Introduction to Financial law: pertaining to initial public offerings, public take-over bids and the legal environment of public companies

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INTRODUCTION

1. A quick survey of the field

I believe it is fair to say that about 15 years ago in many countries in the EU (with the notable exception of the UK and the Netherlands) the "real world" economy consisted overwhelmingly of family-owned corporations or enterprises driven by individuals, families and industrial holdings. Except in Germany, institutional banks had little investment in listed stock and even less in unlisted stock.
Listed corporations were the exception: often very large, they were seen as national champions and not infrequently were very old. The stock exchange was reserved for corporations with a "safe" track record, most of whom were active in the traditional industry sectors.
The picture in the US had been different for some time. Possibly because the US was a much larger market than the national EU markets and because it is a more homogenous market than the EU still is today, US corporate leadership required more money more quickly in order to exploit the "franchise". US corporations found that money on reasonably performant stock exchanges, expanded quickly, and they then used their national position to build global positions early on.
From the early 1990s, but especially in the late '90s, the market for IPOs became strong in the EU. Financial conditions played a role: lower government deficits, lower interest rates, a better economic cycle. But more importantly, the realisation by many national champions in the EU that their market and the competition were likely to be built in a pan-European perspective made business leaders look again at their options and consider listing, both as a model and as a way to attract capital.
However, although Americans would "naturally" see an IPO as one of the items on the corporate finance "menu", this is less true in Continental Europe, where the market capitalisation of listed companies compared with GNP is still smaller than of the relevant figure for the US and the UK.
While a law student in the US will learn about the legal aspects of IPO-ing a company, generations of law students in Europe have had little or no education on the subject.
The rush to the stock exchange, especially in the wake of large privatisations in the telecom and other sectors, and the privatisation of stock exchanges themselves were closely followed by initial steps towards pan-European stock exchanges (like Euronext). However, this first created a "sentiment" that only very large corporations would still be welcome as only they could offer the kind of liquidity that institutionals favour. The result was a disaffection for small or micro stock and lower stock market valuations. Then came the enormous correction of 2000 and 2001; Nasdaq's tumble from an index of over 4,500 to 1,400, the dotcom bust, the revelation of the high-tech illusion, the accounting scandals and the regulatory reaction.
Interestingly, small and micro stock started to perform better and companies came to realise that, like in America, going public can also be a worthwhile process for small corporations.
If done properly, going public basically entails inviting outside shareholders to join the company but without the loss of control that accepting a financial partner or an industrial partner normally

entails. It is a choice for autonomous development of the corporation and often operates as a change of model when an exit is offered to family owners or financial partners, whose dissatisfaction would otherwise result in the company being sold.

After the many disappointments of recent years, the market was again bullish until the credit crises of a few weeks ago, a crisis which is long expected . Let's hope that the lessons of the past will not have been forgotten.

There is considerable analysis to the effect that in the very long term, subject to state of the art risk allocation, stocks are the only inflation-proof form of investment. Traditionally, Continental individuals have saved by investing in bonds. One of the purposes of governance is to ensure the necessary level of confidence for private investors to discover or rediscover the road to the stock exchange.

Equity capital markets are much more important in the US and the UK than on the EU Continent (although that pictures is gradually changing). On the Continent, banks, private equity and holdings have traditionally played a more important role, although less now than before, as does commercial lending. This situation is not helped by the fragmentation of EU equity capital markets as compared to major stock exchanges in the US. Local champions continue to command local loyalty, which is based in part on familiarity with the business and on natural sympathy. Comparatively speaking, institutionals have traditionally invested less in stock, and they do not have the same "equity culture" as in the UK and the US. European institutions are mostly attracted to EU class shares that offer high liquidity, although overall they have performed rather less well than small stock over the last couple of years.

In general, risk capital, in its various forms (from seed capital to public share subscriptions) is less widely available all over the Continent than in the US. This is paradoxical since the savings rate in Europe is much higher than in the US. People save more but they risk less in managing their savings.

The accounting scandals, the scandalous remuneration levels of some CEOs, the equity funding scandals and the favours done in allocating shares in the framework of IPOs have truly caused what is described as a "systems failure" rather than being viewed as a number of separate incidents. Beyond individual or corporate misbehaviour, it is difficult not to suspect the investment banking industry of having condoned or even inspired accounting practices that became unsustainable or deceptive, even when accounting law was not violated. The now retired FED Chairman Greenspan used the term "irrational exuberance" to describe the period during which it was felt that the classic economic cycles were a thing of the past and "trees would now grow into heaven". Strategy and technology consultants contributed to an irrational belief that the new economy would make normal economic behaviour obsolete. The irrationality was such that according to the Financial Times we will probably not see in our lifetime a Nasdaq index of the level "achieved" in early 2000 (i.e. 4700 as compared to 2600).

"Irrational exuberance" created enormous opportunities for investment bankers, corporates and employees (and their advisors). Some were probably fooled by those circumstances, others were aware that time was growing short and abused the "exuberant" market conditions to the hilt.

In Europe, stock exchanges attempted to create a simpler environment that would attract newcomers especially in the high-tech field. The "Nouveau Marché", Easdaq and the German Neuermarket all failed in their attempts. Simplicity cannot replace due diligence and bankers lending their credibility to the companies which they sponsor.

Given the fragmentation of the EU capital markets, an overview precludes all but the broadest generalities.

Basically, each member state (all 27 of them) has its own securities laws. The same is true in the US for all 50 states but the US has an overriding US securities law, this lack is gradually addressed in the “peculiar” EU way, as described below. Most importantly there is in the US a

single authority, the SEC, which sets policy and determines most of the "traffic rules". Each EU member state also has its own corporate law. This corporate law applies to all companies incorporated in that country. As we saw in the previous session, Europe has more corporate governance models than the rest of the world combined. This too contributes to increased complexity.

Finally, each stock exchange has its own listing rules, which corporations seeking a listing must abide by. These listing rules are not usually a hugely complicating factor but they add yet another level of complication on top of the complexities described above.

Many EU corporates who wanted to tap the huge US securities market and achieve higher liquidity sought US listing (on NASDAQ or the NY Stock Exchange) in addition to their listing on one or several stock exchanges in Europe. This is called "dual listing". The consequence of additional US listing is to further increase complexity …. exponentially.

Satisfying US listing requirements is much more daunting than seeking an additional listing in the EU. The detail, the depth and the stringency of US securities laws are simply of another order. US listed companies need to restate their accounts in accordance with US GAAP and accordingly must then translate the effects of their decisions into several accounting languages. Finally, the litigious environment in the US with its complex combination of SEC enforcement, class action bar and federal and state courts (not to speak of state securities legislation) make for legal costs that are a multiple of the costs in Europe.

As certain European corporates have learnt at their own expense, the legal and other costs of compliance with the US securities environment are such that only very sophisticated and large companies can afford them.

If there is one area of EU law where I believe that there is no choice but to end fragmentation, this is it. We need an “authority” at least guiding national regulators, standardising listing requirements as far as possible, a single body of rules applicable to take-over bids, and liquidity of a magnitude comparable to that of the US.

If we are to believe the European policy makers, they intend to achieve competitive parity with the US by the year 2010 (the Lisbon declaration). Growing and competitive corporations need equity and in large part that equity must be provided by well-functioning pan-European equity markets. This is not to say that smaller players will not continue to command a local listing and a local following. There is nothing wrong with that; it is also part of the US financial landscape.

In my view there is no excuse for the EU not to evolve to a single set of rules (e.g. in respect of mandatory bids) but even more importantly to a limited number of large and sophisticated markets where liquidity can be achieved on a European scale. In fact expected progress in this respect (the Take-over Directive) was challenged by precisely those member countries continuing to protect their EU champions from fellow Europeans (or Americans).

The challenges are daunting. If a single EU "SEC" were to be set up, it would need to be able to build up competence in the multiple types of financial services and securities offered on the market and also provide its service in about 20 languages with more than a superficial knowledge of the applicable law in all 27 member states. This huge bureaucracy would be in addition to national authorities. Accordingly, in respect of regulatory authority, the present track is to develop coordination between the national authorities and push for harmonisation through informal technical committees. The process carries the name of the Belgian expert who devised it, Baron Lamfalussy.

