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Proposal for Directive on transparency requirements for listed companies and proposals on country by country reporting – frequently asked questions

The European Commission has proposed amendments to the existing Directive on transparency requirements for listed companies and to the Directives on accounting rules for annual accounts and consolidated accounts, inter alia to introduce country by country reporting, as part of a Responsible Business Initiative package of measures (see IP/11/1238).

1. What are the existing EU rules on transparency for listed companies?

The existing Transparency Directive (2004/109/EC) requires issuers of securities traded on regulated markets within the EU to ensure appropriate transparency through a regular flow of information to the markets. This information consists of:

(i) yearly, half-yearly and quarterly financial information;

(ii) on-going information on major holdings of voting rights and

(iii) *ad hoc* information disclosed pursuant to the Market Abuse Directive (for example: inside information has to be made public as soon as possible to the market under the conditions of the Transparency Directive).

2. Why is the Commission proposing to modify the existing Transparency Directive?

1. The existing Directive foresees a number of notification thresholds for acquirers when they reach a certain stake in a listed company. However, the current rules contain ***a notification gap***: holdings of certain types of financial instruments that can be used to acquire economic interest in listed companies without acquiring shares are not currently covered by the Directive's rules for disclosure. This was much less of an issue in 2004 when the existing Directive was adopted. But it can eventually lead to secret stake-building in listed companies with a view to acquire significant influence which in turn can give rise to possible market abuse situations, low levels of investor confidence and the misalignment of investor intentions with long-term interests of companies.

There are several reported examples of such behaviour, such as the recent "LVMH"/Hermes case. Louis Vuitton Moët Hennessey ("LVMH") announced in October 2010 that it had built a 17.1% stake in Hermès International at a purported 50% discount by using cash-settled equity swaps, without any previous disclosure of its holdings of such instruments. Consequently, LVMH acquired significant interest in Hermes without Hermes and the market being aware. This created an information asymmetry with possible incorrect market pricing of the underlying Hermes shares.

2. In addition, some of the current transparency requirements result in a disproportionate ***administrative burden***: the requirement to publish quarterly financial information contributes, in particular for small and medium-sized issuers, to the high costs of compliance linked to listing on the regulated markets. This requirement is also perceived as a regulatory incentive encouraging the culture of short-termism on financial markets.

3. What are the main elements of the proposal to modify the Transparency Directive?

1. In order to close the existing gap in the notification requirements, the proposal to modify the Transparency Directive would require **disclosure of major holdings of all financial instruments that could be used to acquire economic interest in listed companies** and had the same effect as holdings of equity.

The proposal would also provide for more harmonisation concerning the rules of notification of major holdings in particular by requiring aggregation of holdings of financial instruments with holdings of shares for the purpose of calculation of the thresholds that trigger the notification requirement.

2. In order to reduce the administrative burden and to encourage long term investment, **the requirement to publish quarterly financial information would be alleviated**. Companies could of course continue to publish quarterly information on a voluntary basis if they wished to.

4. Would the requirement to publish quarterly financial information be abolished for all the companies listed in the EU markets?

In order to reduce the administrative burden linked to listing on regulated markets and encourage long-term investment, the requirement to publish quarterly financial information [this covers both interim management statements and quarterly reports] would be abolished for all listed companies. For the sake of efficiency and in order to provide for a harmonised regime for disclosure, Member States would not be allowed to continue to impose such an obligation in their national legislation. Listed companies would have the discretion to publish quarterly information if they so desired.

5. Would suppressing the requirement to publish quarterly financial information reduce the transparency in the market and damage investors' protection?

A thorough impact assessment was carried out before deciding on this option. Its results show that quarterly financial information is not necessary for investors' protection even if it can provide useful information for some investors. Investor protection is already sufficiently guaranteed through the mandatory disclosure of half-yearly and yearly financial results, as well as through the disclosures required by the Market Abuse Directive.

