Law and economics of corporate finance in Europe
– from diversity to convergence and harmonization

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1 Introduction

This paper reports on recent (and not so recent) developments of corporate finance in Europe from a banking and company lawyer’s perspective. After a short recollection of what corporate finance and the law of corporate finance is basically about, I will try to contrast the Anglo-Saxon practice of corporate finance in capital-market-oriented systems to the Continental European tradition of bank-based systems. I will then explain the movement of convergence of the historically distinct systems of corporate finance and the emergence of one universal pan-European system, for which the pace is set and which will in fact constitute a hybrid system of corporate finance with effective capital markets as well as with vital credit markets. Thus, my paper does not claim to be innovative, but informative; my speech pursues merely a reporting and explanatory task.

2 Corporate finance – some basics

Corporate finance means, in essence, the way in which companies finance their business and the way in which the legal order regulates those operations. Theoretically, there are two categories of corporate finance – and many sub-categories. Companies can, firstly, finance their business from their own internal resource, i.e. from the money collected from the founders originally or from earned and retained profits (surpluses). Companies can, secondly, finance their activities by external sources. Sub-category one of external financing is raising money by issuing securities to investors in the market; this is the equity capital option by equity capital financing

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in the form of stocks or other equity rights. Sub-category two is borrowing money from banks and other financial institutions; this is the option of debt capital financing, by which capital is procured by loans such as mortgages, secured or unsecured investments, operating credits and current-account-credits or bonds (debt securities). According to the different options the firms choose for their external finance, the banks offer their different services and instruments.

Corporate finance is by far no longer a subject matter only for business administration people, for financial managers of companies and for bankers. It has gained shape also as a particular field of law: corporate finance law is today a subdivision of banking law as well as of company law, but it involves also the law of securities regulations. With regard to the use of internal resources of finance companies legislation governs; in the field of external resources banking law comes into play. In any case, corporate finance is also a matter for the banking and company lawyers to deal with. At least this is the case in the U.S. and in Europe where law departments of the universities offer even postgraduate LL.M.-courses in corporate finance law¹ and where books on the law of corporate finance are quite common,² which focus on capital formation transactions, fund raising in the capital markets, hedge funds, securitisation, convertible securities, or mergers and acquisitions from the legal point of view.³

It has often been observed and described repeatedly that the Continental European approach to corporate finance has developed, over the last century and particularly after Word War 2nd, in a way decidedly different from the Anglo-Saxon model with has been pursued in the U.K. and in the U.S. as well as in Australia and Canada, but also in South Africa.⁴ As it is the case with

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¹ See e.g. the corporate finance law course descriptions of Professor Ellis Ferran from University of Cambridge: [http://www.law.cam.ac.uk/courses/llm/corporate_finance_law.php?show=video]; see also Prof P.L. Davies and Dr J. Benjamin of London School of Economics on law of corporate finance (course guide): [http://www.lse.ac.uk/resources/calendar/courseGuides/LL/2006_LL437.htm]; Dr Joe Tanega of University of Westminster is the leader of a LLM/MA course on corporate finance law: [http://www.wmin.ac.uk/law/page-294]; see also Professor Anabtawi of UCLA on Corporate Finance: [http://www.law.ucla.edu/home/index.asp?page=100].


³ For finance research in South Africa and for “the state of health of the discipline” see C. Firer, Half a century of finance research in South Africa, Investment Analysts Journal No. 62, 2005, pp. 5 et seq.

corporate governance, corporate finance has, in the post-war period, evolved into two “dramatically different systems”. The Continental European and the Anglo-Saxon model each attribute a different role to banks as intermediaries between the suppliers of capital and those who demand it. The Continental European or credit-market-, respectively bank-oriented approach as well as the Anglo-Saxon or capital-market-oriented financial system each serve external financing requirements of companies, i.e. their needs for external capital or loan procurement. In a macro-economic perspective credit and capital markets withdraw financial means from shrinking or stagnant sectors of the economy and channel them into booming or more promising growing sectors. Although pursuing the same tasks, the Continental Europeans do it, however, in a way traditionally different from that of the Anglo-Saxons. Let us have a closer look at the two different systems.