US competitors of EU companies are often (but not always) bigger, simply because they grew up in a larger domestic market. EU markets were until recently very fragmented and the "agency cost" of cross-border business within the EU continues to be significant for linguistic, legal and cultural reasons. The obvious impediments to trade, such as different specifications, quality

requirements and licensing, have largely been eliminated, but the "psychological" impediments remain.

One of the main challenges in developing an EU market is to address the needs of those smaller national champions who wish or have to become pan-European (or global). It is therefore essential that stock markets accommodate the needs of small and mid-sized companies seeking capital for such expansion. Initially, the EU stock markets catered to large, highly liquid shares but they now appear to have become aware of the above.

However, while stock exchanges used to be set up or run as an essential service provider (often in a cooperative form) in a capitalistic economy and regulated from that perspective, most of them are now privately owned and run on a for profit basis. Some stock exchanges actually are listed on their own exchange. Transaction costs have been reduced enormously as a result of competitive pressure.

The legal analysis of public companies basically requires an understanding of four sets of rules:

- the articles and bylaws of the company;
- the corporate law to which the company is subject, i.e. the law of the country of incorporation;
- the securities laws of all the countries where a public offering has taken place;
- the rules and listing requirements of the stock exchanges on which the securities of that company are listed.

While maintaining public confidence in stock and accordingly promoting IPOs is essential to providing European companies with much needed capital, we should not forget that during the past decade and especially in the late 1990s abusive practices regarding IPOs abounded on both sides of the Atlantic.

That IPOs were sometimes done at highly inflated prices is clear. Bankers will counter that IPO pricing simply follows valuations and multiples in respect of existing corporations. In short, the "exuberance" of investors for existing stock leads to a high valuation in the framework of IPOs. If telecom stock is valued at say 20 times EAT, an IPO at 15 will unavoidably cause immediate realigning of a lower IPO price on the existing multiples. This is unfair to existing shareholders who sell at too low a price or who are excessively diluted. A worse problem, I believe, has been that certain companies were listed when they simply did not have the necessary level of maturity, discipline, sophistication or plain honesty. It is basically for investment bankers to due diligence and assess candidates for listing.

The more restrictive regulatory and governance environment and, for some companies, the disappointing stock performance, has made certain listed companies reconsider their model and envisage a "public to private" (P2P) process. A P2P can be expensive because in order to collect e.g. 95% of all outstanding shares (from which point a "squeeze-out" can be organised), a premium over market price will have to be paid (about 30%). In addition such a transaction will usually have to be funded by a financial party, who may exact a considerable measure of or total control in the process. Management may be demotivated and lose liquidity for its share options. In addition, as indicated in the session on governance, the model based on financial partnership is rarely a permanent arrangement, and the likelihood is that a few years after the P2P the company will either be sold in a trade sale or relisted, which increasingly raises questions whether certain types of private equity provide the stable environment which corporations and management require.

For larger transactions, the kind of money needed is mostly supplied by Anglo-Saxon funds, who will introduce strict performance measures and are anything but relaxed if management does not perform according to expectations. While this is not a bad thing in itself, the risk is that relatively short-term exit requirements get in the way of good strategy.

It is somewhat ironic to see that the investment bankers who "preached IPOs" a few years ago next preached P2P. Remember always that investment bankers, lawyers and other consultants live from change, whatever direction the change might take.
I have not enclosed the new Take-over Directive. It is a very disappointing document, which hides behind principles of subsidiarity to excuse what is effectively a failure to achieve a much-needed EU "level playing field".

Apart from item 2 below, I have tried to address the "reality" of the processes rather then the technicity which in this field (as well as others) requires the use of the best available legal technicians (and often discussion or bargaining with the prudential authority). Market practises do differ from country to country, stock market to stock market and change rapidly.

Whether or not to list is a hugely important decision which beyond technicity requires understanding of the strategic and tactical issues. These are the ones which we will focus on, with the law as a "shaper" of the decisional environment.

2. The EU legal scene

The EU legal scene is largely "work in progress", with major political agreements and EU rules being agreed and applicable, but member state implementation (the EU way remember) in part recent or late. Important implementing EU legislation (Council Directives) are applicable or in process.

Internally the Financial Services Action Plan, the EU's "grand design", purports to achieve, in essence I believe, the following:

(i) regulatory convergence, improvement and coordination within the EU;
(ii) integration in this field with a view to achieve economics of scale;
(iii) better consumer protection;
(iv) spreading best market practises;
(v) increasing market confidence and facilitating access to risk capital;
(vi) making the EU speak "with a single voice" in respect of especially the US but also Russia, China and others;
(vii) verifying the cost/benefit analysis of new regulation and the progress made;
(viii) pressuring member state into adapting their domestic law in accordance with the directives and before the relevant deadline;
(ix) using coordination and peer pressure at the level of national regulatory authorities rather then a "super EU SEC like authority";
(x) ensuring a "level playing field" for operators including by eliminating tax disparities.

In general the progress, at the EU statutory level at least, is rather impressive.

The body of legislation at the EU level and the Minister State level is huge. I will try to capture the essence below. EU summaries may be provided for further reading to those of you who should be interested. Please visit the EU website which is quite well organized and user friendly.

1. The EU set up (in 2001), pursuant to the Lamfallucy report, a number of committees with advisory powers in order to ensure speed, flexibility and market responsiveness. The

most important ones are the ESC and the CESR (the latter essentially consisting of the national regulators).

2. MIFID is a directive which purports to ensure a better protection of retail customers of securities by requiring the intermediaries to seek the best trading conditions for their customers and to protect them from buying products which do not correspond to their risk profile (the duty of care). In addition, as Member States are harmonizing the “single passport” must facilitate pan EU operations with prudential oversight by the home authority (rather than by all those were services are offered). Ultimately this should lead to a single European “securities rule book”. It should also further competition including between banks and stock exchanges.
3. MAD, is a directive purporting to define “market abuse” in reference to “accepted market practise”. In addition to listing (forbidden) abusive trading practises it harmonizes the field of insider trading, by introducing “best practises”. Those include the requirement to provide to the authority a list of (company or external) insiders and have them report to the market any of their transactions, so that the market would know e.g. whether the insiders are generally or suddenly buying or selling.
4. Reporting under IFRS is now mandatory for listed companies in the EU. Its use is optional (as required by Member State law) for other companies.
5. The Prospectus Directive purports to harmonize and improve the quality of information in prospectuses (to be provided with respect to market operations) and to provide for a “single passport for issuers”, much reducing the need to obtain clearance in all the countries where securities are offered. In short if the Belgian prudential authority approved it, it can be used without (much) further review in all other EU countries.

1. THE LISTING PROCESS – GOING PUBLIC

1.1 Success factors, advantages and disadvantages and role of some players

1.1.1 Success factors

In considering a possible IPO, the first task of the company's board and management, its investment banker and advisors is to establish whether the company has a profile that is attractive to market investors. The history of the company, in particular its financial performance and historical growth profile, and the absence of major "incidents" in respect of e.g. tax compliance, product liability litigation or environmental problems are important. Most attention will go to the company's outlook and ambitions. The company will be valued for what it is worth and accordingly investors will buy on the basis of its expected future. Establishing that future, ambitiously but realistically, is essential.

In this respect, the reputation, track record and general quality of the management will be crucial. It is important to look not just at whether there is talent for the present but whether it is also capable of achieving the company's ambitions.

Much of the presentations (the road shows) will be about these factors, which relate to the company itself.

In addition to those features of the company itself, market conditions are of great importance. Some relate to the general environment for IPOs, others to the particular sector or sectors in which the company is active. Most of you will remember times when telecom shares were highly valued by the market and accordingly telecom IPOs were easy to sell. To build the valuation model, bankers will refer to recent IPOs (often in the US) of comparable companies.

All of the above will result after much strategizing and model building in tentative valuations, which will then have to be tested against the market.

