THE REGULATION OF CORPORATE BOND OFFERINGS: A COMPARATIVE ANALYSIS

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1. INTRODUCTION

Frequently overshadowed by the more scintillating equity markets, the corporate debt markets are currently the focus of closer regulatory scrutiny—a result of the recent corporate meltdowns and the concurrent, albeit unrelated, integration of the European financial markets. Debt issuances are a longstanding staple in the arsenal of financing tools used by corporate issuers. In the United States alone, total underwritings of corporate debt totaled $2.66 trillion in 2004 compared to $202.7 billion in underwritten equity deals. Notwithstanding the large volume of corporate debt deals, because so many of them are effected in the over-the-counter ("OTC") market or through off-exchange transactions with sophisticated institutional investors, debt offerings often have not garnered the regulatory attention often paid to equity deals.

One of the byproducts of the recent financial frauds has been

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2 In this article, the term "OTC transaction" refers to the trading of unlisted corporate bonds. The term "off-exchange transactions" refers to bonds listed on an exchange that are traded off that exchange.
an enhanced appreciation by regulators on a global basis of the importance of debt offerings as a source of financing. A quick survey of some of the financial frauds that have occurred in the past few years—Enron, WorldCom, Parmalat, Adelphia—reveals how corporate debt securities loomed large as instruments for the losses suffered by investors. For example, the year before it collapsed, WorldCom, Inc. raised at least $12 billion in a public debt offering.\(^3\) Parmalat Finanziaria SpA ("Parmalat"), which had debt securities listed on the Milan and Luxembourg securities exchanges, had approximately $9.4 billion in bonds outstanding at the time insolvency proceedings were instituted, a substantial portion of which were held by retail\(^4\) and non-Italian investors.\(^5\) Debt holders were left holding billions of dollars in losses as a result of these frauds, most of which involved accounting irregularities\(^6\) and, in many cases, questionable related-party

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\(^4\) Throughout this Article, "retail investors" refers to investors who purchase and sell securities on their own behalf, and not on behalf of an organization.

\(^5\) By the time that Parmalat’s insolvency proceedings were instituted, it had approximately $18 billion in debt, of which $6.2 billion was held by non-Italian bondholders and bank lenders. *See* Soma Biswas, *Parmalat’s Foreign Creditors Upset*, DAILY DEAL, Mar. 17, 2004, available at LEXIS, News Library (describing foreign bondholder dissatisfaction with insolvency proceedings); Paul Betts, *Parmalat Sting Hits Italian Pensioners*, FIN. TIMES, Mar. 4, 2005, at 22 (noting that many individual investors in Parmalat bonds or shares are over 60 years old).

transactions that enabled companies to hide their losses through the use of related companies and special purpose entities.7

These recent corporate debacles have highlighted the need for full and fair disclosure to investors when issuers raise capital in the markets through debt offerings and listings, particularly when retail investors are involved. The International Organization of Securities Commissions ("IOSCO"), which consists of 183 securities regulatory agencies from around the world,8 published a report dated February 2005 that highlighted the need for greater regulatory focus on a global basis in improving such disclosures.9 The IOSCO Report noted in particular the increasing involvement of retail investors in the market for corporate debt securities.10 Retail investment in the corporate bond market most likely will


7 See, e.g., Law Differs for Italian and US Parmalat Shareholders, INS. DAY, Apr. 14, 2004 (noting that Parmalat used roughly 250 related entities to inflate earnings); Stephen Taub, supra note 6 (detailing Parmalat's alleged strategy of creating holding companies with fake assets); SEC Charges Jeffrey K. Skilling with Fraud, supra note 6 (alleging the use of special purpose entities to manipulate financial results). Other related-party transactions included, among other things, loans to insiders, such as Adelphia Communications' loans to the Rigas family that controlled it, and WorldCom's alleged $400 million loan to its Chief Executive Officer. See Jill Goldsmith, Tell-All Findings on Adelphia Unfold, DAILY VARIETY, May 28, 2002, at 7 (noting that Adelphia gave private loans to family members to fund a variety of ventures); Pradnya Joshi, 'Telecom Cowboy' Goes on Trial, NEWSDAY, Jan. 18, 2005, at A35; SEC and U.S. Attorney Settle Fraud Case Against Adelphia, supra note 6 (noting that Adelphia engaged in self-dealing, which included the use of Adelphia funds to finance the Rigas family's business undertakings).


10 IOSCO FINANCIAL FRAUDS REPORT, supra note 9, at 19 (citing IOSCO BOND TRANSPARENCY REPORT).
increase as a result of the aging of the population in the developed markets. As individual investors get closer to retirement age, more of them are expected to shift their investments from equity securities to the comparatively more secure bonds.11 In October 2005, IOSCO further underscored the importance of high quality corporate debt disclosures by publishing for public comment proposed IOSCO International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers.12 These Principles set forth substantive disclosure guidance for prospectuses and other documents used in the public offering and listings of "plain vanilla" corporate debt securities and, once a final version of the Principles is endorsed by IOSCO, are expected to be used by securities regulators who are developing or reviewing their disclosure regimes for cross-border offerings and listings of debt securities.13

In addition, the tectonic shift in the regulation of the financial markets in the European Union ("EU"), precipitated by the EU Financial Services Action Plan ("FSAP")14 in 1999, has forced EU regulators into a delicate balancing act. The FSAP establishes an ambitious legislative program aimed at integrating the financial markets of all 25 EU Member States into a single capital market.15

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13 Id. at 1.


This integration is being effectuated through a series of Directives (such as the Market Abuse Directive,\textsuperscript{16} the Prospectus Directive,\textsuperscript{17} and the Transparency Directive\textsuperscript{18}), which EU Member States must implement into national legislation by certain dates; and Regulations (such as the International Accounting Standards Regulation\textsuperscript{19}), which become effective without further action by EU Member States. While expected to improve the regulatory and supervisory framework of the European financial markets, these legislative acts will also subject issuers in many of those markets to more stringent disclosure standards. In implementing the FSAP, EU regulators have to consider the best strategy for protecting investors and facilitating the smooth functioning of their newly integrated markets, while at the same time safeguarding these markets from competition by other, less regulated, markets in non-EU member jurisdictions. Inroads into the lucrative Eurobond market,\textsuperscript{20} which is based predominantly in London and Luxembourg, are already being made by several non-EU securities the progress of FSAP implementation).


\textsuperscript{19} Council Regulation 1606/2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1 [hereinafter International Accounting Standards Regulation].

\textsuperscript{20} Eurobonds are bonds that are issued multinationally and denominated in a currency other than the currency used in the country in which the bonds are issued. For example, this would include U.S. dollar-denominated bonds sold by a U.S. issuer to Dutch investors. \textit{See generally SEC, REPORT OF THE STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMMITTEE ON ENERGY AND COMMERCE ON THE INTERNATIONALIZATION OF THE SECURITIES MARKETS, at G-3, II-35 to II-51 (outlining the development of the Eurobond market); Alex Skorecki, \textit{Eurobonds LSE Plans a Fresh Way of Listing}, FIN. TIMES, Jan. 21, 2005, at 41 (describing risky methods for exchanging Eurobonds.).
The new regime for the regulation of the public debt markets in the EU presents an interesting case study of the challenges faced by regulators in implementing the FSAP. Currently in the developed markets, the approach taken to regulating the disclosures by corporate issuers of public debt securities differs among securities regulators, depending to a great extent on their perception of the relative risks faced by investors in corporate bonds. In some jurisdictions, corporate issuers are not required to disclose as much information about the issuer’s operations and prospects when they list and publicly offer bonds compared to what is required of them when offering presumptively riskier securities, such as shares. The reason for this disparity is that debt investors’ interests in the issuer are presumably more limited than the interest of equity holders. Under the new EU Prospectus Directive, corporate issuers that make public offerings or have their securities admitted to trading on “regulated markets”\(^\text{22}\) in the European Union are required to provide prospectus disclosures under a “building blocks” approach.\(^\text{23}\) This means that different prospectus disclosure requirements apply to each category of security that is offered or listed, reflecting securities regulators’ assessments of the level of information that investors would find relevant to their investment decisions. In addition, the prospectus requirements

\(^{21}\) See Michael Evans, Swiss Make Play for Eurobond Market: Disclosure Rules Are Forcing Issuers to Consider Listing Outside the EU, INT’L FIN. L. REV., December 2004, at 15 (describing how Singapore’s recent success in luring to its markets Asian issuers that otherwise would have listed in Europe has encouraged efforts by the SWX Swiss Exchange to attract Eurobond listings); Mark Kalderon & Alexandra Hope, How the Prospectus Directive Will Affect Issuers, INT’L FIN. L. REV., BANKING YEARBOOK 2004, at 12 (claiming the FSAP will affect all security exchanges within the EU); Edward Roby, European Regulators Pile Pressure on Bond Markets, EFINANCIALNEWS.COM (April 17, 2005), available at LEXIS, News Library (explaining that the SWX Swiss Exchange’s Eurobond market will not be subject to the EU Directives).


\(^{23}\) See Prospectus Implementing Regulation, supra note 17, art. 21 at 12 (describing mandatory minimum disclosure requirements).
differentiate between bonds that are most likely to be purchased by retail, as opposed to sophisticated institutional, investors.

In other jurisdictions such as in the United States, however, these distinctions between investments in equity securities and debt securities are not observed in the prospectus disclosure requirements. Debt securities that are registered for a public offering may be freely traded in the public markets, so there is a presumption that retail investors in those securities may resell them in the secondary markets. Because retail investors in registered debt are not expected to hold corporate bonds to maturity, investors in these securities are viewed as needing the same level of information as investors in shares.

Because the EU and the United States follow two diametrically opposed paradigms in regulating prospectus requirements for debt offerings and listings to retail investors, this article compares and contrasts both debt disclosure regimes to determine the salient factors that influence the regulatory approaches taken by securities regulators in these jurisdictions. Part I of the article describes the characteristics of the corporate bond market in each jurisdiction. Part II of the article describes the prospectus disclosure regime for debt securities that is being implemented in the EU and the regime currently in place in the United States. Part III considers the role that the legal framework plays in encouraging the development of a particular type of regulatory regime. Jurisdictions in which issuers may be subject to substantial litigation risk may provide regulators with a strong incentive to establish more detailed disclosure rules, as opposed to a so-called "principles-based" system. Part IV considers the way that all of these influences play out in the approach taken in the EU and the United States for specific disclosure items that arguably should be provided in the non-financial statement portion of debt prospectuses, such as Management’s Discussion and Analysis ("MD&A") and related-party transactions. Finally, this article considers how the internationalization of the markets may influence the further evolution of these disclosure regimes.

