to issues raised by the Transparency Obligations Directive.

Third country issuers (Article 19)

Member States can exempt third country issuers from having to comply with many of the provisions of the Directive, providing that their domestic law contains "equivalent" requirements. This would perhaps benefit from some clarification, particularly regarding the accounting standards that should apply. Would the Commission expect non-EU issuers to apply IAS? How does the Commission expect to enforce notification requirements on non-EU investors in the securities of non-EU issuers? If non-EU issuers were to face additional costs, such as the need to convert to a different accounting standard, they may be driven away, thus reducing choice for EU investors, who would find it more difficult to invest in non-EU companies. On the other hand some argue it should be avoided to undermine the credibility of the EU capital market by granting a lighter regime to third country issuers.

Language regime

The Commission proposes that investors should be able to notify change to their shareholdings in a language customary in the sphere of international finance. Issuers whose securities are admitted to regulated markets in more than one Member State, may also opt to use such a language. It is thought that this should help to attract investors from abroad. In the home Member State, information shall be disclosed in a language accepted by the competent authority. If the securities are only traded in one host Member State (and not in the home Member State), the language must be acceptable to the former. However, in both cases, if the denomination of the securities is greater than Euro 50 000, the issuer can opt for "a language customary in the international sphere of finance".

Disclosure of shareholdings (Article 9)

Investors will have to disclose the acquisition or disposal of major shareholdings in listed companies, based on a series of thresholds, starting at 5%. The definition of shareholder for this purpose will include custodians and those holding securities for clearing and settlement unless for a short time only. There might be a danger that the market would be more irritated than informed by the expected multitude of notifications. The notification requirements also extend to derivative securities. Investors would therefore have to try to calculate the potential shares that they could obtain through derivatives, which could become an administrative burden. There is an argument that notification of shareholdings should be mandatory only for those who can exercise the resulting voting rights in their own interest and without having to follow any special instructions (e.g. this is not the case of proxy voting rights).

Cost of implementation

It will be important to seek a balance between the costs associated with implementing the measures contained in the proposals, and the expected benefits. There is an argument that the quality of the information available to investors is more important than the quantity.

Grandfathering

As drafted, the Directive contains no provision for grandfathering of existing long-term instruments which are nearing their maturity.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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