1.1.2 Advantages of being listed

By seeking a listing, a company pursues a number of objectives. The primary reason is to attract additional equity on the basis of a valuation that minimises dilution for existing shareholders. But even if the IPO occurs through a secondary offering, i.e. the sale of existing shares, an IPO can be very meaningful. In that case, the company seeks to position itself for a future capital increase when the need arises. There is no good reason to increase the capital if there is no proper use for the funds so obtained. Through listing, companies seek to have a permanent "objective" valuation (the market capitalisation). In this case, "objectivity" is nothing more than the sum of many subjectivities but that is simply what "market" means. Companies also seek to improve their profile, their image and their reputation. Being listed also means accepting a certain discipline, in terms of financial reporting, transparency and governance. In this sense, listing can be supportive of a drive for greater professionalism and objectivity in decision-making, as compared to the family model.

By listing, companies generally increase their attractiveness on the recruitment market. This is particularly important for industry sectors that are considered less "sexy".

From the shareholders' point of view, especially if they hold a minority position within the company, listing provides a chance to exit totally or partially at optimal price conditions. Even if they do not exit, they are provided with at least a measure of liquidity. Shareholders who exit obtain the chance to diversify their holdings and lower their risk profile. Paradoxically it is by moving out of the closed family model that a more lasting long-term loyalty of the family can be achieved. Listing may simply create a better environment for the company and a greater chance of liquidity for shareholders who wish to sell. Obviously, such loyalty must be structured (through continuity structures) and the exit potential limited if control is to be maintained.

1.1.3 Disadvantages of listing

In the US, where unlisted companies have hardly any financial disclosure requirements to reckon with, the process of listing is more abrupt in this respect than it is in Europe. As a result of the 4th Directive, all EU companies must publish annual accounts in accordance with a specified format and that information is publicly available. In addition, reporting requirements for unlisted companies to work councils already involve considerable loss of privacy. However, the new rules on disclosure of, for example, governance practices, executive compensation and IFRS unarguably require additional transparency and accordingly increase vulnerability in terms of information given to competitors.

Existing shareholders will reduce their participation in the company, either by selling or by being diluted as a result of a capital increase. It is not unimportant to distinguish the reduction of one's participation for consideration (“power dilution”) from dilution, which occurs for example when a company is undervalued in the framework of a capital increase (“financial dilution”).

Whether the listing will result in a loss of control will depend on the participation held after the listing by the control group and its capacity to sustain that position. Paradoxically, as argued above, it is often by reducing a participation that one makes the control group more sustainable in the longer term (through improved liquidity and loyalty) subject always to adequate structuring.

Admittedly, given the increased publicity of corporate decisions, aggressive tax and financial planning and structured finance will have to be reviewed in the light of media and analyst

attention. Sophisticated products that are well received in the cool and rational environment of a boardroom may be seen differently by the general public or an investigative journalist.
There may be competitive disadvantages in having to disclose quarterly or half-yearly financial information or having to announce other important information, like the signing of a letter of intent in respect of acquisitions. Competitors may not be listed themselves and the information supply may therefore be quite unequal. The requirement under IFRS to report more precisely about different segments will increase the competitive disadvantage of listed companies. In short, listing probably unavoidably results in providing additional intelligence to competitors.
All corporations must respect the "traffic rules" that apply to them, but it is fair to say that if a mistake (or worse) occurs, putting things right in the privacy of a closed corporation is quite different from doing it in the public eye. The liability risk for directors is *de facto* much greater in a public corporation, although conceptually it is not different from a closed corporation.
Listing is a costly process – in Europe typically 3 to 5% of the transaction value (and in the US up to 8%). However it is an investment with a quasi-immediate enormous return. The listing will provide liquidity and the illiquidity discount is reckoned to be between 25 and 30% (judging from the holding discounts). The return may be say a 1000% on day one.
In my view, the true disadvantage of being listed is the increased complexity of management: one must balance the short term and the long term, both in real terms and in terms of perception. In a closed corporation one can convince the board and the bankers that an investment is required notwithstanding expected losses in the immediate future. A similar decision in a listed environment can wreak havoc on the share price. Balancing the short and the long term is indeed a more complex exercise when the company is listed.
Finally, never forget that stock performance is not just driven by the performance of the company itself: "bear markets" unavoidably follow "bull markets". It can be very demotivating for management and shareholders alike to IPO at the end of a bull market and see the stock depressed for several years, even when the company performs better than expected. The annoyance of management who obtained stock options or warrants at the time of the IPO and who calculated their potential capital gains at that time can be greater still. In Belgium, in addition, tax is usually paid on the basis of the lump sum value of the option (a deemed value for tax purposes) at the time the option is granted. If the stock is depressed for a long time after that, they are out of pocket for the tax without seeing their options "in the money" (i.e. having a market value). Other "fashions" can also affect performance like the dislike at one particular time for "small caps".
In short, the valuation might have been done quite artfully, the process might have been conducted brilliantly, the company might be performing better than expected … and still stock performance can be relatively bad. One simply cannot control all the conditions relevant to stock performance. Listing a company is therefore always, to some extent, a step into the unknown.

1.1.4 Choice of the lead manager and the syndicate

The lead manager, usually an investment bank, is the architect of the IPO (together with the legal counsel for the company).
The lead manager will advise on the size of the transaction (e.g. the percentage of shares to be sold in a secondary transaction or the size of the capital increase), the structure of the transaction (e.g. which company will be used as a top company whose shares will be listed), and the timing and placement method of the transaction.
By definition, the company to be listed is relatively unknown to the market and, by "sponsoring" the IPO, an investment bank will lend its credibility, based on prior successful introductions, to the company.

On the Continent, investment bankers used to be rather "relaxed" about doing their homework; that attitude has changed. It is now common for investment bankers to conduct extensive business due diligence, and to have their own lawyers conduct legal due diligence, of the company.
The main job of investment bankers is to price the issue of securities and accordingly to make a valuation of the company.
Investment bankers will decide on how the shares will be marketed, whether they will be firmly underwritten (i.e. securing whether bankers will agree to buy the shares which the market does not buy) and how to achieve book building (i.e. securing firm commitments to buy the shares before the actual IPO).
The lead manager will coordinate the banking syndicate (i.e. all the banks involved in placing shares with their clients), which is often quite a difficult task.
The investment banker will also involve a "market maker" or a specialist in the shares (or take that role on itself) and will arrange for support of the shares after the IPO in order to avoid a sharp drop in prices immediately after the introduction.
Finally the market will have to be informed about how the company is doing through research reports.
The selection of a lead manager (and of the members of the syndicate) is extremely important. It is certainly wrong to select only on the basis of cost and/or valuation projections.
The selection is above all determined by the choice of the stock exchange on which the listing will be sought. This will be reviewed below. Other elements that come into play are the experience and reputation, sometimes as relevant to the sector of industry of the listing candidate, the research capability, the quality of analysts, the international feel, look and reputation, and the quality of post-IPO support or analysis.
Overall, the choice of the syndicate is determined by the market segments that the company is trying to reach. If it is intended that a rather smaller issue be held by local individuals, a commercial bank with a strong local network will probably be part of the syndicate and a tranche will be reserved for it. If, however, the intent is to place the stock with European class institutionals, a lead manager of the same class will have to be chosen.
The battles between syndicate members for prestige, a larger part of the tranche and marketing advantages can distort the process considerably. Sometimes the listing candidate (or their lawyers) must intervene to settle competing claims.
The largest part of the cost of an IPO is the placement cost, i.e. the fees paid to the lead manager and the syndicate. These costs must cover the analysis and structuring of the transaction (due diligence, prospectus, etc.), the compensation to the sales network (i.e. the multiple bankers of the network who will recommend and sell shares to their customers), the underwriting cost (which may or may not be firm, i.e. may involve an obligation to buy the shares if the market is not a taker) and marketing, printing and other expenses.

1.1.5 Role of the legal advisors

Legal advisors play an important role in IPOs since the potential legal problems are numerous. Apart from satisfying the "traffic regulations" i.e. the set of rules under corporate and securities laws and the listing requirements, lawyers must ensure that the prospectus reflects reality. This process is basically about managing risk, and avoiding liability of the board, which must represent that the prospectus is accurate, and of the banking syndicate, which also has a duty of care in this respect.
Drafting prospectuses is often a difficult and lengthy exercise. Some part may be heavily negotiated in order to ensure the proper balance between marketing the stock and properly advising the market of the risks involved. In the US in particular, with its highly litigious

environment, prospectuses often read as an incentive not to buy the stock and several pages of "risk factors", some sounding rather ridiculous, are carefully drafted to reduce the risk of liability.
IPO-ing a company also involves a highly ritualistic succession of corporate, information and marketing events requiring decision-making by the company's board and judgement calls by the bankers, especially when market conditions are unstable.
One heavily negotiated document is the legal opinion given by the company's lawyers, in which they effectively guarantee to the market that the information in respect of which they "opine" is correct. The lawyers want to limit their liability as far as possible and the bankers often wish the opinion were more extensive.
The role of legal advisors in US-style IPOs is even broader and includes extensive contacts with the SEC.
On the Continent, the prospectus is reviewed by the Stock Exchange authorities and the government authority in charge of these matters (e.g. in Belgium the CBFA, in France the COB).