2. OVERVIEW OF THE CORPORATE BOND MARKETS IN THE UNITED STATES AND EUROPE

Although many companies involved in the recent financial frauds had substantial issuances of public debt, historically, offerings of debt securities as a financing mechanism have been
used more commonly by U.S. companies. In Europe, bank lending traditionally has predominated as a source of capital, but more European issuers have been tapping the bond markets since the creation of the euro in 1999.

In the United States, most of the corporate bond issuances are of investment grade debt. In 2004, approximately eighty-five percent of the corporate bond issuances in terms of dollar volume were in investment grade debt, and the remaining corporate bond issuances were in high-yield debt (i.e., junk bonds). The vast majority of investment grade corporate bonds are registered for sale in the public markets. Secondary market trading in the corporate debt market occurs primarily among institutions in the over-the-counter market.

In contrast, most of the high-yield corporate bonds trade in the Rule 144A market. Under Rule 144A of the Securities Act of

24 See Valentine V. Craig, The Changing Corporate Governance Environment: Implications for the Banking Industry, 16 FDIC BANKING REV. 121 (2004) (identifying the main developments of the changing banking environment and issues of corporate governance that U.S. bankers are likely to face); Italian Need for Corporate Governance Reform Increases in Wake of Parmalat, INS. DAY, Apr. 15, 2004 (noting that large family owned and controlled companies in Italy traditionally have enjoyed close relationships with banks, which made it easier to obtain low interest bank loans); Brian Quinton, Continental Shifts, CORP. LEGAL TIMES, Aug. 2004, at 54 (identifying the main developments of the changing corporate governance environment).


27 See George W. Fenn, Speed of Issuance and the Adequacy of Disclosure in the 144A High-Yield Debt Market, 56 J. FIN. ECON. 383, 387 (2000) (attributing the heavy reliance on Rule 144A by many issuers of high-yield debt to their inability to meet the requirements for shelf registration); Miles Livingston & Lei Zhou, The Impact of Rule 144A Debt Offerings Upon Bond Yields and Underwriter Fees, FIN. MGMT. 5, 12 (2002) (estimating that over 80% of investment-grade bonds are offered in the public debt market). By registering debt securities for sale in the public markets, issuers may be able to avoid paying premium yields to compensate for the reduced liquidity of Rule 144A issuances. See Livingston & Zhou, supra.


29 See IOSCO BOND TRANSPARENCY REPORT, supra note 9, at 24 (discussing transparency for corporate bonds in the over-the-counter market).

1933 ("Securities Act").\(^{32}\) securities that have been privately placed or sold in an offering that is otherwise exempt from registration (such as under Regulation S\(^{33}\)) may be resold to certain large institutional investors without registration. This means that resales of these restricted securities to institutions that satisfy the Rule’s definition of a “Qualified Institutional Buyer” ("QIB")\(^{34}\) need not be accompanied by a prospectus and are not subject to the U.S. Securities and Exchange Commission’s ("SEC") disclosure requirements. A substantial number of Rule 144A transactions are underwritten, however, which has resulted in the use of an offering memorandum and substantive disclosures that are similar to the information that is provided in a prospectus for a public offering.\(^{35}\) In addition, bonds sold in U.S. private placements frequently contain financial covenants that provide debt holders with important protections which are less commonly seen with Eurobonds.\(^{36}\)

As in the United States, the bond market in Europe is dominated by institutional investors.\(^{37}\) In Europe, most corporate

\(^{31}\) See Fenn, supra note 27, at 384 (noting that more than 80% of high-yield debt securities were issued in the Rule 144A market in 1997, with market analysts predicting that this figure would likely increase over time); Livingston & Zhou, supra note 27, at 5 ("Rule 144A issues have accounted for up to 80% of the high-yield bondmarket in recent years.").


\(^{34}\) A “Qualified Institutional Buyer” ("QIB") is defined in Rule 144A(a)(1) as an institution that in the aggregate owns and invests on a discretionary basis, either for its own account or the accounts of other QIBs, at least $100 million in securities of issuers that are not affiliated with it. 17 C.F.R. § 144A(a)(1).

\(^{35}\) See Felicia H. Kung, The Rationalization of Regulatory Internationalization, 33 LAW & POL’Y INT’L BUS. 443, 453 & n.49 (describing how the demand by institutional investors for underwritten Rule 144A deals has helped to expand the Rule 144A market); Fenn, supra note 27 (ascribing the prospectus-like documentation to demands by underwriters of Rule 144A offerings).

\(^{36}\) See Colleen Marie O’Connor, The Private Route, INVESTMENT DEALERS DIG., Aug. 16, 2004, at 30, 33 (noting that the majority of private placements in the United States, including those executed by an increasing number of German companies, are executed with covenants designed to protect bondholders); Experts Stumped on Stunted European Market Development, PRIVATE PLACEMENT LETTER, Oct. 27, 2003, available at LEXIS, News Library (studying the rise of a European private placement market in the shadow of the huge Eurobond market).

bonds are listed on an exchange, but a large amount of the trading in these bonds actually occurs off the exchange. Exchange listings are sought as a means of obtaining favorable tax treatment for the issuer, and to satisfy the investment restrictions of some institutional investors and fund managers.

Although the institutional market is the most significant one for corporate bonds, the retail market is becoming increasingly important. In both Europe and the United States, most of the trading volume in bonds occurs in the institutional market, but the highest number of bond transactions occurs in the retail market.

In Italy, Switzerland, Germany, Belgium, the Netherlands, and Luxembourg, an active retail debt market exists, albeit on a much smaller scale than the institutional one.

The growing significance of the retail bond market can be attributed to several factors. In the past few years, the equity markets have performed relatively poorly, as evidenced by the equity sell-offs during 2000 through 2003. Investors appear to be...
searching for investments that provide relatively high income, but at a low capital risk. Banks have also been eager to reduce their exposure to non-performing loans, so the reliance by European issuers on bank lending has been eroding slowly. Indeed, this decreased reliance on bank lending is viewed as evidence of the successful efforts in the EU to develop an integrated European capital market. In addition, a series of pension fund scandals in Europe have highlighted the risks of investing too heavily in equity securities. All of these factors have led to increased retail investor interest in the bond markets, which concomitantly has stimulated issuers' interest in the retail bond market as an attractive source of financing.

In the United States, sales of new corporate bonds to retail investors have doubled to $25 billion annually since 2001. The transparency of corporate bond pricing has also been improving in the past few years, with vast improvements seen on the retail side. This greater price transparency should enhance the liquidity of secondary market trading in the retail market.

44 Batchelor, Wallflowers of the Markets, supra note 41, at 24; see O'Connor, supra note 36, at 32 (concluding that the weakness of the German banking sector has encouraged German corporations to look to more diversification of funding sources).
45 EUROPEAN COMMISSION, supra note 15, at 1.
46 Batchelor, Wallflowers of the Markets, supra note 41, at 24. See also Ben Hall, Challenge Remains to Revive Occupational Savings System, FIN. TIMES, May 15–16, 2004, at 3 (arguing that British government initiatives have done little to rebuild investors' confidence in pension fund investment in light of recent pension scandals); Rachel Stevenson, Move to Protect Workers from Pension Fund Scandals, THE INDEP. (London), June 12, 2003, at 2 (analyzing the scheme put forth by the British government to help protect pensions when a firm goes bankrupt).
47 See Kim, supra note 43 (noting that companies are offering products and services to stimulate retail investment in bonds). See also Schaub, infra note 56 (describing marketing efforts to attract a wider investor base).
49 Kim, supra note 43, at D2.
50 A "foreign private issuer" is defined under the U.S. federal securities laws as any issuer incorporated under the laws of any foreign country that is not a foreign government, except if more than 50% of its outstanding voting securities are directly or indirectly owned of record by U.S. residents and any of the
including both registered and privately placed securities, must be reported to the National Association of Securities Dealers, Inc. ("NASD") within fifteen minutes after the transaction. This information is available to the public through the NASD's Trade Reporting and Compliance Engine ("TRACE") system.\footnote{The Bond Mkt. Ass'n, supra note 37, at 37. TRACE was launched on July 1, 2002. Id. Prior to July 1, 2005, the reporting time for trades was within 30 minutes after the transaction. Id.} Price information about corporate bond trades is immediately accessible to retail investors, without charge, through an investor education website.\footnote{Press Release, The Bond Mkt. Ass'n, Association's Award-Winning Investor Education Website, www.InvestinginBonds.com, Adds Free Real-Time Corporate Bond Prices, Site Now Carries Free Corporate, Municipal & Treasury Prices (Feb. 7, 2005), available at http://www.bondmarkets.com/story.asp?id=1679.}

European issuers are increasingly turning to the bond markets as an alternative source of financing. For example, Porsche AG and other German companies raised almost $3.9 billion in U.S. private placements of debt securities in the first half of 2004.\footnote{O'Connor, supra note 36, at 30.} Part of the impetus for this has been the forty percent decrease in the number of German banks between 1992 and 2003, which reduced the pool of potential bank lenders, as well as the relative weakness of the German banking sector during this period.\footnote{Id. at 32.} This reduced reliance on bank lending will undoubtedly become more pronounced after July 2005, when the German state guarantee for the state-owned regional banks (Landesbanken) and savings banks (Sparkassen) expires. By improving the bond ratings of these banks, this guarantee has been credited with allowing those banks to reduce their cost of borrowing, thereby enabling them to lend funds at very low rates.\footnote{Id.} Recently, as a result of intensified issuer interest in the retail market, some European issuers have actually been targeting bond issuances to retail investors.\footnote{See Alexander Schaub, Financial Integration in EU25—Lessons Learnt and Prospects for the Future, Keynote Address at the Euro Symposium, Tokyo (Nov. 12, 2004), http://www.iima.or.jp/pdf/others/sympo_2004_1112/Speech%20text.pdf}
Nonetheless, compared to the U.S. markets, price transparency is more limited for retail investors in the European bond markets. Post-trade price information about transactions in European sovereign and high-grade corporate bonds is more readily available for institutional investors.57

3. COMPARISON OF EU AND U.S. DEBT DISCLOSURE REGIMES

3.1. EU Initiatives

As the significance of the retail debt markets has grown, the appropriate regulation of those markets has become increasingly important.58 In the EU, securities regulators have recently grappled with this issue in the context of their efforts to implement the legislation set forth in the FSAP.