In addition, quarterly financial information as currently required by the Transparency Directive is not prepared according to the accounting standards and therefore this information might not offer adequate quality nor give sufficient assurance to investors. Information disclosed is also not easily comparable at the EU level.

6. What is the objective of the proposed country by country reporting requirement in the Transparency Directive?

The proposals to amend the Accounting Directives (78/660/EEC and 83/349/EEC) would introduce a new obligation for large extractive and logging companies to report the payments they make to governments (the so called country by country reporting-CBCR). Reporting would also be carried out on a project basis, where payments have been attributed to specific projects. The existing Accounting Directive regulates the information provided in the financial statements of all limited liability companies which are registered in the European Economic Area (EEA).

The same country by country requirement has been incorporated in the proposal to revise the Transparency Directive in order to include all companies which are listed on EU regulated markets even if they are not registered in the EEA and incorporated in a third country.

See specific questions on country by country reporting at the end of this memo (from question 13 onwards)

7. What would be included in the new definition of financial instruments covered by the disclosure requirements?

In order to close the existing gap in the notification requirements, the proposal to modify the Transparency Directive would require disclosure of major holdings of all financial instruments that could be used to acquire economic interest in listed companies and have the same effect as holdings of equity.

The definition of financial instrument would be broadened to cover all instruments of similar economic effect to holdings of shares and entitlements to acquire shares, whether giving right to a physical settlement or not. It would cover cash-settled derivatives (a derivative contract where one party holds a long position and the other party holds a short position in a particular stock, with any nominal value difference at maturity settled in cash) as well as other similar financial instruments not yet available on the markets but which could be the result of future financial innovation.

The proposed new definition focuses on the economic effect of a financial instrument rather than enumerating the types of financial instruments covered. The general principle of notification of all instruments of similar economic effect to holdings of shares and entitlements to acquire shares would be subject to exemptions in order to avoid providing the market with irrelevant information and spare notification costs for market players which by definition should not exercise any influence on voting policies or acquire a secret stock in the underlying company. The European Securities and Market Authority (ESMA) would be responsible for developing draft technical standards to adapt the existing exemptions if necessary.

The holdings of financial instruments would be calculated taking into account the nominal amount of the underlying shares.

8. What would be the rules for aggregation of holdings of shares with holdings of financial instruments?

In order to provide a sufficient level of transparency with regard to major holdings, holdings of financial instruments would be aggregated with holdings of shares for the purpose of calculation of the thresholds that trigger the notification requirement.

However, to avoid any confusion as to the nature of holdings, the holder of shares and financial instruments would have to specify separately the amount of holdings of shares and the amount of holdings of financial instruments in its notification.

9. Does the proposal provide for maximum harmonisation of the thresholds for notification of major holdings?

Taking into account the differences of ownership structures in listed companies in different Member States, it did not appear appropriate to harmonise the thresholds for notification of major holdings and to prohibit Member States from setting lower thresholds for notification in the proposal. Consequently, Member States with dispersed ownership of listed companies would continue to be able to set the lower thresholds than those provided for in the Transparency Directive.

10. How would the system of storage of regulated information be modified?

The Transparency Directive requires each Member State to establish a storage mechanism to ensure access of the public to regulated information. However, access to such information on a pan-European basis is currently complicated: interested parties need to go through 27 different national databases which are not sufficiently interconnected. The lack of a centralised storage system is thus a major barrier to the functional integration of European securities markets, and the creation of an effective pan-European marketplace for capital. It can also be a barrier for cross border visibility of small listed companies.

For this reason, it is proposed that the European Commission receives further delegated powers in this respect, in particular regarding the access to regulated information at the Union level. ESMA would assist the European Commission by developing draft regulatory technical standards concerning, for example, the operation of a central access point for the search of regulated information at the Union level. These measures would also be used to prepare for the possible future creation of a single European storage mechanism which could ensure storage of regulated information at the Union level.