3 Main features and functions of bank-oriented corporate finance

There is much scholarly, partly law-oriented, partly policy-based literature about the features, advantages, disadvantages, merits or deficits of the two different systems of corporate finance. 


The Continental European approach is called bank-oriented. Germany is often named as the first and foremost exponent. Financial economists continue to point to Germany as a comparatively successful system of bank-centered (as opposed to market-based) system of corporate finance. The other Continental European countries, particularly France, Spain and Italy, traditionally follow more or less this bank-based model. Outside Europe, Japan must be mentioned as a representative of a predominantly bank-based model. Its characteristics are that bank loans constitute the most important means of external financing of companies and the main share of banks’ balance sheets.

According to the bank-oriented system of corporate finance it is the financial services of the banks which steer the process of capital transfer. Banks function as financial intermediaries. They recycle their clients’ funds, savings deposits, investments or bonds into the economy through granting secured or unsecured loans. Make no mistake: also here market mechanisms take place, namely mechanisms of the credit-market. It is, therefore, in order to speak of a credit-market-orientation equivocally to a bank-orientation and in contrast to the Anglo-Saxon capital-market-orientation. The decisive point of the banks’ intermediary activities is, however, that the market mechanisms of supply and demand do not work immediately and directly between the depositors and the companies (as it is the case in capital-market-oriented systems), but only indirectly, namely through the banks as intermediaries.

Although banks are not lending their own money, but that of their depositors, they do so at their own risk and are therefore aiming at long-term client-relationships exceeding one specific lending business. This entails a disciplinary pressure and controlling power on borrowers which tends to unfold a stabilizing effect on a company’s ownership structure and on the price of a company’s shares. Environmental impacts, public interests in the prevention of unemployment and other social responsibilities loom large due to the long-term orientation of the banks’ controlling strategies. Long-termism with regard to the banks’ controlling attitudes and strategies is a key feature of bank-based systems.

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In addition, in bank-oriented systems of corporate finance the depositors bear no legal or factual risk, since it is the bank which grants the loan on its own account and its own risk. The risks of borrower default or corporate failures is, in corporate credit financing, distributed among comparatively few creditors, namely banks, possibly just one company’s house bank or a main bank and perhaps a few other debt capital suppliers or suppliers of goods and services. The company is not confronted with and dependent from a multitude of volatile shareholders. The bank-based system is also a comparatively confidential system in that borrowers can rely on their banks duty of confidentiality and secrecy: client and market information is confined within the banks themselves and will not be disseminated publicly, unless this is required by legal accounting and disclosure standards. Bank-dominated systems are insider systems.

Bank-dominated systems have a clear tendency to cross-shareholding. Moreover, banks are, in countries like Germany, France, Spain or Italy, and unlike in the U.K. the most important large shareholders in companies and enjoy, therefore, a powerful position and often control the companies access to external funds. Their large shareholder status and their presence on the board grant them a direct influence to the management. It is quite a common feature that the house bank of a Continental European company assumes a dual role as important lender and as major shareholder.⁹

4 Main features and functions of capital-market-oriented corporate finance

The capital-market-oriented system of corporate financing differs from the system of credit financing in that capital is accessed more easily and directly over stock and bond markets, whereas loans constitute a relatively small element of banks’ balance sheets. The investment respectively procurement of capital is organized directly in the relevant markets including the stock markets. The law of supply and demand governs immediately. Economic savings flow directly into the economy through bonds, stocks, funds, derivatives and other investment

instruments. Banks are not interest-charging creditors, but fee-charging agents between borrowers and investors. Moreover, banks are to a great deal replaced, in more capital-market-oriented systems, by institutional investors such as pensions, insurance, mutual, venture and hedge funds. The investors (shareholders, risk capital providers, bondholders or partners) have to bear a risk of corporate failure in proportion to their holding, i.e. to their form of corporate equity or bond financing. The risk can be spread among many investors through capital markets.