The International Accounting Standards Regulation (the "Regulation") was one of the first legislative measures to be adopted under the FSAP, and greatly affects the presentation of financial information in prospectuses used in the EU. The Regulation requires EU companies that are admitted to trading on an EU regulated market to prepare their consolidated financial statements according to the International Financial Reporting Standards ("IFRS") that are set by the International Accounting Standards Board ("IASB"), beginning on or after January 1, 2005.59 For an EU issuer that only has debt securities admitted on a regulated market in any EU Member State, the provisions do not

57 THE BOND MKT. ASS'N, supra note 37, at 15.
59 International Accounting Standards Regulation, supra note 19, art. 4.
apply until the issuer's fiscal year starting on or after January 2007.60 Issuers whose securities are admitted to public trading outside the EU, such as foreign companies, that have been using "internationally accepted standards" since before the publication date of the Regulation (i.e., July 2002), are also not required to use IFRS until the fiscal year beginning on or after January 2007.61

Another legislative measure under the FSAP, the Market Abuse Directive ("MAD" or the "Directive") was adopted by the European Parliament and European Council in January 2003. This Directive is aimed at promoting the smooth functioning of the EU financial markets, as well as instilling greater public confidence in those markets.62 The Directive does this by developing a framework aimed at preventing market abuse in the EU (defined in the Directive as insider trading and market manipulation),63 and requires Member States to provide for the availability of administrative sanctions for violations of the Directive.64 The

60 Id. art. 9.

61 Id. The Committee on European Securities Regulators ("CESR"), which consists of staff members from the various EU securities regulatory agencies who provide technical advice to the European Commission, published its technical advice to the European Commission in June 2005. The CESR stated that U.S. GAAP, Canadian GAAP, and Japanese GAAP qualify as equivalent accounting standards to IFRS, although issuers using these GAAPs should be required to provide additional descriptive and quantitative disclosures in certain areas. See Committee of European Securities Regulators, Technical Advice on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries' Mechanisms of Enforcement of Financial Information, CESR/05-230b (June 2005), available at http://www.cesr-eu.org/data/document/05_230b.pdf. Under the Prospectus Directive and Transparency Directive, beginning on January 1, 2007, non-EU issuers (e.g., third country issuers) who make a public offering of their securities in the EU or who have their securities admitted to trading on an EU-regulated market must prepare their financial statements according to EU-endorsed IFRS or the third country's national accounting standards, if the European Commission has declared such standards to be equivalent to IFRS. See Prospectus Directive, supra note 17, art. 20 (laying out the guidelines for admission to trading on a regulated market for issuers incorporated in third countries); Prospectus Implementing Regulation, supra note 17, art. 35 (explaining that the obligation to restate historical financial information in a prospectus does not apply to any period earlier than January 1, 2006); Transparency Directive, supra note 18, arts. 23, 30 (stating the exemptions for issuers incorporated in third countries).


63 Id. recital 12.

64 Id. art. 14. Prior to the Market Abuse Directive ("MAD"), criminal sanctions for insider trading were commonly available to authorities in Member States, but civil sanctions were not as widely available. Some commentators have argued that civil sanctions are arguably more effective in combating insider trading. See, e.g., European Parliament and European Council, European Parliament and Council Decision of January 22nd, 2003, Delegating Authorisation to the Commission to Adopt Measures Intended to Facilitate Compliance with the Market Abuse Directive (2003/87/EC).
adoption of one consistent framework for combating market abuse is expected to eliminate inconsistencies among national requirements, as well as possible loopholes. MAD also establishes the basic disclosure principle for issuers that all inside information should be disclosed to the public as soon as possible, unless one of the exemptions set forth in that Directive applies. EU member states were required to adopt legislation at a national level to implement this Directive into national law by October 12, 2004.

Within that basic framework, the EU adopted the Prospectus Directive in November 2003. This directive sets forth a single set of disclosure requirements for prospectuses that are used for public offerings of securities or when securities are admitted to trading on EU regulated markets, and is to be implemented into national regulations by EU members no later than July 1, 2005. Implementation of the Prospectus Directive is a crucial step in the EU's efforts to make the financial markets competitive globally. Under the Prospectus Directive, a prospectus that is approved for use in one EU Member State can be used in all other EU Member States without the imposition of additional disclosure requirements by the regulatory authorities in the other Member States.

trading than criminal sanctions because an insider trading case is most often developed through the use of circumstantial evidence and the legal standard for prevailing in a civil case is lower than in a criminal proceeding. See Thomas C. Newkirk & Melissa A. Robertson, Speech by SEC Staff: Insider Trading—A U.S. Perspective, Remarks at the 16th International Symposium on Economic Crime (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm (comparing MAD to U.S. government approaches to combat insider trading). The requirement that civil sanctions be available for violations of MAD should enhance the effectiveness of authorities in prosecuting market abuse cases in the EU.

65 Market Abuse Directive, supra note 16, art. 6(1). "Inside information" is defined to be "information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments." Id. art. 1(1).

66 Id. art. 18. Although most EU Member States were not able to transpose the Directive into national legislation by the October deadline, they are widely expected to do so by the second quarter of 2005. See Press Release, U.K. Financial Services Agency, What's New, at http://www.fsa.gov.uk/Pages/About/What/International/EU/fsap/mad/new/index.shtml (last updated July 4, 2005) (reporting it is likely that the full implementation of the Market Abuse Directive will occur during the second quarter of 2005).

67 Prospectus Directive, supra note 17, art. 1(1).

68 Id. art. 29.
States, and without a further approval process. In other words, an approved prospectus may be used as a "passport" by an issuer seeking access to multiple EU markets. This framework is expected to reduce capital raising costs for issuers because they will not have to comply with a myriad of conflicting disclosure requirements throughout the EU, thereby fostering the efficiency and competitiveness of the integrated EU financial market.

Under the Prospectus Directive, issuers seeking to publicly offer or admit securities for trading on a regulated market in the EU prepare a prospectus that must be approved by the competent authority\textsuperscript{69} in its "home Member State," i.e., the EU country in which an EU company has its registered office.\textsuperscript{70} For issuers of debt-only securities in which the denomination per unit equals or exceeds 1,000 euros, however, the home Member State is the EU country in which the issuer has its registered office, in which the securities are admitted to trading on a regulated market, or in which the securities are offered to the public. The issuer, offeror, or person seeking admission to trading, as relevant, selects the home Member State.\textsuperscript{71} For non-EU issuers, the home Member State is the EU country in which securities are first offered to the public or where admission to trading is first sought after the Prospectus Directive's effective date.\textsuperscript{72} Once the prospectus has been approved, the issuer can request the competent authority of the home Member State to send a notice of this approval to the competent authority in any other EU Member State—i.e., "host Member State,"—in which it wants to make a public offering or have its securities admitted to trading.\textsuperscript{73} The competent authority

\textsuperscript{69} In the past, some European countries had several governmental entities that could be viewed as a "competent authority." The Prospectus Directive makes clear the preference for one independent governmental entity to be viewed as a "competent authority" for the purpose of that Directive. \textit{Id.} art. 21.

\textsuperscript{70} \textit{Id.} art. 2(1)(m)(i).

\textsuperscript{71} \textit{Id.} art. 2(1)(m)(ii). In the Prospectus Directive, "offeror" is defined as the legal entity or person that actually offers the securities to the public, such as an investment bank. \textit{Id.} art. 2(1)(i). \textit{See also} Kalderon & Hope, supra note 21, at 15 (noting that the Prospectus Directive imposes clear liability on investment banks, where previously their liability was somewhat uncertain).

\textsuperscript{72} Foreign issuers designate an EU Member State as home Member State by filing a prospectus with the competent authority in that State. Once a Member State has been selected, it becomes the permanent home Member State for all future prospectuses. Prospectus Directive, supra note 17, art. 2(1)(m)(iii). Foreign issuers that already have securities admitted to trading on an EU regulated market must select a home Member State by December 31, 2005. \textit{Id.} art. 30.

\textsuperscript{73} \textit{Id.} art. 18.
in the host Member State may not require additional information in the prospectus, although the Member State, competent authority, or listing authority for the regulated market on which the securities will be admitted for trading may request more disclosure in the context of admitting the securities to trading on a regulated market.

One of the challenges for the EU has been to develop a regulatory regime that ensures investor protection without putting the EU markets at a competitive disadvantage vis-à-vis non-EU markets. Although most corporate bonds in the EU are sold to institutional investors in the wholesale market, because these bonds are often listed to obtain various tax treatments and satisfy investment restrictions, the Prospectus Directive will apply to them. As a result, the prospectus disclosure requirements attempt to protect retail investors who may be investing in a security without creating undue burdens for issuances that are targeted primarily to institutional investors.

One of the premises of the EU disclosure architecture that is noted in MAD and is an explicit basis for the "building blocks" approach used in the Prospectus Directive is that the level of disclosure that is provided by issuers should be tailored to the investors' circumstances. For instance, because both retail and institutional investors presumably purchase shares in anticipation of receiving capital gains on their investment when they sell their securities, they are viewed as being particularly interested in the operations and financial prospects of the issuer. Under the

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74 Id. art. 17.
75 Id. recital 15.
76 See note 39 and accompanying text.
77 The Prospectus Directive contains a number of exemptions for certain types of offers, such as offers that are solely made to "qualified investors" (as defined in the Prospectus Directive, supra note 17, art. 2(1)(e)), offers addressed to fewer than 100 natural or legal persons per Member State (excluding qualified investors), and offers to investors who purchase securities for a total consideration of at least 50,000 euros. Id. art. 3(2). In addition, a public offer in which total consideration paid over a twelve-month period is below 2.5 million euros is exempt from the Prospectus Directive requirements. Id. art. 1(2)(h). An issuer that has bonds admitted to trading on a regulated exchange would need to publish a prospectus in any case. Certain types of securities are also exempted from the application of the Prospectus Directive, such as certain non-equity securities issued in a continuous or repeated manner by credit institutions. Id. art. 1(2).
78 Market Abuse Directive, supra note 16, recital 43.
Prospectus Directive, share issuers are thus required to disclose information about their financial condition, any known trends or uncertainties that are reasonably likely to have a material effect on their prospects, and extensive information about their administrative, management, and supervisory bodies, among other things.\(^7^9\)

On the other hand, retail investors in publicly issued and listed debt securities are expected to hold the securities until maturity, particularly because of the more limited secondary market in the EU for resales of corporate debt securities by non-institutional investors.\(^8^0\) These investors are viewed as primarily interested in information about the issuer’s historical financial information, the terms of the debt securities, and the terms and conditions of the offering, rather than extensive information about the issuer’s operations. Their disclosure needs are presumably limited to information about the issuer’s ability to pay interest on the debt securities and to pay the principal on the corporate bonds, not to any potential profit from resales of the bonds in the secondary markets. Moreover, debt investors are viewed as subject to less investment risk because they have priority over equity holders in obtaining payments on any outstanding obligations on the debt if an issuer becomes insolvent. As a result, prospectuses for listings and public debt offerings in which retail investors may be able to participate are not required to include MD&A,\(^8^1\) information about the remuneration and benefits paid to members of their administrative, management, or supervisory bodies, or related-party transactions. These disclosure items are all required for prospectuses relating to shares.