1.1.6 IPO parameters

Much of the discussion between company and bankers will turn around the number of shares to be placed and accordingly how much money will be sought from the market. If the transaction is a primary issue, i.e. a capital increase, the decision is driven by the company's cash requirements. This can relate to the repayment of existing financing (e.g. if a company does an acquisition first and then seeks equity in the market), or expected future needs.
Conversely, one of the essential parameters is the so-called "float", i.e. the shares that will be freely tradable on the stock exchange (and that are not held e.g. by controlling shareholders), which will drive liquidity, a concept of paramount importance as discussed above. Listing requirements usually include a certain percentage of the shares (typically 25%) having to be freely tradable. Liquidity, however, is not driven by the percentage of shares registered for trading but by the actual volume. Liquidity is basically about whether a typical trading position can be bought or sold without undue influence on the market price within a reasonable period. Lack of liquidity (typically for smaller market capitalisations) will result in a lower valuation of the company (expressed in multiples of EAT or EBITDA) as institutional and sophisticated operators wish to be able to liquefy their positions very quickly.
For existing shareholders, in the case of a capital increase, the effect of dilution is also important as discussed above. If existing shares are being sold (a secondary offering), the shareholders have to decide whether to prefer diversification of their assets or whether the value of their shares will increase following the listing. Sometimes, a company wishes to list but existing shareholders do not wish to sell sufficient numbers of shares to satisfy float and listing requirements. Some shareholders reason that the shares are likely to increase in value after the listing and accordingly wish to sell at a later time. However, as a part of the deal structuring, existing shareholders will normally have to undertake "lock up obligations", essentially protecting investors against massive sales of shares just after the listing. Lock up periods are usually about six months after the listing.
The prospectus must provide an insight into how the proceeds of the public capital increase will be used, e.g. to reduce existing debt, or whether the company intends to proceed with an acquisition programme or other types of investment.
You may be familiar with the saying: "in business, love and tennis, timing is everything". This is certainly true for IPOs. The general "sentiment" of the market, political occurrences (the fall of a government), terrorist incidents, etc. can, in a matter of minutes, wreck a deal that looked very promising. On September 11, 2001, within literally minutes of the second plane impact, deals were off all over the world until the ramifications were clear, and the market could regain a level of confidence in the future. The stock markets still have not fully recovered. But basically, if a

deal is right, one does want it in the market as soon as possible, and it is not unusual to see all those involved work literally around the clock. All commitments will usually be subject to what is known as a MAC clause (a "material adverse change" clause), i.e. a situation or event that, if it had been known, would have precluded the parties from committing. Given that such events cannot be described very precisely, commitments in the framework of an IPO are always "a bit tentative".

The size of the transaction does determine to some extent which lead managers and syndicate members will be interested. Some players (like the large American investment banks) are only interested in very large transactions (that can support their fees), while others will be mid-market or small market players. The size of the transaction also drives the number of syndicate members. The motivation of the syndicate members to put their sales network to good use will depend in large measure on the fee that can be allocated for their efforts.

Finally, if the demand is high, allocation can be a tricky exercise. In devising the marketing plan, allocation objectives are always discussed, e.g. the international tranche, the tranche for personnel, the institutional tranche. It is in respect of allocation that much of the IPO abuse in the US occurred. For most IPOs, the price of the shares was expected to quickly rise above the subscription price. It was a perfect opportunity to "make a quick buck", and investment bankers exploited it to "buy the loyalty" of influential senior managers in the hope of obtaining further business from their corporations. Similar practices occurred on the Continent where, for example, friendly pension funds were treated well in allocation exercises, which were anything but transparent. The trend is now for allocation to be more transparent and "strategic".

1.2 Legal structuring and IPO planning

1.2.1 Restructuring the IPO candidate

The IPO usually involves the parent (the corporation that is listed) and its network of domestic and international subsidiaries and branches.
The pre-IPO restructuring might involve any or a combination of the following: splitting off assets that are not business related (e.g. the residence of the family owner), splitting off activities and assets that are not suitable or are unrelated to the core activity, gathering relevant assets (like intellectual property) and activities under the corporate umbrella of the parent (e.g. when they were directly owned by controlling shareholders), etc. The purpose of the exercise is to make sure that all relevant assets are included in the listing and that those that would detract from the value of the company are excluded.
In anticipation of the IPO taking place, the relationship between the company and its controlling shareholders must be formalised and structured. This will involve verifying the absence of conflicts of interest (e.g. if the controlling shareholders own property that is let to the company), setting compensation for the managers supplied by the controlling shareholders or members of the "ruling family", transferring intellectual property to the IPO candidate (e.g. patents or trademarks used by the company) and generally establishing codes of conduct relating to the use of the controlling position. Most corporate laws have specific rules on how to deal with conflicts of interest of this nature, and anticipation of the potentially embarrassing effect of applying those rules is very relevant. Tax planning issues are to be reviewed in the framework of the future structure. It may be useful for sub-holding companies to optimise the dividend flow. Capital gains planning, essentially avoiding the restructuring resulting in divestiture of assets giving rise to tax liability, and ensuring the group's future ability to sell off divisions as that need may arise are highly relevant. If for valuation purposes one applies a multiple on EAT (earnings after tax) or calculates the present value of future free cashflows, every penny of, for example, tax optimisation is multiplied for the final valuation. If the EAT multiple is 12, every million euro of tax optimisation will be worth 12 times that in the valuation.

1.2.2 Amending articles and bylaws

The articles and bylaws (in French *statuts*, in Dutch *statuten*) of the company must be reviewed to prepare the company for its listed status. There are usually several corporate law requirements that must be addressed before the IPO, while other matters are basically tactical.
Of particular interest to the controlling group is the continuation of that control and therefore the defensive structure against hostile take-overs. If a large majority of the shares continues to be held by the controlling group, this may appear to be unnecessary. However, it is much easier to introduce these defensive measures when 100% of the shares are held, thus anticipating defence against future dilution, than to do so in the framework of a general meeting at which public investors will be present. In short, it is necessary to anticipate future events rather than wait until a pressing need is felt.
In particular the following items must be reviewed:

- the level of "authorised capital" (the ceiling up to which the board may increase capital without shareholder approval);
- the procedure for and the limits within which the company may acquire its own shares (usually on the stock exchange) within the relevant legal limits;
- voting restrictions or multiple voting allowances as permitted by the relevant corporate law;

- nomination rights, e.g. the right of the controlling group of shareholders to nominate a majority of the members of the board as long as they control a certain percentage (for example 30%) of the shares;
- reduction in the transparency threshold: in the EU the Transparency Directive requires anybody who acquires 5% of the shares to disclose that position to the market; that threshold may be reduced in the company's articles (e.g. in Belgium to 3%).

An IPO is usually an occasion to review the articles and bylaws critically also for items that are not directly related to the IPO. For example, the future governance structure may require rewriting the articles and bylaws on the subject (e.g. in Belgium setting up a "*comité de direction*/*directiecomité*" under the code).

1.2.3 Elaboration of the corporate governance model

As indicated in previous lessons, increasingly governance codes are requiring companies to "comply" with "best practices" or to "explain" why they do not comply. Conformity may be required either by the regulator or under the listing rules of a particular stock exchange. Although governance codes are essentially "soft law" (i.e. not enforceable law), there is an increasing "migration" of these rules into hard law. It is expected that, in assessing directors' liability, the courts will be influenced by what is generally recognised as "best practice".

The dominant model in the country where one is listed will significantly influence the marketability of the share and determine its attractiveness, especially for institutionals. In difficult market conditions, the governance model may become more determinative than we have seen in the past, but in my experience it is the profitable growth potential that usually carries the day.