11. What would be the proposed sanctions for breaches of the requirements of the Transparency Directive?

Following the European Commission Communication on Sanctions in December 2010 (see IP/10/1678), today's proposal would require Member States to provide that appropriate administrative sanctions and measures could be applied if violations of the Transparency Directive were identified. The lack of sufficient sanctions had been identified as one big weakness in the wake of the financial crisis in 2008. The proposed rules mirror those in the approach taken recently in the revisions of the Capital Requirements Directive IV (MEMO/11/527) and the Markets in Financial Instrument Directive.

The revised Transparency Directive would require Member States to adopt common minimum standards on:
types and addressees of sanctions;

- the level of fines;
- the criteria to be taken into account by competent authorities when applying sanctions;
- the publication of sanctions.

These provisions would be without prejudice to the provisions of national criminal law.

12. Who would benefit from the revised Transparency directive and how?

- Issuers and in particular small and medium-sized issuers would see their administrative burden reduced. A regulatory environment that is more favourable to securing long-term support for issuers would be encouraged.
- The regulatory environment would correspond better to the needs of today's markets and investors. Investors would be better informed about ownership of listed companies.
- Civil society would benefit from increased transparency and could hold government accountable to the revenues received from companies for exploiting natural resources.

13. What Directives are you proposing to revise in order to introduce a country by country reporting system?

The Accounting Directives (78/660/EEC and 83/349/EEC) currently regulate the information provided in the financial statements of all limited liability companies which are incorporated under the law of a European Economic Area (EEA) Member State. These rules will now be revised.

But in order to ensure a level playing field between companies, the country-by-country requirement is also proposed to be incorporated in the Transparency Directive (2004/109/EC). It would include all companies which are listed on EU regulated markets even if they registered in a third country.

14. What is the country by country reporting system proposal about?

The Commission proposes to introduce a new obligation for listed and large non-listed extractive and logging companies to report all material payments to governments broken down by country and by project, when these payments have been attributed to a specific project. The following types of payments shall be reported:

a) production entitlements

b) taxes on profits

c) royalties

d) dividends

e) signature, discovery and production bonuses

f) licence fees, rental fees, entry fees and other considerations for licences and/or concessions

g) other direct benefits to the government concerned

15. What are the main objectives of the proposal?

The proposal aims to improve the transparency of payments made to governments all over the world by the extractive and logging industries. Such disclosure would provide civil society in resource-rich countries with the information needed to hold governments to account for any income made through the exploitation of natural resources, and also to promote the adoption of the Extractive Industries Transparency Initiative (EITI) in these same countries. The information disclosed on payments to governments would be publicly available to all stakeholders either through the stock market information repository or the business registry in the country of incorporation (in the same way as financial statements are made available).

16. What is EITI? How does it compare with the EU proposals?

The Extractive Industries Transparency Initiative (EITI) is a voluntary initiative with the objective of improving transparency and accountability in countries rich in oil, gas, and mineral resources. Once a host country endorses the initiative, the EITI process is mandatory for all extractive industry operators (including those that are state-owned) operating within that country.

An EU mandatory disclosure requirement would complement the EITI efforts by legally requiring companies registered or listed in the EU to disclose payments to governments along the same lines as EITI. In doing so, the EU proposal's ultimate objective is to contribute to the strengthening of the EITI and to extend its scope to all resource-rich countries.

17. Why are you proposing to introduce such a system?

The Commission is responding to international developments in particular the inclusion of a requirement to report payments to governments in the Dodd Frank Act in the United States. The SEC (the Securities and Exchange Commission) is currently working on the implementation rules.

In September 2010, the European Parliament made a request to the European Commission for action in this area. In May 2010, President Barroso publicly expressed the Commission's willingness to propose legislation mandating disclosure requirements for extractive industry companies. A similar pledge was made in the concluding Declaration of the G8 Summit in Deauville of May 2011, where G8 governments committed "to setting in place transparency laws and regulations or to promoting voluntary standards that require or encourage oil, gas, and mining companies to disclose the payments they make to governments." The proposals today deliver on that commitment and help deepen the G8's special commitment to Africa.