Moreover, the Prospectus Directive further differentiates

\(^7^9\) Prospectus Implementing Regulation, supra note 17, Annex I.

\(^8^0\) See Batchelor, Wallflowers of the Markets, supra note 41 (noting that bonds in Europe primarily trade off the exchange in large volumes and on terms that are difficult for retail investors to comprehend, thereby limiting the involvement of retail investors in the secondary market).

\(^8^1\) EU Member States use different terminology to refer to Management’s Discussion and Analysis (“MD&A”). For example, in the United Kingdom, this disclosure is referred to as “Operating and Financial Review.” See, e.g., U.K. DEP’T OF TRADE AND INDUS., DRAFT REGULATIONS ON THE OPERATING AND FINANCIAL REVIEW AND DIRECTORS’ REPORT: A CONSULTATIVE DOCUMENT 6 (May 2004), available at http://www dti.gov.uk /consultations/files/publication-1177.pdf (defining the Operating and Financial Review as “a narrative report by quoted companies that will be made annually to shareholders, setting out the principal drivers of a company’s performance both in the past and in the future”).

https://scholarship.law.upenn.edu/jil/vol26/iss3/2
required disclosures for debt offerings according to the level of sophistication of the expected investor. Prospectuses for public offerings and listings of debt securities with a denomination per unit of at least 50,000 euros, which are more likely to be purchased by institutional or wholesale investors, may contain less information than prospectuses for offerings and listings of debt securities with a denomination per unit of less than 50,000 euros, which are more likely to be accessible to retail investors. This structure addresses concerns raised when the Prospectus Directive was proposed that listed Eurobond deals, which are primarily targeted to the wholesale market, would require prospectuses that are as detailed as prospectuses for offerings directed to retail investors.

Even with a disclosure framework that tries to balance concerns over investor protection against the desire to safeguard the EU's dominance of the Eurobond market, competition for that market will most likely only get fiercer as the new EU legislation is implemented. Several Japanese issuers that have recently listed on EU exchanges have insisted on dual-listing clauses that would allow them to delist if they are required to prepare financial statements under, or reconciled to, IFRS. With a dual listing, they can opt out of the EU market at any time. These types of concerns have spurred non-EU exchanges to develop programs to entice non-EU issuers to list Eurobonds on their markets. The SWX Swiss Exchange, for example, recently adopted rules that would permit non-Swiss issuers to delist Eurobonds from an EU exchange and immediately relist them on the SWX Swiss Exchange, using abbreviated prospectuses that contain financial statements based on their most recent annual reports. Moreover, the financial statements can be prepared according to any number of accounting standards, including IFRS, Swiss GAAP, U.S. GAAP, and Japanese GAAP. The Hong Kong Stock Exchange and the Singapore

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82 See Prospectus Implementing Regulation, supra note 17, Annexes IV, V, IX, XIII (detailing the schedules for minimum debt disclosure requirements).


84 Evans, supra note 21, at 15.

85 See id. at 14 (explaining that the new rules will allow issuers to use accounting standards other than Swiss or EU standards); Skorecki, supra note 20 (noting that prior to the new rules, the SWX Swiss Exchange had a small
Stock Exchange\textsuperscript{87} have also been successful in obtaining Eurobond listings by Asian issuers.

To forestall the potential loss of market share in the Eurobond market, exchanges in various EU Member States are developing market segments that would not qualify as "regulated markets" under the new EU legislation. Both the London Stock Exchange and Luxembourg Stock Exchange are preparing to set up alternative Eurobond markets that would be geared toward professional investors and that would not qualify as "regulated markets."\textsuperscript{88} The Alternative Investment Market ("AIM"), the segment of the London Stock Exchange which lists equity securities issued by smaller companies, has already changed its status so that it no longer qualifies as an EU "regulated market."\textsuperscript{89}

3.2. Comparison to the U.S. Framework

In contrast to the EU's approach to prospectus disclosure, the SEC requires corporate issuers to provide the same types of information in prospectuses for equity and debt securities.\textsuperscript{90} Registered debt is freely tradable in the U.S. markets, so retail investors in debt securities are viewed as having the same

\textsuperscript{86} See Skorecki, supra note 20 (explaining that some Asian issuers have already switched exchanges, mostly to Hong Kong).

\textsuperscript{87} See Evans, supra note 21, at 15 (noting Singapore's success in attracting Asian issuers that would have traditionally listed in Europe); Skorecki, supra note 20 (stating that some Asian issuers have switched exchanges to Singapore).

\textsuperscript{88} See Roby, supra note 21 (describing that the costs associated with new EU rules are driving issuers to list with "exchange-regulated" markets in Europe). See also Alison Smith, Swiss Role, FIN. TIMES, Mar. 31, 2005, at 22 (discussing the new SWX Swiss Exchange rules and the London Stock Exchange's plan to establish a similar professional securities market); Tett, supra note 85 (noting the London Stock Exchange's plans to launch a self-regulated Eurobond market).

\textsuperscript{89} Brian Hanney, AIM Gets IAS Reprieve, ACCOUNTANCY, Nov. 1, 2004, available at LEXIS, News Library; see Lisa Bushrod, AIM to Become Exchange-Regulated Market, EUR. VENTURE CAP. J., June 2004, at 3 (detailing the changes at in the Alternative Investment Market as a result of the new EU directives).

\textsuperscript{90} Unless there is an exemption from registration, issuers must register securities that will be publicly offered with the SEC. The greater part of the registration statement that is filed with the SEC consists of the prospectus. The registration statement also includes exhibits and certain undertakings required by Item 512 of Regulation S-K, 17 C.F.R. § 229.512 (2005), among other things.
informational needs as investors in shares. Because the issuer's operations and prospects can affect the profitability of retail investors' bond investment if they resell the debt prior to maturity, the same type of information about the issuer is required in both equity and debt prospectuses. In addition, even though debt holders may stand in priority over equity holders with respect to the issuer's assets if it ever becomes insolvent, companies may favor shareholders over bondholders via enhanced dividends and share buybacks during periods when their stock prices are low.\footnote{See Mark Whitehouse et al., The Sky Darkens for Bondholders, \textit{WALL ST. J.}, May 12, 2005, at C1 (discussing the risks in the U.S. credit market, including bondholder fears that executives may be lured by low stock prices into taking actions that favor shareholders).}

Information about the company and its operations is thus viewed as equally relevant to debt and equity holders. Moreover, because so many securities products in the modern marketplace defy easy classification, distinctions between equity and debt securities can be difficult to draw.\footnote{Cumulative preferred stock is a relatively simple example of this. Although it is classified as equity, it has many characteristics more typical of debt securities, e.g., dividends on cumulative preferred stock that are declared but not paid out accumulate and must be paid before any dividends can be paid on common stock, and holders of this type of stock have priority over holders of common stock if the issuer's assets are liquidated.} Applying different disclosure requirements based on whether a particular type of security can be characterized as primarily debt-like or primarily equity-like is impractical for a market in which well over 13,000 corporate issuers\footnote{See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068 [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶86,923, at 87,676, 87,705 (June 5, 2003) (imposing additional disclosure requirements on certain corporations and estimating the eventual number of forms received to be in the tens of thousands).} are registered with the SEC.\footnote{Although as a general principle equity and debt securities are subject to the same basic disclosure requirements, such as business information about the issuer and unique terms or characteristics of the securities, special disclosure requirements do exist for a few unique securities, such as asset-backed securities. The SEC has recently adopted special rules and forms for asset-backed securities because the nature of asset-backed issuers and securities differs greatly from operating companies and corporate securities. See Asset-Backed Securities, Securities Act Release No. 8518, Exchange Act Release No. 50,905, [2004-2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,323, at 81,573 (Dec. 22, 2004) ("adopting new and amended rules and forms to address comprehensively the registration, disclosure and reporting requirements for asset-backed...").}
Not only does the SEC require issuers to provide the same types of information in prospectuses for equity and debt securities, but generally the same types of information must be provided by issuers in the annual reports that they file with the SEC.\(^9\) One of the innovative premises behind the SEC's integrated disclosure system\(^9\) is the notion that purchasers of securities in the primary market and secondary markets should receive the same information. Not only is there no differentiation in the disclosure required based on the type of securities offered or listed by an issuer, but there is also no distinction drawn between the information provided for an initial public offering and the information provided on an ongoing basis to the public. Because no distinction is drawn, issuers that are already reporting with the SEC are able to use short-form registration statements that incorporate by reference periodic reports previously filed by an issuer with the SEC in order to go to market more quickly with their public offering. In addition, all filings with the SEC must be made through its Electronic Data Gathering and Retrieval system ("EDGAR"),\(^9\) and are immediately available to the public at no charge through the SEC's website. As a result, full disclosure about a company is available to the public as soon as the company makes an offering or listing in the U.S. markets, so that full information is available to all participants in the secondary markets contemporaneously with the SEC filing. This facilitates immediate liquidity of the securities in the secondary markets.\(^9\) On an

\(^{95}\) Regulation S-K, 17 C.F.R. §§ 229.10–.915 (2005), sets forth the core requirements for prospectuses used by U.S. companies. The various SEC registration statement forms that these issuers use for public offerings and listings, as well as the annual report Form 10-K, 17 C.F.R. § 249.310 (2005), incorporate selected requirements from Regulation S-K. For foreign private issuers, Form 20-F, 17 C.F.R. § 249.220f (2005), available at http://www.sec.gov/about/forms/form20-f.pdf, contains the core requirements for prospectuses used by these issuers in public offerings and listings in the United States, and is also the annual report form for these issuers.


ongoing basis, the same full disclosure about an issuer that was contained in the prospectus is provided to the secondary markets through the issuer's annual reports.

