

**EUROPEAN SHADOW FINANCIAL  
REGULATORY COMMITTEE (ESFRC)**

# STATEMENT NO. 21 DEREGULATING CORPORATE FINANCE IN EUROPE

The European Shadow Financial Regulatory Committee is a group of 13 professors and other independent experts drawn from across Europe. Chaired by Harald Benink, who is a professor of finance at the Rotterdam School of Management of Erasmus University Rotterdam and who is a senior associate to the Financial Markets Group of the London School of Economics, the Committee meets three times each year to discuss issues in financial regulation and to issue policy recommendations.

## **1. Deregulating Corporate Finance in Europe**

The European Commission's Action Plan on Company Law and Corporate Governance adopted in 2003 takes the view that harmonization is beneficial for the completion of the single market. In this statement we argue that the need for harmonized rules must be clearly identified before any common rules are adopted or retained. Specifically, we recommend that the Second Company Law Directive, which harmonizes the rules on legal capital and pre-emption rights, be repealed. To the extent there are national preferences for such rules, it is consistent with the principle of subsidiarity to leave such legislation to EU Member States.

The 1976 Second Company Law Directive regulates the basics of corporate finance. Largely following the German model, it established a comprehensive regime of "legal capital" applicable to stock corporations, but not to private limited

liability companies. In addition to imposing capital formation and maintenance rules designed to protect creditors, the Directive requires companies that increase their capital to distribute to their shareholders pre-emption rights allowing them to acquire newly issued shares.

The Directive was adopted at a time when the U.S. Model Business Corporation Act eliminated legal capital and of mandatory pre-emption rights as useless devices burdening corporate activities with unnecessary costs. It took some time before this message was received in Europe, but dissatisfaction with the rigid rules imposed by the Second Directive has finally led the European Commission to consider its reform. The working group established under the 1996 Simpler Legislation for the Internal Market (SLIM) initiative, as well as the "High Level Group of Company Law Experts" set up by the Commission in 2001, have recommended change. Acting upon these recommendations, the Commission has proposed in October 2004 the relaxation of the Directive's requirements regarding the valuation of assets contributed to pay for new shares, pre-emption rights in case of capital increases, a company's financial assistance to third parties acquiring its shares, and the company's acquisition of its own shares.

The Commission's proposals are in line with the conclusions of the 2004 Rickford Report, drafted by an interdisciplinary working group established by The Accounting Standards Board and the British Institute of International and Comparative

Law. The Report concluded that the existing EU regime “is not widely relied on in practice by creditors, is complex, expensive and anomalous, producing inconsistent results as between companies within Member States and between different Member States within the EU”.

The ESFRC welcomes the Commission’s proposals. However, for the reasons mentioned below, the ESFRC finds that these proposals do not go far enough and that the Second EU Company Law Directive could be dispensed altogether.

## **2. Mandatory Legal Capital Rules**

Legal capital rules have a price. They slow down the raising of equity capital, they burden the companies with avoidable costs, and they hinder useful corporate activities. For example, restrictions on the repurchase of shares can disadvantage European corporations when they have to compete on trans-national markets. It has also been argued that venture capital financing is discouraged by not allowing entrepreneurs to obtain equity capital against the promise of future services.

The Second Directive is generally defended as a device for the protection of creditors: the mandated capital should provide a “cushion” reducing the risk of default. However, European creditors, like their US counterparts, are protected by alternative means. To further explain this point it is useful to distinguish involuntary from voluntary creditors. Involuntary creditors are victims of torts like patent infringements or the disregard of required safety measures. It is generally agreed that these creditors should be fully compensated. Should neither corporate funds nor liability insurance provide adequate protection, torts victims are allowed to recover from shareholders and/or managers. Voluntary creditors, particularly financial institutions like banks or leasing firms, enjoy an increasing inventory of contractual safeguards. They can ask for the personal commitment of shareholders and/or managers or for collateral (mortgages, pledges).

They can require the corporate debtor to respect financing restrictions like limitations on distributions to shareholders. They can abstain from extending credit and they can price their credit risk by requiring an appropriate rate of interest; it will be lower for a well financed than for an undercapitalised firm. Information problems can be solved by credit ratings and other instruments.

## **3. Mandatory Pre-Emption Rights**

Mandatory pre-emption rights are often justified as a way to protect existing shareholders against the dilution of the value and the voting power of their investment. On the other hand, mandatory pre-emption rights burden corporations and their shareholders in various respects. They complicate and lengthen the process of issuing stock: a company wishing to raise equity capital has to distribute pre-emption rights to its existing shareholders, then allow a trading period and thereafter exchange the newly created shares against the pre-emption rights and the cash contributions. This procedure requires several communications to shareholders, creates odd lots, and generates the need for advice to the beneficiaries of the pre-emption rights. In the end the cost of capital may increase as a result of the imposition of pre-emption rights. Thus, these rights can become a cure for an ill they have themselves aggravated.

Pre-emption rights can also be a burden for international securities transactions. The issue of pre-emption rights is a public offering which can trigger the obligation to register with the securities regulators. This situation will either cause considerable costs for the issuer or generate unequal treatment between shareholders.

## **4. Leaving Room for Regulatory Competition**

In some Member States it is still assumed that mandating legal capital and pre-emption rights serves a

useful purpose. By contrast, other Member States would prefer to be able to adopt a regime more like the American system. There is no reason to prevent Member States from shaping corporate finance rules to best suit their respective needs. This is already true for private limited liability companies, for which there are no harmonized European rules. Countries like the UK can follow a liberal approach, and countries like Germany can retain their complex regimes of mandated legal capital. These differences have not been shown to be the cause of any harmful effect. The uncertainties about the EU-wide benefits of legal capital and pre-emption rights requirements indicate that there is no need for a harmonized approach. Legislative competition appears superior to regulatory harmonization in this area. Hence, the ESFRC recommends to repeal the Second Directive as a whole rather than engaging in piecemeal efforts to modify some of its provisions.

The ESFRC currently consists of the following 12 members, coming from 10 European countries and from the United States:

*Harald Benink*

(Erasmus University, Rotterdam, The Netherlands & FMG/LSE)

*Tom Berglund*

(Swedish School of Economics and Business Administration, Helsinki, Finland)

*Franco Bruni*

(Bocconi University, Milan, Italy)

*Philip Davis*

(Brunel University, London, United Kingdom & FMG/LSE)

*Hans Geiger*

(University of Zurich, Switzerland)

*Friedrich Kübler*

(Johann Wolfgang Goethe University & Clifford Chance, Frankfurt, Germany & University of Pennsylvania, Philadelphia, United States)

*Karel Lannoo*

(Centre for European Policy Studies, Brussels, Belgium)

*Rosa Lastra*

(University of London, United Kingdom & FMG/LSE)

*Reinhard H. Schmidt*

(Johann Wolfgang Goethe University, Frankfurt, Germany)

*Benn Steil*

(Council on Foreign Relations, New York, United States)

*Niels Thygesen*

(University of Copenhagen, Denmark)

*Clas Wihlborg*

(Copenhagen Business School, Denmark)