18. What types of companies would be required to disclose payments to governments on a country by country basis?

The Commission proposes to introduce a disclosure requirement for payments to governments by **listed and large**[1] **non-listed** companies with activities in the **extractive industry and the logging of primary forests**.[2]

[1] The revised Accounting Directives defines a large company as one which exceeds two of the three following criteria: Turnover €40 million; total assets €20 million and employees 250.

[2] Concession-based logging of natural and semi-natural forests.

Both of these industries are often associated with a great source of wealth in resource-rich developing countries. By disclosing payments to governments by the extractive and forestry industries, communities in resource-rich countries would be better informed about government income from licensing such activity and whether the cost to society from losing the natural resource is adequately compensated.

Targeting both listed and large non-listed companies would create a level playing field in the EU. It reflects the fact that large non-listed companies can potentially make significant payments to governments in the countries in which they operate.

19. How would the proposal benefit stakeholders in resource-rich countries?

In general terms, the reporting of payments to government by the extractive and logging industries would provide civil society with significantly more information on what specifically is paid by EU companies to host governments in exchange for the right to extract the relevant countries' natural resources.

By requiring disclosure of payments at a project level, where those payments had been attributed to a specific project and were material, local communities would have insight into what governments were being paid by EU multinationals for exploiting local oil/gas fields, mineral deposits and forests. This would also allow these communities to better demand that government accounts for how the money had been spent locally. Civil society would be in a position to question whether the contracts entered into between the government and extractive and logging companies had delivered adequate value to society and government.

20. Would such disclosure requirements not harm the competitiveness of EU business?

The Commission's approach is balanced. EU companies would be required to report payments to governments (e.g. taxes on profits, royalties, bonuses) on a country and project basis where those payments had been attributed to a specific project, and with appropriate thresholds. The material critieria would be further defined by the Commission in delegated acts. The reporting on a project basis would be made on the basis of companies' current reporting structures.

Given that some extractive industry multi-nationals have already voluntarily decided to disclose some payments to governments, the Commission considers that the effect on the competitiveness of EU extractive and logging companies would be limited. The system would be reviewed and modified, as appropriate, within five years of coming into force, taking into account *inter alia,* international developments and the competitiveness of EU industry.

21. How do the EU proposals for country by country reporting differ from the US requirements within the Dodd Frank Act?

The EU proposals are broadly similar to the US Dodd Frank Act requirements, but go further in two respects. Firstly, the EU logging industry is within the scope of the proposed reporting requirement in addition to the oil, gas and mining industries (in the US oil, gas and mining are the targeted sectors). Secondly, the EU rules would apply to large unlisted companies, as well as listed companies, whereas the US rules are restricted to listed extractive companies only.

22. Does this proposal include conflict minerals disclosure requirement?

No, conflict minerals disclosure requirements are not covered by the proposal.

The Commission supports the Kimberley Process (Kimberley Process Certification System Certification - KPCS), which requires participating countries to certify that imported or exported rough diamonds are not conflict diamonds. The Kimberley Process has had considerable success, even though there is still scope for improvement in the system (e.g. improvement in controls in some countries).

23. Why would the proposal not require the reporting of payments to governments where it would be a crime to do so?

Some businesses that would be within the scope of the proposed rules have claimed that in certain countries in which they operate it is illegal to report details of what may have been paid to governments by way of royalties, bonuses, taxes etc. A very limited exemption is therefore being proposed in order to protect employees working for such companies from disclosing payments, and potentially being subsequently charged with breaking local criminal law. As a safeguard and to prevent abuse of the exemption, a company would nevertheless have to disclose that it has had to invoke the exemption and name the particular country for which payments information had been withheld.

More information:

http://ec.europa.eu/internal_market/securities/transparency/index_en.htm

http://ec.europa.eu/internal_market/accounting/sme_accounting/index_en.htm

See MEMO/11/730, MEMO/11/732 and MEMO/11/735

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