This approach contrasts with the approach taken by the EU with respect to the ongoing disclosure obligations of issuers. Under the Transparency Directive, companies with equity or debt securities admitted to trading on an EU regulated market will be required to file annual financial reports that contain audited financial statements, and half-yearly financial reports that contain a condensed set of financial statements that need not be audited as long as the issuer makes clear in the report that auditors have not audited or reviewed the report. Both of these reports will consist primarily of the issuer's financial statements and a management report. In addition, these reports must contain statements made by persons responsible for the report within the issuer that to the best of their knowledge the financial statements contained in the report give a "true and fair view" of the issuer's financial position and the management's report gives a "fair review" of the information required. Consistent with the approach taken in the Prospectus Directive, share issuers are subject to slightly more disclosure requirements under the Transparency Directive than issuers of only debt, reflecting EU regulators' concerns that equity securities present more of an investment risk. An issuer with shares admitted to trading on an EU regulated market must also publish interim management statements at six-month intervals that explain material events and


100 In the Transparency Directive, "debt securities" are defined as bonds or other forms of transferable securitized debt, except for securities that are equivalent to shares or that may be converted into shares or securities that are equivalent to shares. Id. art. 2(1)(b).

101 Id. art. 4(2)(a).

102 Id. art. 5(5).

103 Id. arts. 4(2)(a)–(b), 5(2)(a)–(b). The interim management report included in the half-yearly financial report must disclose the important events that occurred in the first six months of the financial year, their effect on the condensed financial statements, and a description of the main risks and uncertainties faced by the issuer for the remainder of the financial year. Issuers of shares must also include a description of major related-party transactions. Id. art. 5(4).
transactions during the covered period that had an impact on the issuer's financial position, as well as a general description of the issuer's financial position and performance during the covered period.\textsuperscript{105} However, share issuers that publish quarterly financial reports, whether as a result of national law or voluntarily, are exempt from the requirement to file interim management statements.\textsuperscript{106} Unlike the Prospectus Directive, the Transparency Directive is a "minimum harmonization" directive, which means that home Member States may impose additional requirements that they deem necessary on issuers incorporated in their jurisdictions.\textsuperscript{107}

4. LEGAL FRAMEWORK IMPLICATIONS

Disclosure frameworks are not just affected by market considerations. The legal environment in which issuers operate also affects the disclosure regime in a country. The EU Prospectus Directive has more fluidity built into its structure in part because issuers in Europe have been insulated from the massive shareholder class actions that have plagued their brethren operating in the United States. This enables regulators to implement disclosure obligations that can be characterized as "principles-based," rather than being oriented toward more detailed disclosure requirements. In contrast, the threat of securities class action litigation is a serious consideration for issuers operating in the United States, so the disclosure framework provides more guidance to issuers as to what would be viewed as material information that must be disclosed in a prospectus. The U.S. disclosure regime is thus often described as "rules-based." In truth, of course, the characterization of a disclosure regime as either principles-based or rules-based is essentially just a difference in degree. In reality, every disclosure regime has elements of both systems: a "principles-based" regime still contains certain detailed line items and a "rules-based" regime prescribes detailed disclosures against a framework of general principles. Nonetheless, the legal framework of a jurisdiction greatly impacts the shape of its securities regulations.

\textsuperscript{105} Id. art. 6(1).
\textsuperscript{106} Id. art. 6(2).
\textsuperscript{107} Id. art. 3(1).
4.1. U.S. Legal Framework

One of the hallmarks of the SEC's prospectus disclosure regime is the precise guidance contained in its disclosure requirements. This reflects, in part, the highly litigious environment in which issuers in the United States must operate. In the United States, litigation is well-recognized as a profitable business in and of itself, an inadvertent manifestation of the cultural emphasis on the right of an individual to protect her interests.\footnote{The availability of effective legal remedies reflects the "cultural preference" and respect that the U.S. courts and legislature have accorded to individualism. See Jeswald W. Salacuse, Corporate Governance in the New Century, 25 Company L. 3, 69, 76, 82 (2004) (discussing individualism as a U.S. cultural value that plays out in a legal emphasis on individual rights and remedies).}

Historically, reliance on litigation as a means of protecting one's rights developed as a response to the social welfare problems of the early twentieth century. Since private insurance coverage for personal injuries was not common in the United States in the early 1900s, individuals who were harmed by the poor working conditions in the industrialized workplace or by defective products were eventually encouraged by pro-plaintiff judicial decisions to resort to the courts as a means of creating "social insurance."\footnote{See Mike France, How to Fix the Tort System, Bus. Wk., Mar. 14, 2005, at 70, 74 (explaining the rationale of progressives and New Dealers for expanding tort liability); Michael L. Rustad & Thomas H. Koenig, Taming the Tort Monster: The American Civil Justice System as a Battleground of Social Theory, 68 Brook. L. Rev. 1, 25-49 (2002) (tracing the expansion of corporate liability under tort law from the early nineteenth century to 1980).}

Some academics even proposed using tort liability as a means of providing market incentives that would ostensibly encourage manufacturers to improve the safety of their production processes or the products themselves, that is, a form of market-based regulation.\footnote{France, supra note 109, at 74. See generally William M. Landes & Richard A. Posner, The Economic Structure of Tort Law (1987) (suggesting that statutory tort law is designed to promote efficient behavior); Guido Calabresi, Some Thoughts on Risk Distribution and the Law of Torts, 70 Yale L.J. 499, 519-24 (1961) (discussing the economic consequences of "enterprise liability" for accidents); William M. Landes & Richard A. Posner, The Positive Economic Theory of Tort Law, 15 Ga. L. Rev. 851, 852-57 (1981) (considering whether negligence or strict liability is the most efficient standard in tort law).}

This belief in the importance of enabling individuals to protect and enforce their rights, instead of relying solely on enforcement by the government, is evident in the framework of the federal securities laws. Indeed, Congress recognized that the market crash...
of 1929 decimated the lifetime savings of many individual investors. As a result, the federal securities laws provide all investors, from the retired senior citizen in Booneville, Missouri, to the large hedge fund in New York City, with the ability to bring a private action, if necessary, to enforce their rights as investors. Both the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act") expressly provide for private rights of action by injured investors. Although it may be cost prohibitive for individual investors to pursue legal actions against a company, the ease with which class actions may be brought in the United States has made individual investor enforcement of claims a reality.

The ensuing explosion in class action litigation, including claims based on the securities laws, that occurred throughout the twentieth century has famously led to calls by business to rein in frivolous class action lawsuits. When he signed the Class Action


112 See id. at 743 (describing the role of the Great Depression and a lack of private enforcement capacity at the time in spurring changes in the securities laws).


114 See generally James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497, 497 (1997) ("Few things are as American as the class action."). In addition, injured investors are better able to pursue a claim in the United States than in other jurisdictions because contingent fee arrangements, in which the attorney for the plaintiff only collects fees if the plaintiff wins, are accepted practice. This reduces any cost barrier that might otherwise discourage individual investors from pursuing their claims. See generally John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 677-84 (1986) (explaining the economic incentives the class action system creates for plaintiffs' attorneys). In Europe, the usual practice is for the loser to pay the legal fees of the winning party, a practice that effectively reduces frivolous claims. Heather Smith, Shareholders, Unite!, AM. LAW., May 2005, at 118; Directors and Officers Insurance Market Set To Grow In United Kingdom, BESTWIRE, Feb. 20, 2004, available at LEXIS, News Library; see also Thomas Rouhette & Amanda Croushore, View from Here: Proposing to Take Action, LEGAL WK., Jan. 27, 2005, available at http://www.legalweek.com/ViewItem.asp?id=22793 (describing alternative protections against spurious claims employed in the French legal system).

115 Since the enactment of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. §77z-1 (2000), at least 2,322 issuers have been named in federal class action securities fraud lawsuits. Stanford Law School Securities Class Action
Fairness Act of 2005 into law in February 2005,\textsuperscript{116} which is expected to reduce the number of class action lawsuits, President George W. Bush asserted that frivolous lawsuits resulted in legal bills, civil awards, and settlements that totaled approximately $240 billion each year in the United States.\textsuperscript{117}

Issuers in the United States face the threat of litigation not only from investors, but also from federal and state law enforcement authorities. Enforcement actions for violations of the securities laws are brought by the SEC, the U.S. Department of Justice (for criminal matters), and the various states' attorneys general (for violations of state law). In its 2003 fiscal year, the SEC obtained orders in judicial and administrative proceedings that resulted in disgorgement from securities violators of approximately $900 million in illegal profits and $1.1 billion in penalties. The SEC also sought orders to bar 170 individuals from serving as officers or directors of public companies.\textsuperscript{118}

In this environment, more detailed disclosure rules have been developed to provide issuers with a minimal level of guidance as to what is considered material information that should be disclosed in their prospectuses, registration statements, and other SEC filings. Because the issuer, its directors, named experts,


underwriters, and any person who signed the registration statement have liability for material misstatements or omissions contained in the prospectus, a disclosure regime that consisted primarily of general disclosure principles would essentially leave issuers vulnerable to innumerable investor lawsuits that could hamper their ability to operate or function effectively. It would not be feasible to tailor disclosure requirements on a case-by-case basis for specific issuers or specific securities products, given the limited staff resources of the SEC compared to the number of registered issuers.

4.2. EU Legal Framework.

In most European countries, investors are not able to pursue a class action claim against an issuer's senior management and directors in the same fashion as is permitted in the United States. The ownership of many EU companies is relatively concentrated, so that controlling shareholders have the financial incentive and clout to deal directly with the companies in which they invest to protect their interests. These investors have less need to resort to formal legal action against an issuer as a means of protecting their rights. Nonetheless, some European countries permit investors to join together in a group to bring a single action. However, the individual claims often still have to be evaluated separately, and a judgment rendered on one claim will not be binding on the entire group. Issuers are essentially forced to litigate or settle against each plaintiff in the class individually.