This explains the so-called short-termism which is linked to capital-market-oriented corporate finance: The investors as stockholders, i.e. equity capital providers, or as debt capital providers, i.e. corporate bondholders, have an immediate interest in the prosperity of the pertinent company (or at least an indirect interest when they are just holders of funds units). These investors exercise an influence on companies through their security-specific instruments. First of all, the interest of shareholders and other stakeholders are represented through the exercise of voting rights. This leads to an increased pressure to pay out dividends which means in a macro-economic perspective that capital can circulate more effectively and can increase the supply of funds to innovative new firms.

In addition, capital-market-oriented systems are characterized by highly developed liquidity interests of the investors who want to hold easily tradable securities in order to possibly react quickly on economic and corporate information available. When the company’s management issues bad news, the liquidity-orientation enhances the chances respectively the risks of a change in the composition of capital suppliers and possibly the danger of a hostile take-over. Capital-market-oriented systems are outsider systems and rely on capital market discipline over the market for corporate control. With regards to the dissemination of corporate data, the company can not - as in bank-based systems - rely on a duty of confidentiality, since information transparency plays a major role in the capital-market-oriented system.

In the U.S. and the U.K. the importance of stock markets – in relation to the gross domestic products, GDP - is traditionally by far greater than in Continental European countries. Germany in particular has been lagging behind other countries with regard to exchange-listed domestic companies and companies ready to go public.¹⁰ Throughout the post-war decades the numbers of exchange-listed companies and of initial public offerings (IPOs) were significantly higher in the

U.S. and the U.K. relative to population. Also the relative number of institutional investors like pension funds, insurance companies and investment companies is remarkably higher. However, in the Anglo-Saxon countries credit finance also constitutes an indispensable pillar of external financing. Even in capital-market-oriented systems loans represent an important component and source of external financing, particularly for small and medium sized enterprises (SMEs).

5 The model character of the two types of financial systems

The differentiation between the two types of financial systems must be flanked by four important remarks and annotations. Firstly, the differentiation described has nothing or little to do with the often and rightfully emphasized difference between a system of universal banks and a system of specialised banks. It is well known that in Continental European countries a universal bank system dominates with banks offering all kind of services to all kind of clients, whereas in the U.S. a system of functionally separate banks is prevailing with specialized banks concentrating on particular kinds of services for particular types of customers. However, a functionally separate banking system is not as such a sufficient condition for a capital-market-oriented system. This is shown by the fact that in the U.K., despite its capital-market-orientation, also a universal bank system has evolved – as it is the case, by the way, in South Africa where the “big four” (Absa Bank, First National Bank, Nedbank and Standard Bank) are full-service-banks in a capital-market-oriented system of corporate finance with some 400 companies listed at Johannesburg stock exchange.11

Secondly, one must be aware, from the outset, that the frameworks of bank-based and of market-oriented systems of corporate finance are first of all theoretical conceptions of model-character. They are helpful for the purpose of understanding, but neither finds, in its purity, an equivalent in economic and legal reality. “Neither capital-market-orientation nor bank-orientation exists as a pure culture.”12 Only various combinations can be encountered in the different economic and legal systems. Also in capital-market-oriented countries like the U.K. or the U.S. credit financing remains an indispensable mode of external financing for companies; and also in credit-market-oriented systems banks assume an indispensable function as


intermediaries between companies and the capital market, for instance as gate-keepers in connection with bond issues or initial public offerings (IPOs). The terms “bank-dominated” financial system and “capital-market-dominated” system denote and emphasize mainly the relative importance of the features described in an economy at a certain time.