Of paramount importance, whatever the model, is the new composition of the board. In addition to having the right mix of executive, non-executive and independent directors, the prestige and reputation of the people joining the board will often impact the credibility of the transaction.

The prospectus will have to address how the company will tackle issues of governance, in anticipation of the reporting on its governance practices, which is required in its annual report or intermittently if significant changes occur. The setting up of committees and their composition (in particular the audit committee) is one of the many issues to consider.

As indicated above, the quality, reputation and track record of executives is highly relevant to investment decisions. Increasingly the methods and level of compensation is or will have to be disclosed to the market, and practices must therefore be reviewed in anticipation of that.

Of great importance to valuation is the dividend policy (the pay out ratio or other similar concept). For a certain time it was assumed, especially in the US, that shareholders were only interested in growth and capital gains on their shares rather than recurrent dividend income. That attitude has again changed also in the US. In Europe a "substantial" dividend never ceased to be relevant.

Another element in respect of governance is the existence and disclosure of agreements between controlling shareholders relating to the company, especially to the extent that these controlling powers will be used to direct the company's strategy. In short, agreements to act in concert must be disclosed and existing agreements must be reviewed in anticipation of this requirement.

1.2.4 Elaboration of the control structure

The controlling shareholders must either organise themselves with a view to perpetuating that control or terminate it at some point. They may organise themselves by way of a holding company, a fiduciary structure (typically in Belgium a *stichting*), a voting trust or by syndicate

agreements. All techniques have their advantages and disadvantages and must be suited to the purpose that is being pursued.
Points of special interest in this respect include the tax effects of the structure. For example, if a holding is used, capital gains will have to be dividended out to the ultimate shareholders who may or may not be taxed on the dividend. The structure may have to function as a war chest (i.e. hold on to dividends with a view to further capital increases). Accordingly, the participants may agree on various restrictions including:

- a standstill arrangement: the obligation not to buy or sell shares in the company during a certain period;
- lockup obligations: the undertaking not to sell any shares during a certain period;
- take along obligation: the obligation, usually on a large party, to allow the other shareholders to sell at the same price as that party;
- right of first refusal: the obligation of the parties, in the event of a sale, to first offer the securities held to another contract party;
- agreements on composition of and representation at the board of the listed company or the holding company and all other matters relevant to the functioning of the listed company for which the parties wish to give undertakings.

1.2.5 Estate planning for the controlling shareholders

If the controlling shareholders are individuals or quite typically a family (whether or not they are organised as a holding company), it is of particular interest to them that the process of listing has two separate consequences concerning their assets.
First, transparency requirements will make their fortune very obvious and determinable for both third parties, their family (including in case of divorce) and the tax administration. It will be easy to calculate how much they have received from a secondary offering or how much their remaining participation in the listed company is worth. The listing basically wipes out the illiquidity discount, and the valuation for estate tax purposes will now, de facto or de iure, be based on the list price of the shares. In short, the value of the estate and accordingly the taxable base for estate tax purposes will usually greatly increase and much room for negotiating the "true" intrinsic value of the corporation disappears. Estate planning is therefore essential in an IPO.

The following matters are of special interest to the controlling shareholders:

- ensuring that the controlling group will continue to act together in their own interest and in the interest of the corporation by structuring understandings about the exercise of power,
- ensuring that the death of one of the controlling group will not result in the need to sell shares in a way that weakens control,
- the tax treatment of the dividend flow to the controlling group and, if relevant, the war chest function of the controlling structure,
- capital gains planning for exit of the controlling group and the tax consequences of a further distribution to its members,
- planning for possible cash needs of the members of the controlling group in the present or the future.

1.2.6 Share option or warrants for employees and/or management

IPOs create an opportunity for the company to widen its range of HR incentive schemes. While option schemes are conceivable in a closed group, they are usually more difficult to implement since ultimately the only possible buyer is the majority shareholder and there is no market valuation for the shares. Both problems can be solved but the reality is that most option schemes are devised for public companies.
Share options relate to the right to buy existing shares, which are either held by the company in treasury or are bought on the market, at a price that remains fixed for a certain period independent of the list price. A warrant is a right to subscribe to a capital increase (i.e. future shares) at a fixed price. If the market value of the security is equal to or higher than the price to be paid by the employee, the option or warrant is reckoned to be "in the money".
In high tax environments, the use of share incentive schemes is often driven by tax and social security considerations (i.e. the opportunity to provide compensation at a low tax and social security cost to the employer), rather than by well considered managerial and HR objectives. In particular, it is often underestimated how disastrously demotivating such plans can be when dreams of easy money are shattered by poor stock performance. The excessive use of stock options in the US has been a major contributing factor in accounting violations. It is tempting to keep bad news from the market until the options are cashed. This has apparently driven much corporate misbehaviour.
On the other hand, if properly conceived, share incentive schemes can be a great tool in attracting and retaining management talent in the corporation and "sharing the spoils" of the IPO between shareholders and management.
Share incentive schemes (especially international ones) are very complex. That complexity relates to the different treatment in EU member states for social security, labour law, corporate law and tax law purposes of the compensation obtained by management and employees.
The major question in respect of taxation is whether an option is taxable at the time it is granted (the taxable base being the difference between the price paid for the option and its value at that time), at the time of the exercise of the option (i.e. at the time the relevant number of shares are bought) or at the time of the sale of the shares obtained pursuant to the exercise. Ideally no income tax is due at the time of exercise, and future gains are exempt on account of capital gains treatment. Various jurisdictions have attempted to favour share incentive schemes to bridge the traditional rift between labour and capital. However, I generally do not believe that it is good policy to involve large numbers of employees with limited understanding of the issues and capacity to overcome difficult times.

1.3. Choice of the market

The European landscape is very fragmented with large sophisticated exchanges, including Euronext (now merged with the N.Y.S.E.), the London Stock Exchange (which rebuted NASDAQ) and the Deutsche Börse takeover (whose offers were rebuted) and multiple national exchanges, most of them tiny. The new stock exchanges tailored to young or high-tech companies have lost much of their appeal due to the accounting scandals, which were disproportionately high amongst their clients with the exception of AIM (the SE offspring). The willingness to seek listing in the US (especially on Nasdaq) on account of higher valuation for technological stock is much abated given the far more demanding regulatory regime and the expense of listing and post-listing compliance.

1.4 The listing process

1.4.1 Time line

Once the board of the listing candidate has approved the project, a "beauty contest" might be held for which a number of bankers are invited to propose their services on the basis of a summary set of documents. Bankers basically put together a glossy brochure with their track record, their initial valuation and what they see as the most suitable strategy for achieving the company's goals. A committee usually selects a lead banker. It is important to select on the basis of the relevant criteria, which include reputation and experience with the stock exchange which the company has chosen.
After the selection, there is usually a kick-off meeting and the next one to three months are used to conduct due diligence (explained below) and draft the prospectus.
The next stage is communication (and often negotiation) with the market authority to finalise the prospectus and the preparation of road shows and other marketing initiatives. This usually takes at least another month.
The final period is the actual marketing and price setting, the book building and ultimately the listing itself, usually quite a festive occasion.

1.4.2 Due diligence

Due diligence is a process (largely comparable to the process that occurs for acquisitions) where all the important features of the company are systematically analysed with a view to bringing to light risk factors and initiating remedial action if necessary. In essence, the business due diligence relates to the company's current activities and its prospects. It will also have a legal, tax, financial, social and environmental review. There will be interviews with management, a review of business plans, internal governance, etc. Clients and customers are often also interviewed.
The purpose of the exercise is to ensure that sufficient and correct information is provided in the prospectus, to verify the accuracy of financial statements and to avoid liability.
While the ultimate responsibility for the prospectus lies with the board, the investment banker's interest is to protect the bank's reputation and its client investors.
During the due diligence process, the investment bankers will gain an understanding of the issuer's activities and business, be able to assess the quality of the management and understand better what the prospects of the company and its industry sector might be.