This is certainly the case in France, Spain, Italy, and Germany. Although France permits a collective suit known as

120 See Alan L. Beller, Dir. Div. of Corp. Fin., SEC, Regulation in a Global Environment, Remarks Before the American Academy in Berlin (Apr. 20, 2004), http://www.sec.gov/news/speech/spchalb042004.htm (noting that the SEC declined to adopt a current reporting requirement to disclose all material developments because of "the U.S. enforcement scheme and because of concerns that a more general requirement would cause excessive compliance burdens and costs").
121 Craig, supra note 24, at 122.
122 See John C. Coffee, Jr., Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, 102 COLUM. L. REV. 1757, 1780, 1780 n.93 (2002) (observing that few jurisdiction outside the United States recognize class actions; however, firms that cross-list on a United States stock are subject to class actions); Smith, supra note 114 (describing Judge Wösthoff's strategy of hearing ten securities suits at once while awaiting
"en representation conjointe," in which a group of plaintiffs brings a single action, each plaintiff is still required to present her individual claim and each claim must be evaluated separately. Because of these and other procedural restrictions, this procedure is used only sparingly. In Spain and Italy, U.S.-style class actions against an issuer are not permitted. Moreover, shareholders may bring derivative actions (lawsuits in which shareholders sue a third party on behalf of the company) only if they hold at least five percent of the issuer's shares, among other requirements. For companies with a large public float, this ownership requirement effectively forestalls minority shareholder action.

The lack of a class action mechanism translates into a substantially lower threat of litigation for issuers in Europe, and arguably less protection of minority shareholders. At the same time, however, when issuers are not haunted by the specter of potential litigation by investors for disclosures they make in a prospectus, the disclosure framework can provide issuers with more leeway to determine what information is material to investors and must be disclosed. This approach can be seen in the EU's approach to developing prospectus disclosure requirements for new types of securities that would not be adequately covered by the schedules contained in the new regulations. Under the new regulations, the content of prospectuses for offerings or requests for admission to trading of new types of securities that cannot be classified under any of the existing schedules will be negotiated between the issuer and the relevant competent authority. The EU regulation that implements the Prospectus Directive indicates that the competent authority of the home Member State shall decide "in consultation with the issuer, the offeror or the person requesting admission to trading" what information should be included for a new type of security that would not be adequately covered by the schedules or building blocks in the Regulation. As a general matter, the prospectus disclosure requirements are

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123 See Rouhette & Croushore, supra note 114 (addressing the limitations of the French 'action en representation conjointe,' or 'action in joint representation,' system).

124 Ashley McKeen, Corporate Governance in Spain: A Vibrant Transition Fueled by the Recent Reforms of Aldama, 35 GEO. J. INT'L L. 105, 120 (2003); Italian Need for Corporate Governance Reform Increases in Wake of Parmalat, supra note 24.

125 Prospectus Implementing Regulation, supra note 17, recital 23.

126 Id. art. 23(3).
predicated on the notion that the appropriate content of any given prospectus will be determined by a combination of schedules, depending on the nature of the issuer, the type of securities, and the involvement of a third party guarantor, among other things.\textsuperscript{127} The whole "building blocks" approach, in which different schedules are applied to different types of securities, is essentially premised on flexible prospectus requirements that can be negotiated on an individual basis.\textsuperscript{128}

Although issuers in some countries have been effectively shielded from minority shareholder suits, recent initiatives in several EU member countries indicate that this may be changing. In 2002, Sweden enacted legislation to permit a form of class action.\textsuperscript{129} One chamber of the Dutch Parliament recently passed legislation that would make a settlement between a defendant and members of a class binding for all members of the class who have not opted out, unlike the current system in which defendants must litigate or reach settlements with each plaintiff individually.\textsuperscript{130} In January 2005, President Jacques Chirac announced proposals to introduce a type of class action lawsuit in France that would permit claims of a group of plaintiffs to be evaluated at the same time, instead of on a case-by-case basis.\textsuperscript{131} Lawmakers in Germany are currently considering reforms to permit shareholders to sue senior managers of an issuer and to permit groups of shareholders

\textsuperscript{127} Id. recital 6.

\textsuperscript{128} Id. art. 23. This flexible regulatory approach regarding the regulation of new securities products could enhance the competitiveness of individual markets, depending on the regulatory approach taken, but this could also eventually undermine the "passport" framework established by the Prospectus Directive if different EU Member States take different approaches.

\textsuperscript{129} Jörgen Eklund, Sweden Product Liability, MONDAQ, July 11, 2003, available at 2003 WLNR 10821709; see Frost, supra note 117 (noting that a variant on class actions had been recently legalized in Sweden).

\textsuperscript{130} See New Dutch Class-Action Law Could Hit Insurers, REACTIONS, Mar. 2005, at 69 (noting that such legislation was under review at time of writing). See generally Smith, supra note 114 (debating whether the benefits of Germany’s proposed class action legislation, such as judicial efficiency, outweigh the costs of the legislation, such as more litigation).

\textsuperscript{131} See Rouhette & Croushore, supra note 114 (noting that safeguards within the French legal system, such as a lack of contingency fees, a lack of punitive damage awards, and rules of evidence that reduce the chance that frivolous claims will be brought, reduce the opportunity for abuses of the proposed system). See also Peggy Hollinger, France Mulls Allowing Class-Action Suits, Fin. TIMES, Jan. 7, 2005, at 7 (highlighting the view that restrictions on contingency fees would help France avoid frivolous lawsuits).
to band together to sue a company. Italy also is reportedly contemplating legislation to permit class actions.

It is unclear at this point the extent to which class actions will be available for securities law claims in all of these jurisdictions, but U.S. and U.K. institutional investor activists who have begun investing in EU companies are already beginning to transport their brand of activism through litigation to Europe. They are likely

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132 Carter Dougherty, Germany Taking Lead on Financial Disclosure; It Is First in EU to Pass Tougher Laws, INT’L HERALD TRIB., Sept. 28, 2004, at 15. See also New Dutch Class-Action Law Could Hit Insurers, supra note 130 (reporting that Germany is considering legislation similar to that passed in the Netherlands); Hollinger, supra note 131, at 7 (“German lawmakers are considering similar moves” to allow for “collective legal action”).

133 Cf. Frost, supra note 117 (“Britain and Sweden have recently opened their courts to limited forms of class actions and Italy is considering them . . . ”).

134 The main impetus for these initiatives appears to be concerns about enhancing consumer protection in financial services to counteract the perception that consumers have difficulty enforcing their rights and seeking redress in Europe. Christa Randzio-Plath, Europe Prepares for a Single Financial Market, INTERECONOMICS, May/June, 2004, at 142. One commentator has noted that the threat of forum shopping among EU countries could eventually result in the enactment of EU-level legislation permitting class actions. See, e.g., Richard O. Faulk, Armageddon Through Aggregation? The Use and Abuse of Class Actions in International Dispute Resolution, 37 TORT & INS. L.J. 999, 1020 (2002) (arguing that since most European Community Member States must enforce judgments rendered by other Member States, the enactment of class action rules in any single State effectively permits class actions by the citizens of all Member States). But see Frost, supra note 117 (outlining arguments against France altering its rules to allow class actions).

135 When Procter & Gamble Company made a takeover bid for Wella AG in 2003, a U.S. hedge fund sued the acquirer for discriminating between minority (holders of preference shares) and majority (holders of ordinary shares) shareholders. Sylvia Pfeifer, Elliott Takes BaFin To Court Over Wella Offer, BUS., June 8, 2003, at 6, available at LEXIS, News Library; see also Michael D. Goldhaber, Merger Meisters: Minority Shareholders Got Creamed in Two Recent Cosmetics Deals. Even Botox Couldn’t Hide The Flaws in the New German Takeover Law, AM. LAW., Apr. 2004, at 124, 124–27 (describing the history, process, and people involved in the suit); BaFin, ANNUAL REPORT ‘03 206 (2003), available at http://www.bafin.de/jahresbericht/jb03_en.pdf (remarking that BaFin’s decision that minority shareholders had no standing to oppose the deal in the courts had been affirmed by the judiciary); Susan Hansen, Battling the New Takeover Law, FOCUSEUROPE: AM. LAW. MEDIA SUPP., Fall 2003, at 7, 7–9 (indicating that a hedge fund holding nonvoting shares planned to raise constitutional arguments and discussing German law in the area of corporate takeovers). Cf. Quinton, supra note 24, at 55, 58 (noting that European shareholders may benefit from U.S. and U.K. investors “exporting” the activism they normally employ in their home markets); Norma Cohen & Patrick Jenkins, Seifert’s Downfall: How a Shareholder Revolt Sent His Plans For Deutsche Börse Up In Smoke, FIN. TIMES, May 25, 2005, at 15 (analyzing how a failed Deutsche Börse deal resulted in part from “activist Anglo-American investors”).

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to test the limits of these new forms of collective legal action, which could eventually result in pressure by issuers for more detailed guidance in the prospectus disclosure requirements.

5. EFFECTS OF THESE FACTORS ON DEBT DISCLOSURE REQUIREMENTS FOR PROSPECTUSES

The effect of each of these influences can be seen in how these jurisdictions approach two significant disclosure topics: MD&A and related-party transactions. After the recent financial frauds, regulators in some jurisdictions expanded disclosure requirements in these areas after concluding that improved disclosure could have alerted the public to the irregular and, ultimately, fraudulent practices of some issuers. Internationally, more attention has been focused on the adequacy of MD&A in recent years. The IOSCO International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers of equity securities, which were endorsed by IOSCO in 1998, established MD&A standards for prospectuses used in cross-border offerings and listings. In February 2003, IOSCO also published a set of general principles on MD&A that discussed the global regulatory consensus about the importance of this disclosure.

Although regulators around the world are recognizing the importance of these disclosure topics, there is no uniform approach to soliciting such disclosures. An analysis of the EU and U.S. debt disclosure frameworks illustrates how market characteristics, the jurisdiction's general paradigm for regulating prospectus disclosures, as well as the legal environment in which issuers must operate, affect regulators' approach to these disclosure items.

5.1. Approaches to MD&A

MD&A provides management's narrative explanation of the financial statements, and enables investors to see the company

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137 Id. at 3.
through the eyes of management. Although the numbers included in financial statements appear to provide hard, cold facts, in reality the numbers alone cannot provide useful information about known trends and uncertainties that are reasonably likely to have a material effect on the issuer’s financial condition or operating performance. MD&A helps bridge the chasm between pure financial numbers and investors’ ability to assess the company’s prospects.