Thirdly, it must be noted that a system of corporate finance in any country is never indifferent to its environment, is never static, but subject to all sorts of influences to which it must react and adjust itself. I do not refer here to the periodic stock market booms and troughs, but to the consequences of the internationalisation of credit markets and of capital markets and the institutionalisation of asset management. These developments have repercussions on the national and international legal framework of regulations, e.g. regarding accounting standards. In this context it should be recalled that, as already mentioned, the divergence has only evolved in the decades after World War 2nd. It is noteworthy that in Germany, which is today regarded as the leading paradigm for a bank-centered model of corporate finance, the equity markets once were among the most highly developed in the world, namely in the years leading up to World War 1st. In 1914 there were nearly 1,200 companies listed on German stock exchanges, whereas at that time only about 600 were listed on the New York Stock Exchange. For German stock exchanges the figure of 1,200 listed companies seems to be beyond reach presently, as today fewer than 1,000 can be counted.

The fourth remark concerns the only relative importance of external corporate financing in comparison with internal financing through a company’s free cash flows derived from its operational activities and from the retention of profits. If a company’s products and services are sufficiently market-viable and if a liquidity shortfall due to fluctuations in revenue and expenditure can be circumvented, internal financing can make recourse to external finance options and strategies redundant - apart from unusual projects of expansion, innovation or upgrading. After all, internal financing is the cheaper option. Insofar it is fair to say that external financing is of subsidiary nature.

6 Reasons for the differences and the superiority question
As to the reasons of the different corporate finance systems or the different “structures of financial intermediation”\textsuperscript{13} we find relatively little focus in the scholarly writings. Of course, cultural and historical accidents play a mayor role. Among them is the closeness of connections and the tightness of links between banks and their corporate borrowers in countries like Germany, France, Spain or Italy which is unparalleled in the U.K. and in the U.S. Mainly, however, the fundamental legal and regulatory differences in Anglo-Saxon countries on the one hand and in Continental European countries on the other account for the discrepancies in corporate financing. Some studies have revealed\textsuperscript{14} that the severity of legal and regulatory restraints on a dominant influence of large investors is undeniably a responsible factor for a capital-market-oriented system of corporate finance. U.S. laws tend to prohibit banks from owning stocks on their own account and are decidedly more hostile to this type of investor, compared to Continental European countries or to Japan. A bank-holding exceeding 5 percent of a non-bank company must meet with the approval of the U.S. Federal Reserve Board and must remain passive, according to the U.S. Bank Holding Company Act of 1956.\textsuperscript{15} Even in their holding of equity for beneficial owners of their trust funds banks are restricted. In Continental European countries banks traditionally do not face comparable constraints on their using larger stock positions for corporate control tasks.\textsuperscript{16}

A “good reason” and plausible explanation for bank-orientation of corporate finance may be the more or less active suppression of non-bank finance over a long time of the post-war period in many Continental European countries, particularly the numerous impediments to security markets by taxation and accounting requirements. Perhaps the most important reason for bank-orientation is probably the lacking of rigid discloser-requirements by companies desiring to issue securities to outside investors. Up to today, it seems, no country knows standardized disclosure


requirements of such a rigidity and severity like the U.S. It has clearly been established by
empirical studies that the level of protection afforded by a legal system to investors and creditors
correlates positively and immediately with the vitality of the country’s stock market. The
reason is, of course, that investors are more easily prepared to invest their money in stocks,
which in turn makes the stock exchange more attractive for corporate financing.

It might be added what the American corporation lawyer Frank H. Easterbrook has pointed
out already ten years ago, namely that the efficiency of capital markets in the U.S. and the U.K.
or the relative inefficiency of capital markets in most of Europe and in Asia is not a matter of the
sheer amount of regulations and statutory provisions or court judgements. Not quantity, but
quality matters. In fact, in countries where financial markets are traditionally more efficient
“there is both less law and greater investor protection”. Restrictions on U.S. banks aside and
not taking into account investor protection, it has been observed that corporate law in the U.S. is
“enabling”, i.e. it lets people do largely what they want in organizing, managing and financing a
company. Corporate law in Continental Europe (or Japan) is much more “meddlesome”,
“intervening” and “directory”. Apart from that, effective capital markets reflect, of course, first
of all a vital and strong economy and are certainly not a necessary output of a certain legal
system. “It is the economy, stupid”, not - or not only - the law. At least a great deal of the
traditionally more restrictive regulatory provisions, relevant for corporate finance issues, can be
explained as substitutes for a vital and effective capital market. When capital markets are vital
and efficient due to a booming economy, the valuation process works better and provides the
investors with stronger assurances of fairness. When capital markets are less vital and less
efficient due to a sluggish economy, banks tend to assume a partly substitutive role for the
valuation process and assume a greater responsibility in corporate governance and financing. The
companies issue debt instead of issuing equity. As we can see, a lot of reasons can be held