1.4.3 The prospectus

The prospectus is put together with different goals in mind. Essentially this document is to inform the investors about what they are buying (including risks and opportunities pertaining to the company) and perhaps most importantly to reduce the risk of liability of the Board of the listing candidate.
In addition to listing the risk factors, the prospectus will describe the transaction including its size, describe the issuer, its capital structure and its activities, and inform about the capital financial position and revenue. It will also inform about how the proceeds of the transaction will be used, what dividend policy the company will follow and have a section on who's who within the company.
Satisfying marketing needs and risk management objectives is not an easy task and requires considerable balancing.

When reading an American prospectus, it is obvious that because of the litigious environment, the risk management objectives are satisfied at the expense of marketing objectives to the point where most US prospectuses are unintelligible for anybody but the most sophisticated investors. There is now a drive to use "plain language" and eliminate the "legalese" which hides the truth rather than explaining it.

1.4.4 Approval of prospectus

The draft prospectus must be submitted to the supervisory authority before it is distributed to the public and in the meantime, the sale of shares must not be promoted. Interviews, for example with management or board members, are best avoided, as they will be subject to the scrutiny of the supervisory authority. This is often difficult, as the media like to "scoop" prospective IPOs.
Apart from reviewing whether the prospectus complies with applicable regulations, which have been more or less unified within the EU, listing authorities will often insist on further disclosure on risk items. Informally, listing authorities will also voice their views on such matters as board composition and pricing if they feel that general market confidence may be affected. In the absence of a single supervisory authority in the EU, mutual recognition by national authorities for dual and multiple listings or offerings within the EU has been arranged through "Protocols". The approval requirements in jurisdictions other than that of the issuer are then much reduced.

1.4.5 Underwriting

Underwriting is basically the process whereby the lead banker and its syndicate agree to sell securities to the market and are given a mandate to that effect. Underwriting can be on a firm basis, which means that if the market does not buy the shares, the bankers are on the hook. They must then buy the securities and place them on the market at a later date. The alternative is a "best efforts underwriting" where no "firm" obligation is undertaken. In reality "firm" underwriting is a relative concept. Of course the firm underwriting obligation is undertaken against a fee (usually 1% of the amounts involved) covering the bank for the risk of not being able to place the shares. Typically bankers will then make this obligation subject to a MAC clause (e.g. a major event causing distortion in the market) and in practice will delay actual signing as long as possible. If for any reason the IPO is unlikely to succeed in the market, it is often better policy to call it off and start again at a later date rather than end up with several bankers unwillingly holding large chunks of the stock. Firm underwriting is therefore often more psychological (comforting the market that the bankers were willing to take the risk), and when the market is bullish some issuers avoid the cost of firm underwriting.
Book building is the exercise pursuant to which, between the time marketing starts and the actual IPO, bankers obtain commitments mostly from institutionals to buy stock, subject to the IPO taking place. This further reduces the banks' risk but those investors' obligations will themselves be subject to MAC and other clauses.
Bankers often negotiate a "green shoe option" (so named for the company, Green Shoe, which first used the approach in the US). This means allowing for an additional tranche to be placed in the market if the market is very bullish about the share. The market practice used to be that the gain on those additional shares would go to the bankers, but now issuers make sure that gains on the exercise of the option go to the issuer or the selling shareholders.
In the framework of the mandate, bankers may ask for representations and warranties from management and the board of the issuer, further insulating themselves against risk. They may also impose lock-up restrictions on the controlling shareholders.

1.4.6 Marketing

For larger issues, the securities to be offered in the framework of an IPO will be marketed in the larger financial centres throughout Europe. Smaller issues will be marketed domestically. The whole process involving private meetings with important institutionals ("one-to-ones") and "road shows" are usually extremely demanding on senior management who are sometimes given special training in order to live up to their role and the expectations of sophisticated investors.

1.4.7. Allocation

Allocation has now become part of the marketing strategy and is becoming more transparent. The marketing strategy will basically be about how to allocate between institutional and private investors, whether to provide a separate tranche for personnel (with or without a discount) or to other groups of potential investors with particular interest in the company (e.g. franchisees, subscribers to services).

1.4.8. Price setting

Price setting must generally be such that it allows for some (but not excessive) price increase during a period following the IPO. The expectation of a quick gain is the carrot that should attract investors. But, ultimately, it is the market's long-term interest in the share that must be sought.
Pricing in the framework of an IPO is an art rather than a science and requires a good reading of the market.
Pricing can be achieved by a variety of methods but they are basically variations on two themes: either the price is set by the bankers on the basis of their analysis or the price is set by the market itself by obtaining commitments from potential investors as to the price. In the latter case, one picks the price at which the full issue is taken up.

1.4.9. Admission to the market

The next step in the process is the formal admission by the market authority and the choice (by the market authority) of the market segment.

1.4.10 The after market care

The investment bankers' role is not finished after the IPO. Bankers and brokers will be called on to act as specialists in respect of the shares or as market maker, depending on whether the stock market is organised as "market-driven" or "order-driven". Investors require financial services for trading in the share and e.g. for the payment of dividends.
It is essential that the market be informed regularly and objectively about the company. This research and analysis has traditionally been and still is supplied by the banks who "sponsored" the IPO.
This is, potentially at least, a field where conflicts of interest abound. Between the commercial side of the bank and the analysts, there are or should be "Chinese walls" ensuring objective analysis. In the US in particular (but not only in the US), the effectiveness of these Chinese walls has been criticised in the wake of analysts continuing to show confidence in stock performance when, pursuant to "adverse events", they (at least arguably) should have known better. In the US, there is now a drive to finance totally independent organisations supplying analysis to the market.

A second set of potential conflicts arises from analysis being unavoidably based, at least in part, on communication with the company's management. As market communication is strictly regulated with a view to ensuring that there is "a level playing field" for all investors, there is always a risk that the thin line is crossed between background information, which is not covered by those regulations, and material new information, which must be disclosed in the proper way. It is the job of investment relation officers to build a "rapport" with the media and analysts. This rapport may be entirely professional or may become "incestuous". I never cease to marvel at how intelligently analyst can predict the future… often better then the relevant board. The Commission recently decided that at this point it has enough means to monitor analyst behaviour (via MIFID). Rather then new law the Commission appears to be willing to promote a code of conduct and to rely an “investor education”. I am sceptical!
On the legal side, the company will have to build its systems in order to function well in its new regulatory and legal environment. It will have to organise itself to avoid the risk of insider trading by its directors, officers or employees (with the resulting reputational damage to the company), satisfy the transparency requirements in respect of its shareholders, and arrange general meetings, board meeting and its governance in general.

2. THE LEGAL AND REGULATORY ENVIRONMENT OF LISTED COMPANIES

2.1 Basic aims

The essential purpose of the regulation of listed companies is to ensure <u>a "level playing field" for all market participants</u> and thereby <u>general confidence</u> in the markets without which they cannot function well. Regulations aim to require listed companies to provide timely, correct and relevant information, thereby permitting <u>investors to make an educated judgment</u> about their investments.
In this respect, the keyword is "<u>transparency</u>" in terms of strategy, financial statements, management composition and the like. In addition, to avoid market distortion, that transparency must be achieved in such a way that all market parties are informed at the same time.
These attempts at transparency must, however, be carried out with <u>due regard</u> for the <u>corporation's competitive requirements and in</u> the recognition that the company's competitors may not be subject to similar transparency obligations. Competitors may be listed in less demanding jurisdictions or may not be listed at all and not be subject to any disclosure. Competitors may be a division of a larger entity and little or no "sensitive" information about that division may be available. Transparency, accordingly, must be "adequate" and market requirements and competitive strategy must be balanced at all times. Securities laws usually allow for some withholding from the market of information that would seriously harm the company.
There is no doubt that the number and importance of accounting and auditing scandals have greatly affected the level of confidence of the investment community. Few of the main players have been spared and those accused of wrongdoing include senior management, boards, auditors, investment bankers, analysts, strategy consultants and lawyers. As always, a crisis will spur new regulation as it has done in the US with the Sarbanes-Oxley Act and various legislative and other initiatives in Europe.
The reality is that whatever the sophistication of the control and the supervisory environment, the driving factor in the proper conduct of business is ultimately <u>the integrity of management</u>, particularly senior management (the “tone at the top”). We should be wary of systems that test that integrity to the limit and should see proven integrity as an absolute condition for selecting senior management. Apart from companies listed on a stock exchange or otherwise traded in a

public market (like in public auctions or over the counter), companies which have issued security other than shares (e.g. bonds or commercial paper) to the public will be subject to certain requirements, but not all of them. Some rules that apply to listed corporations may also apply to companies whose shares are widely held (more than 50 persons), for example, by descendants of the founder, which is the case in Belgium. The rules discussed below are only those that apply to listed corporations.
Basically, those rules relate to:

(i) periodic reporting to the market (quarterly or half-yearly, and yearly) and publication of an annual report providing for financial, strategic and corporate governance information;
(ii) occasional information requirements: the requirement to publish in a certain way information that is material and is likely to influence the list price;
(iii) information disclosure required by corporate law (e.g. certain decisions of the board relating to specific action undertaken by it);
(iv) procedural and substantive matters concerning a voluntary or mandatory public bid;
(v) informing the market of significant changes in shareholder positions (in application of the Transparency Directive).