5.1.1. U.S. Approach

From its inception in the United States, MD&A was conceived as a disclosure that would augment the information contained in the financial statements, rather than being part of the financial statements themselves. The first SEC guidance on MD&A-type disclosure appeared in 1968 in the SEC’s Guides for Preparation and Filing of Registration Statements, which contained the policies and practices of the SEC’s Division of Corporation Finance. The Guides recommended disclosure of a summary of earnings, including a discussion of “unusual conditions that affected the appropriateness of earnings presentation and footnotes indicating adverse changes in operating results subsequent to the latest period included in the earnings summary.” A subsequent revision was made to the Guides in 1974 to recommend that issuers provide a “full narrative explanation of the summary to enable investors to appraise the quality of earnings or operations.” Finally, in 1980 the SEC expanded and codified its guidance into a disclosure requirement for Management’s Discussion and Analysis in Regulation S-K, which is the regulation that contains the

139 Id. at 2 (explaining how MD&A allows “investors and other users of information to assess the financial condition” of the company).


141 MD&A Concept Release, supra note 140, at 88,622.

142 Id.

disclosure requirements applicable to prospectuses and annual reports prepared by U.S. issuers. The new MD&A requirement focused on disclosure of liquidity, capital resources, and results of operations, with an emphasis on favorable or unfavorable trends and on identification of significant events or uncertainties.\textsuperscript{144}

Since that time, the SEC has continued to view this disclosure as one of the most significant disclosures provided by issuers, as evidenced by the number of interpretative releases that the SEC has published on MD&A.\textsuperscript{145} Indeed, the Sarbanes-Oxley Act of 2002\textsuperscript{146} sought to address some of the abuses highlighted in the recent financial frauds by requiring issuers to disclose off-balance sheet transactions with unconsolidated entities in MD&A.\textsuperscript{147} The SEC subsequently expanded the MD&A requirement contained in

\textsuperscript{144} Integration of Disclosure Systems Release, supra note 143, at 63,636.


\textsuperscript{147} See id. at § 401(a) (to be codified at 15 U.S.C. § 78m(j)) (requiring that the SEC promulgate rules mandating annual and quarterly reports to disclose "material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons").
its prospectus disclosure requirements, so that issuers must now disclose all material off-balance sheet transactions and arrangements with unconsolidated entities that have, or are reasonably likely to have, a current or future effect on the issuer's financial condition, results of operations, or capital resources. In addition, the SEC has taken several enforcement actions through the years to underscore to issuers the importance of providing adequate disclosures in this area.

Several factors contributed to the development of MD&A as a crucial disclosure item in prospectuses for public debt offerings. First, although the corporate debt market is dominated by institutional investors, most of the investment grade debt is sold through registered public offerings. Once the debt securities are registered, both retail and institutional investors are equally able to purchase them. No attempt is made to differentiate among the various types of investors who participate in a given offering. The potential for participation by retail investors has been further enhanced in recent years by improvements in the price transparency of retail bond trades. Second, since the purchasers in

148 MD&A Final Rule Release, supra note 145. For domestic issuers, the MD&A requirement is contained in Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2004), and for foreign private issuers, in Item 5 of Form 20-F, supra note 95.


150 The Rule 144A safe harbor from registration is heavily relied upon for offerings of high-yield bonds because offerings of these securities often do not qualify for the fast track shelf-registration procedure. Form S-3, 17 C.F.R. § 239.13 (2004), and Form F-3, 17 C.F.R § 239.33 (2004), which are used for shelf-registration of reporting domestic and foreign private issuers, respectively, may be used if the issuer has a public float of at least $75 million in common stock or if the issuer is offering non-convertible investment-grade securities. See supra notes 26-27 and accompanying text.
the primary offering of the bonds are able to resell the securities in the secondary market, there is no presumption that investors will hold the bonds to maturity. In order to be able to assess the potential secondary market value of the bonds, debt investors are assumed to need the same types of disclosure to make their investment decisions as are needed by investors in the company’s shares. Third, MD&A is well-established in the United States as an important disclosure. Since financial information about an issuer is considered a core disclosure item in the prospectus, regardless of the type of security that is being offered, disclosure that provides a narrative explanation of the financial statements is viewed as highly material to any investor’s assessment of an issuer and the securities that it is offering. Finally, given the risks that issuers face in the U.S. legal environment, the prospectus disclosure requirements must provide issuers with sufficient guidance as to what information would be viewed as material. A very general requirement to identify significant events or uncertainties, or to disclose trends that could materially affect the company’s prospects, would essentially leave issuers adrift in a sea of potential litigation. Therefore, although the MD&A disclosure requirement is intentionally principles-based to avoid boilerplate disclosure, the SEC has provided detailed interpretative guidance in the disclosure requirement itself, as well as in several interpretative releases, to assist issuers who are concerned about the adequacy of the disclosures that they are providing to the public.

In any case, MD&A disclosure has been viewed in the United

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151 The principles-based orientation of this disclosure item reflects the SEC’s intent “to allow registrants to discuss their businesses in the manner most appropriate to individual circumstances and to encourage flexibility” needed by management for meaningful discussion. Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6349, 23 SEC Docket 962, 963 (Oct. 13, 1981) (not published in the Federal Register). In several of the interpretative releases that the SEC has published on MD&A, the SEC has emphasized the importance of not providing boilerplate disclosures. When it incorporated MD&A into Regulation S-K, the SEC specifically noted that the problem with a mechanistic approach to MD&A would be that the provision of information would be too narrowly focused. See Integration of Disclosure Systems Release, supra note 143, at 63,636 (noting that requiring additional specificity in the disclosure requirements would decrease the management’s ability to have meaningful discussion). See also MD&A Concept Release, supra note 140, at 88,623 (explaining that the disclosure rules were kept general because the SEC thought a more flexible approach would allow more meaningful disclosures for each unique registrant).
States as a topic that is best dealt with in the non-financial statement portion of a SEC filing. In 1987, the SEC issued a release to solicit public input on two sets of proposals by U.S. accounting firms recommending that MD&A be audited, among other things. Almost all of the 196 commentators opposed the proposals put forth by the accounting firms. The SEC never took any other action on the proposals.

Although there is a voluntary auditing procedure in the United States, it is rarely used. As a practical matter, it is extremely difficult for an auditor to audit MD&A in the traditional sense of the word, e.g., to ascertain whether proper accounting treatments were applied to recently completed transactions and, in some cases, ongoing transactions. Audits normally involve reviews of historical financial information. MD&A, in contrast, consists of "soft information," such as management’s analysis about the company and its prospects, which is not easily subjected to what is normally viewed as an audit. In any case, auditors are already expected to review MD&A and other disclosures contained in a SEC filing for consistency with the financial statements contained in the filing.

152 See MD&A Concept Release, supra note 140, at 88,624-25 (describing the proposals that were submitted by Coopers & Lybrand and a consortium of seven accounting firms).

153 See MD&A Interpretive Release, supra note 145, at 62,144 (chronicling how nearly all of the commentators opposed the proposed MD&A changes, but some suggested that an interpretive release might improve compliance).


155 See Public Company Accounting Oversight Board, supra note 154, § 3, Part 1, Rule 3300T, at 45 (adopting the "generally accepted auditing standards, as described in the AICPA Auditing Standards Board’s Statement of Auditing Standards No. 95" in connection with the preparation or issuance of any audit report by a registered public accounting firm and its associated persons); American Inst. of Certified Pub. Accountants, AICPA Professional Standards, Filings Under Federal Securities Statutes, AU § 711 (1981) (describing the auditor’s liability with respect to information contained in registration statements, proxy statements or periodic reports); American Inst. of Certified Pub. Accountants, AICPA Professional Standards, Other Information in Documents Containing Audited Financial Statements, AU § 550 (1975) (providing guidance for the auditor’s consideration of non-financial statement information contained in annual reports filed pursuant to the Securities Exchange Act).
5.1.2. EU Approach

In contrast to the U.S. approach to MD&A, which requires such disclosure regardless of the type of issuer involved or the type of security that is being offered to the public or listed on an exchange, the new EU prospectus disclosure framework only requires MD&A disclosure for public offerings or admissions to trading of equity securities. The equity disclosure requirements are modeled on the IOSCO International Equity Disclosure Standards, which include a section on MD&A. The omission of such a requirement for public offerings and listings of debt securities, regardless of whether the debt will be sold to retail or institutional investors, suggests that this information is viewed as less relevant to debt holders. Such a conclusion would appear inconsistent with the Prospectus Directive’s stated disclosure objective. Article 5(1) of the Prospectus Directive indicates that the objective of the prospectus requirements is to “enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities.” This implies that the financial information about the issuer is one of the most material disclosures contained in the prospectus. If that is the case, then the MD&A should be viewed as essential disclosure because it puts the financial statements into the appropriate context for investors.

This puzzling omission in the prospectus disclosure requirements for debt offerings can perhaps be explained by several essential differences in the market concerns, disclosure paradigm, and legal framework of the EU compared to the United States. First of all, there is little liquidity or price transparency in the retail corporate bond market in the EU, so retail investors are expected to hold their bonds to maturity as a practical matter. Second, the very real competitive concerns the EU faces in retaining its dominance over the Eurobond market has resulted in

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156 See Prospectus Implementing Regulation, supra note 17, Annex I (setting out, among other things, that the minimum disclosure requirements for the share registration document require all changes in equity).

157 IOSCO, supra note 136, Part I.V., at 14 (addressing “Operating and Financial Review and Prospects”). See Prospectus Directive, supra note 17, art. 7(3) (stating that implementing measures would be based on standards set out by international securities commission organizations and in particularly by IOSCO).

158 Prospectus Directive, supra note 17, art. 5(1).

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very nuanced regulatory consideration of the disclosures required for broad categories of securities. As a result, because investments in shares are generally perceived as being at least somewhat risky, MD&A-type disclosure is required. On the other hand, retail investors in corporate bonds are assumed to be primarily interested in the payments of interest and principal on the bonds. The benefits of requiring MD&A disclosure by corporate bond issuers are presumably outweighed by the potential costs to both the issuers and the markets.