2.2 Transparency of shareholding

The directive on the subject was implemented with significant variations in the various member states. It provides that the market must be informed of parties increasing their stake in the company above or reducing it below certain threshold (usually 5%). The parties who do so are required to inform the company and the market and to indicate whether they intend to merely invest in the company or whether they have wider aims (including a possible take-over).
"Parties acting in concert" (i.e. parties who act together, including their agents or intermediaries) are treated as a single party for the purpose of calculating thresholds. In short, the actual association of parties count, not the separate legal identity of the different parties.
The purpose of this directive is to make the market aware of who the large shareholders of the company are and what their strategy is regarding their participation, and to warn the company of possible take-over initiatives. The "quality" of certain market players is relevant information for investors and the yearly report must include a survey of all information known to the company concerning significant shareholders.

2.3 Periodic and occasional information disclosure

The "occasional" information relates to material matters that are relevant to the formation of the list price. The purpose is to ensure a "level playing field", i.e. that all investors and the market receive material information simultaneously and in a timely manner. This information includes matters of relevance to the publicly held securities themselves (issue of new securities and the like) and information concerning strategic and other developments of the company itself.
At times a delicate balance must be achieved between properly informing the market and not putting the company at a disadvantage. In particular, problems arise in respect of intended acquisitions where, as long as the contract is not "written in stone", it is normally in the company's interest to keep the information under wraps. However, preparing a sizeable acquisition needs the involvement of many people, including some third parties involved with the target or the acquirer. The rules are now changing to the effect that parties may withhold relevant information in the interest of the company “at their risk”, must inform the authority and inform the market fully and correctly if there are leaks. Disclosure can be disadvantageous to the company itself, as potential competitors will be aware of the company's intention, and to the

target, given the likely negative effect on customer and employee loyalty while the transaction remains uncertain. Finally, media attention on acquisitions is usually quite high, and investors may remember only the title of the article without appreciating that the transaction is far from certain. Accordingly some level of speculation is unavoidable with a possible negative effect on the stock if the transaction does not go through. Again, there are no simple ways to resolve these difficult situations.
Problems may also arise from conflicting requirements in terms of informing the unions (whose respect for confidentiality cannot always be counted on) and maintaining a level playing field for the market. This is not helped by the variations from one country to another in timing and level of involvement of employee representation.
In Europe there is still considerable resistance to the move towards full quarterly reporting especially with smaller corporations. It is felt that this burdens the company unnecessarily with information requirements and induces short-term thinking and behaviour. In the US in particular, quarterly reporting is said to induce practices detrimental to the company, for example, by creating pressure to book unfavourable contracts just before or at the end of a quarter to "make the numbers". Predating a contract to make it "belong" to a previous quarter is clearly fraudulent. Recently another, apparently frequent, fraudulent practise in the US consisted of predating stock options, thereby eliminating all or part of the risk of taking options for compensation.

2.4 Insider trading

The rules prohibiting "insider trading" have the same objective as those relating to disclosure of material information and reporting. They are basically inspired by a desire to ensure that all market participants have the same level of knowledge permitting them to make “educated” decisions about their position and accordingly whether to buy or sell securities. Insider trading usually applies to all types of securities, whether they are shares, bonds, options or futures.
Generally speaking, privileged information is information that, if known to the market, would influence the share price.
All persons holding privileged information are deemed to be insiders, whether they are primary insiders (e.g. management or board members) or secondary insiders (i.e. people who have been tipped off by primary insiders).
Basically, as long as the privileged information is not "in the market", insiders are prohibited from dealing in securities.
Breaching insider rules exposes the person in breach to criminal and administrative sanctions (like media exposure) and fines (usually a multiple of or forfeiture of the gain achieved through the transaction). The discovery of insider trading usually occurs after "tracking" by the market authority that uncovers atypical movements, and is enforced through judicial action. Increasingly "civil fines" or administrative sanctions are provided for, given the difficulty of proving criminal behaviour and the length and expense of the criminal process.
For the company whose shares have been dealt in breach of insider trading rules, there is also usually a fair measure of reputational damage. Companies therefore try to ensure compliance with insider trading rules through protocols. Typically these protocols:

(1) provide that insiders can only deal in shares after having been permitted to do so by an independent and objective person, usually somebody who knows the law and can assess the risk based on a knowledge of the corporation; or
(2) set out detailed systems, for example, allowing dealing in the shares only in the absence of a prohibition from doing so and during certain periods after periodic information has been given to the market (known as "windows").

Whether to allow a transaction involving insiders is often a difficult decision. Managers and members of the board always have an advantage over the market in dealing with shares in the company that they direct. They can anticipate with some precision the company's earnings several quarters in advance. Roughly speaking, whatever the precision with which the company has communicated with the market, managers and members of the board are always privileged. There are economists who say that insider trading rules are "uneconomical" and that insiders drive the stock in the proper directions. They argue that the laws are based on ethical sensitivities that have no economic substance, a very debatable position.
The rules concerning trading by insiders, which is not necessarily insider trading as prohibited by the law, are tightening. The requirements in the US and in the EU are that insiders must disclose all their share transactions to the market and similar (non-binding) obligations are written into voluntary codes and a list of insiders must be provided to the authorities (and updated). There are even some commentators in the US who suggest that insiders should not be permitted to sell securities of the corporation which they direct until say two years after they have left their job or insider position.

2.5 Conflict of interest

Conflicts of interest arise when a person is called upon to decider or participate in a decision (e.g. as a board member or manager) or in providing advise (as a lawyer or an analyst or a rating agency), while that some person for a variety of reasons (financial reward, family bonds, past occupation, commercial favours, civil servant position, interest in an other corporation) may be induced or seen to be induced not to act exclusively in the interest which the person is called upon to serve.

In a capitalist society conflicts of interest are unavoidable to quite an extend.

Basically I distinguish three situations;

(i) structural “no go’s”: these are situations where the conflict simply may not access and the only solution is to prohibit e.g. that auditors serve as directors or consultants, judges double as advisors, analyst invest in the shares which they analyse, lawyers advise on opposing interests, civil servants serve as directors in fields in which they have prudential responsibility…

(ii) “unavoidable risk”: these are situations which may arise but are impossible to predict. Director of company A may find him or herself to be a director of company B on which company A wishes to acquire. Majority shareholder X may have an opposite interest to that of the company which he controls. A director may have conflicting personal loyalties when called upon to decide whether a CEO should be fired.
In these situations there are no hard and fast rules. The range of options include not participating in the discussion, abstaining in the decision making, seeking independent advise (like a “fairness opinion of an investment bank”) or resigning from one or both positions.

Beyond the “technicality” of the decision itself “reputational effects” must be addressed in respect of the person and the company. Resignation may be seen as an admission of guilt… without possibility for redress.

(iii) the “negative perception risk”: business persons are human and accordingly have friendships, sympathies… Networking is an essential part of “doing business”. In a

mediatised conflict, journalist will seek to establish real or invented plots and patterns of mutual support, often to the surprise of those allegedly involved. In those situations independent confirmation of one kind or another of the decision which is challenged is advisable but once the perception is created, the only real solution is … to let the commotion fade.

2.6 Corporate obligations

Corporate law codes contain several obligations for listed corporations concerning their dealings with shareholders. There are specific rules about advance information to shareholders on decisions that will be made subject to their approval (e.g. proposed dividend distributions and proposed appointments to the board). Elaborate rules exist on proxy solicitation, the organisation of shareholders' meetings, voting and the like.
Further elaborate rules exist for public tender offers concerning both the information of shareholders (strictly supervised by market authorities) and board behaviour. Corporate law also determines what action the board and shareholders can take to defend the company against a hostile bid. As indicated in other sessions, the menu is very extensive in certain countries and quite limited in others (like Belgium).

3. PUBLIC TENDER OFFERS

3.1 Scope of the law

The law on tender offers is substantially national law. The Take-over Directive ("TOD") basically reflects the Commission's failure to get member states to agree on a single set of rules. The "level playing field" in this respect is unlikely to be achieved in the foreseeable future.
Broadly speaking, most matters dealt with by the TOD are already covered by national law and given that member states have much latitude in implementing the directive, little must or will change.
There are a few exceptions. As a result of the TOD, all member states will have to provide for a mandatory bidding for all shares if a change of control occurs, however that may be defined nationally. Normally if one crosses (alone or with others) the 30% thresh hold that will be deemed to be the case. For example, the Belgian requirement that for such an obligation to apply a control premium must have been paid, has been eliminated. All member states will have to provide for squeeze-out and sell out procedures.
The TOD was especially awaited for achieving a "level playing field" concerning the permitted "level of defence" against hostile bids. The catalogue of "poison pills" or outright "impregnable walls" varies from one extreme to another in the EU.
The "breakthrough" approach in the TOD essentially provides that (i) the shareholders alone should <u>decide</u> about a hostile bid, with the Board playing only an advisory role and (ii) for that purpose, all shares are treated equally *ceteris paribus* (i.e. multiple voting is out, voting restrictions are lifted, etc.).
However, the "breakthrough rules" were only accepted politically on the condition that member states can "opt out" of them or can make them conditional on the member state where the bidder is headquartered <u>not</u> having opted out. I am reviewing which member states accept "breakthrough" and if so, on what conditions.
The TOD also intends to regulate which authority is competent and which law applies if, for example, dual listing occurs or a listing occurs outside the country of incorporation.

As the deadline for implementation has now arrived, all member state laws on the subject should now be compliant with the TOD.

Basically, national laws address three types of situations:

(i) tender offers which aim to wrest control of the company away from those holding it;

(ii) tender offers for a limited number of shares, e.g. not exceeding 10% of the outstanding securities, with no intention to obtain control of the company;

(iii) mandatory public offerings, i.e. tender offers imposed by law on entities or persons who have acquired control either by buying out a controlling shareholder in a private transaction or by acting on the market.

3.2 Voluntary offerings

Voluntary offerings (i.e. those that are not required to be made) are subject to detailed rules. They usually provide for a secret phase, when the offer is typically submitted to the supervisory authority for approval, and a public phase, during which the board of directors of the target must advise on whether in its view the bid is of interest to the shareholders and the actual bidding process takes place. Usually, a public bid can only be made if a registered intermediary (usually a bank) ensures that the money needed to pay out the selling shareholders will be available. The offer can be conditional on, e.g. obtaining at least 50% of the shares and thereby obtaining control of the company or unconditional, whatever the number of shares offered.

For that purpose, the bidder will have to submit a prospectus to the supervisory authority containing all relevant information about the bid. In principle, although it does not have the power to determine the price offered, the supervisory authority will verify whether the bid can succeed. If it cannot, approval will be withheld, to avoid unnecessary distortion of the market.

Public bids can become very complicated if the offer is made not for money but for securities of the bidder (an exchange offer, i.e. an offer to exchange shares in the target for shares in the bidder). In this case, representations and warranties and due diligence will be required in order to ascertain the value of the securities offered for exchange.

The board of the target will be asked to advise the market whether they approve or disapprove of the bid and whether they will tender the shares that they own in the target. A board always has a fiduciary duty to provide this advice objectively in the interest of the company and all shareholders. This can be tricky when the bid provides a premium over list price to the shareholders but the transaction is seen as disadvantageous for the other stakeholders, in particular the employees.

Once the tender offer is made, it cannot be withdrawn (unless it was conditional on events that do not take place). Once the offer is made public, it can attract counteroffers from other bidders. Usually the counter bid must be substantially higher, typically at least 5%.

Various "reopening" rules apply if the tender offer succeeds in attracting a large percentage of the shares, essentially giving those shareholders who have refused to tender a second chance because the tender offer was successful.

Further, if the bid is successful for say 95% of the shares, the bidder will be able to "squeeze out", i.e. require the remaining shares to be tendered. In that case, the supervisory authority will verify whether the price offered is fair, since the shareholders in this case have no choice but to agree to sell their shares and there may not be a relevant market price. Squeeze-outs are necessary to permit public to private transactions and to delist the company.

3.3 Change of control and compulsory offerings

In substance, if there is a change of control, i.e. when a set of controlling shareholders is replaced by another one, pursuant to the TOD member state law requires or will require the new controlling shareholder to make a public offering providing an opportunity to all investors to sell.
A change of control can occur in different ways. The most common one is when, as the result of a voluntary offer, a corporation obtains a controlling block whereupon it may be required to re-open its bid in order to provide another opportunity for the remaining investors to sell. On the Continent, a change of control usually occurs when an existing controlling shareholder or group of shareholders sells its controlling block to a corporation. Finally, a change of control may occur because existing shareholders enter into arrangements pursuant to which they are deemed to act in concert or existing shareholders "creep up" to a position which is, or is deemed by law to be, a position of control.
Under the TOD, the acquisition of a controlling block of 30% of all outstanding shares by any means is deemed to be a change of control triggering a mandatory offering. The thrust of this law is to ensure that the control premium is shared amongst all investors willing to sell.
In general, the purpose of this law is to permit investors to reconsider their position given the effect that a change of control may have on the company's strategy, expectations and future.
The definition of "control" for the purposes of this law is usually quite wide and certainly extends far beyond a showing of 50% + 1 of the shares. It includes indirect control or joint control. As explained above, control may include a shift in control and in certain circumstances a consolidation of existing control.

3.4 Squeeze-out bids

As noted above, corporations may decide that being listed is no longer in line with their strategy. This may be because of an attractive valuation, low growth expectations or, as is increasingly the case, a reaction to more demanding regulation.
As it is never possible to recover all outstanding shares through a public bid (shares get lost, burned etc.), member state laws allow for a "squeeze-out" for the remainder of the shares if in the framework of a voluntary bid, the bidder has obtained almost all the shares, e.g. 95% of them.
In a squeeze-out bid, investors have no choice but to tender their shares for the price offered. Since they have no choice, the supervisory authority will verify whether the price is fair. Member state laws provide for the price corresponding with the shares that are not tendered to be paid on a blocked account. After a certain period, this money will either accrue to the corporation or be paid to the state treasury.

3.5 Fairness opinion

In many types of bid situations the authority may require that the Board of the target or that the bidder seek (in order to guard against liability) a “fairness opinion”, i.e. an investment bank confirming that the price is fair.

CONCLUSIONS

In the US, the complexities of financial law is driven by the depth and detail of the regulations, which are constantly changing, the litigious environment, which sees the class action bar sue "deep pockets" and use any incident as an excuse, and a highly sophisticated and increasingly assertive SEC. There is no doubt that Sarbanes-Oxley has added enormously to the requirements of companies to document their governance and control measures.

In comparison, the complexities in the EU come from continued fragmentation, the need to be listed on several stock exchanges and in different markets and the widely different securities and corporate laws applicable to issuers, although gradually progress is made.

The European Union has been criticised, and to some extent rightly so, for not offering enough of an entrepreneurial environment for business. Part of that environment is the existence of a well functioning, highly liquid and truly European equity market. In this respect, one can now look forward, within say 10 years, a level playing field facilitated by pan-European equity raising and risk attribution.

In respect of equity, Europe is improving its game and may achieve competitive parity with the US in a not to distant future.

It is essential that in this process there remain room for two separate models: the autonomous corporation with high liquidity and more short-term shareholder value and the "European" model with significant or controlling shareholders (the only equity providers that we have in large measure) with lower liquidity but more long-term and stakeholder orientation. Both models have advantages and disadvantages. It is important to recognise them and to address them in the actual governance of individual corporations.