Third, the proclivity of EU regulators for principles-based requirements is reflected in the limited trend and prospects-related disclosure required in debt prospectuses. Although debt prospectuses are not required to contain a full-fledged MD&A, they must include certain disclosures that are required to be included in the MD&A section of a U.S. debt prospectus. For example, prospectuses for bond offerings to retail investors in the EU are required to include either a statement by the issuer that there have been no material adverse changes to its prospects since the date of its last published audited financial statements or a description of the material adverse changes,\footnote{Prospectus Implementing Regulation, supra note 17, Annex IV, Item 8.1.} as well as disclosure of "any known trends, uncertainties, demands, commitments, or events that are reasonably likely to have a material effect on the issuer's prospects for at least the current financial year."\footnote{Id. at Item 8.2.} Both of these disclosure items are actually included as part of the MD&A requirements in the U.S. framework.\footnote{See Item 303(a) of Regulation S-K, 17 C.F.R. § 229.303 (2005); items 5.A., 5.B. and 5.D. of Form 20-F, id. § 249.220f (requiring a discussion of changes in financial condition and other information necessary to understanding changes in financial condition).} The EU prospectus requirements for offerings of wholesale debt require even less disclosure in this area. Issuers of such securities are only required to disclose the issuer's statement that there have been no material adverse changes in its prospects since the date of its last published audited financial statements, or a detailed description of the material adverse changes.\footnote{Prospectus Implementing Regulation, supra note 17, Annex IX, Item 7.1.} The more limited information that is required for wholesale debt offerings undoubtedly reflects the assumption that institutional investors can conduct the due diligence necessary before making an investment decision.
Finally, MD&A appears to be a less established concept in the EU markets than in the United States, and is viewed by many EU regulators as more appropriately falling within the domain of accounting standard-setters rather than securities regulators. This is evident from some of the recent initiatives to improve the quality of MD&A disclosure. For example, in the United Kingdom, the U.K. Accounting Standards Board issued a Reporting Standard on MD&A in May 2005 in response to legislation that was adopted in March 2005. The legislation makes it mandatory for a quoted company in Great Britain (i.e., a company with shares listed in a European Economic Area state, on the New York Stock Exchange, or on Nasdaq) to prepare a directors' report that contains MD&A disclosure for financial years beginning on or after April 1, 2005. This will effectively include some corporate debt issuers, as many of them would qualify as quoted companies. The legislation also requires auditors to state in their report whether the information provided in the directors' report is consistent with the relevant financial statements, which is an approach similar to the U.S. requirements for auditors' review of non-financial statement disclosures contained in a SEC filing. Moreover, the IASB recently appointed a project team of national accounting standard-setters, led by the New Zealand accounting standard-setting body, to


164 U.K. OFR Exposure Draft, supra note 163, app. A, at 26. This emphasis on quoted companies reflects the view that such companies have dispersed share ownership, and that this information will better enable institutional investors to "engage with management." See id., app. C, at 33.


166 Id. § 235, ¶ 10.
consider whether MD&A should be taken up on the agenda of the IASB.\textsuperscript{167} Currently, no international accounting or reporting standard requires MD&A disclosure.

Because MD&A elucidates the information contained in the financial statements, there may be a general view in the EU that accounting standard-setters are the most appropriate bodies to set disclosure requirements in this area. However, if MD&A is viewed as part of the financial statements and must be audited, there is a potential risk that a company’s auditors may discourage or try to limit disclosure of desirable forward-looking information and analyses by management because of their discomfort with applying audit assurance mechanisms to “soft” information. In any case, regardless of who is tasked with developing MD&A requirements, the Market Abuse Directive indicates that EU Member States are obligated to ensure that issuers provide price sensitive information to the public.\textsuperscript{168} This presumably means that financial regulators have the ultimate responsibility for making sure that the disclosure requirements for crucial disclosure items, such as MD&A, are adequate.

5.2. Approaches to Related-Party Transactions Disclosure

Related-party transactions disclosure is another issue that illustrates the regulatory divide between the EU and the United States. The same influences at play with respect to MD&A disclosure apply to this disclosure item as well. The EU prospectus disclosure framework largely delegates authority to the accounting standard-setters to set disclosure requirements regarding related-party transactions. Under the EU prospectus disclosure regime, related-party transactions disclosure is only required for public offerings and listings of shares. Even in that context, the prospectus disclosure requirements for that disclosure item refer to the international accounting standard on related-party transactions.\textsuperscript{169} Separate prospectus disclosure requirements for


\textsuperscript{168} See Market Abuse Directive, supra note 16, art. 1(1) (defining insider information as information that if made public would drastically impact the price of the financial instrument).

\textsuperscript{169} See International Accounting Standard 24 Related Party Disclosure (IAS 24)
related-party transactions only apply if IFRS would not apply to a company, such as a company whose securities are not admitted to trading on an EU-regulated market. In that case, transactions that are material to the issuer should be disclosed, as well as the amount or percentage of the company’s revenue that comprise related-party transactions.¹⁷⁰ No related-party transactions disclosure is required for public offerings or listings of debt securities. Such disclosure would only be required to the extent that IFRS required the disclosure of these transactions in the financial statements.

The EU approach to related-party transactions may again highlight greater participation by retail investors in the equity markets compared to the debt markets. Under the International Accounting Standards Regulation, EU companies that are admitted to trading on an EU-regulated market must prepare their consolidated financial statements according to IFRS.¹⁷¹ As a result, IAS 24, the relevant accounting standard on related-party transactions under IFRS,¹⁷² only applies to financial statements prepared by listed issuers that prepare consolidated financial statements. These types of issuers are larger and presumably more likely to have dispersed share ownership. This standard mandates more detailed disclosure than the analogous U.S. accounting standard, most likely because it is the only source of disclosure requirements in this area. In addition, the reliance on accounting standard-setters may reflect a historical bias that auditors are better able to obtain and enforce such disclosures through their audits of the financial statements.¹⁷³

In contrast, issuers in the U.S. markets must provide disclosure of their related-party transactions in their financial statements, as

¹⁷⁰ Prospectus Implementing Regulation, supra note 17, Annex I, Item 19.
¹⁷¹ See supra note 59 and accompanying text.
¹⁷² See supra note 170.
well as in the non-financial statement portion of their prospectuses according to the disclosure requirements set by the SEC. Although the relevant accounting standard, Statement of Financial Accounting Standards No. 57 ("FAS 57"), requires financial statements to include certain disclosures about material related-party transactions, the requirements are relatively general, especially when compared to the prospectus disclosure requirements. FAS 57 requires disclosure of the nature of the relationship involved, a description of the transactions, the dollar amount of the transactions, and amounts due from or to related parties for the relevant periods for which the financial statements are prepared. On the other hand, the prospectus disclosure requirements for related parties are significantly more detailed, and require disclosure of transactions that would be material to investors. The assessment of whether a transaction is material specifically includes an evaluation of the importance of the transaction to the related-party itself, the relationship of the parties to each other, as well as the amount involved. This definition of materiality is more expansive than the one contained in the EU Prospectus Directive for share issuers, and would require disclosure of a wider range of transactions, especially where a large issuer is involved. This is an important distinction, as many related-party transactions may not be viewed as material to the issuer, but could be very material to directors or officers of the issuer who could be tempted to make certain decisions for the company that would benefit themselves and harm the company.

Several of the recent financial frauds involved abusive related-party transactions that effectively resulted in the looting of various companies by insiders, and substantial losses suffered by bond holders. In light of that experience, related-party transactions

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174 See FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 57: RELATED PARTY DISCLOSURES 2 (1982) (specifying that the disclosures must include: the nature of the relationships involved, a description of the transactions, the dollar amounts of transactions for each of the periods, and either the amounts due or the terms and manner of settlement).

175 Id.


177 See 17 C.F.R. § 229.404 (explaining paragraph (a) of Item 404, Regulation S-K).

178 See supra note 7 and accompanying text.
disclosure would appear to be as relevant to bond holders as to equity holders. In the EU, there appears to be greater recent recognition of the importance of this disclosure, notwithstanding the differential treatment between debt and equity offerings in the Prospectus Directive. In October 2004, the European Commission proposed amending the Accounting Directives to require unlisted companies to provide more disclosure about related-party transactions.\textsuperscript{179} If adopted, these amendments would effectively require companies that do not have securities listed on an EU regulated market to provide at least a minimal level of disclosure in this area. This proposal implicitly recognizes that even though disclosure cannot prevent fraudulent acts, the mere requirement to disclose may help prevent the perpetration of some frauds.\textsuperscript{180}

6. CONCLUSION: IMPLICATIONS FOR THE FUTURE

Regardless of whether securities regulators take full responsibility for setting prospectus disclosure requirements, or delegate some of the responsibility to accounting standard-setters in specific instances, the real regulatory concern is to ensure that all investors have access to the material information needed to make their investment decisions. The requirements that have been developed on either side of the Atlantic reflect the different market characteristics, regulatory paradigms, and legal frameworks within each jurisdiction. The EU has done a remarkable job implementing the comprehensive legislative framework set forth in the Financial Services Action Plan. The new challenge will be to implement the legislation in a way that achieves the FSAP's objectives of market efficiency, competitiveness, and investor protection.

If the EU Prospectus Directive is successful in eliminating some of the overlapping costs and burdens issuers currently face in order to comply with the different prospectus requirements throughout the EU, the cost of issuing bonds to retail investors will be reduced. Coupled with the "graying" of the population in the


\textsuperscript{180} See Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1352 (1966) (averring that "many a transaction that could not stand the light of official or public scrutiny has not occurred (or has been undone) simply because it would have been exposed to that light.").
developed markets and the resulting need for investment options other than equity securities, retail investors will likely become more significant participants in the corporate bond markets in the future.

As retail investors become a larger factor in the corporate debt market, the differentiation in the EU's prospectus disclosure requirements between debt and equity securities may eventually become inapt. Changes in the legal landscape in the EU may create more pressure for detailed and more comprehensive disclosure requirements for both debt and equity securities. Some form of class action is being adopted in various EU Member States, which could increase the likelihood that such a mechanism will eventually become broadly available throughout the EU. At the same time that investors on the whole are more able to enforce their rights, the greater participation of foreign investors may result in institutional investors from the United States and other countries exporting their activism to the EU markets. Moreover, with the greater globalization of the markets generally, increased foreign investor participation in the EU capital market could result in the transport to the EU of investor expectations for more comprehensive disclosures, disclosures that are similar to what these investors obtain in their home markets.

In any case, as evident from the discussion of the different regulatory approaches for soliciting MD&A and related-party disclosures, prospectus disclosure requirements are not static. The increasing globalization of the securities markets may well result eventually in more convergence in disclosure requirements and in regulatory approaches.