\[17\] See R. La Porta / F. Lopez de Silanes / A. Schleifer / R. Vishny, Legal determinants of External Finance,

\[18\] Frank H. Easterbrook, International Corporate Differences: markets or laws?, Journal of Applied
Corporate Finance, Vol. 9, issue 4, 1997, pp. 23 – 30; cf. also Nicholas Capaldi, Corporate and social
responsibility and the bottom line, Journal of Social Economics Vol. 32, issue 5, 2005, 408; John Parkinson,
Models of the Company and the Employment Relationship, British Journal of Industrial Relations, Vol. 41,

\[19\] Frank H. Easterbrook, International Corporate Differences: markets or laws?, Journal of Applied

\[20\] Cf. Christoph Van der Elst, Economic Analysis of Corporate Law in Europe: an introduction, Working
accountable for the differences between bank-based and capital-market-orientation in corporate finance.

The question has been asked: “Bank-Based or Market-Based Financial System: Which is better?”21 It has been argued that the larger number of decision makers, the number of investors and preferences in the capital-oriented financial systems makes it superior to the bank-based system with regard to financing innovative and high-risk projects and companies. If economic growth is basically driven by capital accumulation and technological progress, then capital-market-orientation is apparently preferable. This sounds plausible – in theory, that is. In practice, though, empirical evidence for the superiority of capital-market-based over bank-based systems is questionable: Germany as well as Japan and other bank-oriented systems have achieved remarkable growth rates in the 80s of last century. It is true that these countries suffered from growth deficits in the 90s. It is also true that this decade was characterized by an outstanding technological progress and that the Anglo-Saxon countries could well cope with it and transform it into growth of companies and economic sectors. However, the causality question remains open: in Germany, for instance, the historical reunification project posed an immense burden to the country’s economy; in Japan the rise of China as new economic giant constitutes an enormous challenge to cope with. Thus, it might very well be the case that the growths deficits in more bank-oriented countries in the 90s were due to other factors than the purported weaknesses of bank-based systems of corporate finance. In fact, the question remains open, whether one system is to be preferred over the other. Besides, even if one single best way to organize and finance firms were theoretically conceivable, the debate on the relative superiority of one system over the other tends to neglect the fact that the concrete design of one particular system is the output of specific legal and regulatory environments which can hardly be created overnight in other countries.22

7 The theory of convergence


The theory of convergence has been developed in the early 1990s and has been manifold formulated. It mainly postulates that corporate finance is converging on a hybrid model with an increasing role for institutional investors and capital markets and a declining role for banks except those which diversify into investment banking and fund management. The movement of a convergence is usually attributed to globalisation, or to be more precise: to the enhanced pressures of word-wide competition as corollary of increasingly open and deregulated markets for goods, services and capital.

If you have a closer look, the theory of convergence alleges a convergence in the sense of a mutual approximation of the two systems which would meet, so to speak, some day somewhere in the middle. Convergence of the financial systems on a hybrid model is, however, not the only possible understanding of convergence. In fact, the convergence is sometimes expressly envisaged as an assimilation of the bank-oriented system to a capital-market orientation which sooner or later would lead to a full adaptation. In this view, convergence means that the Continental European financial systems are becoming more and more Anglo-Saxon, whereas the Anglo-Saxon systems do not move. Convergence of this type amounts in fact to a friendly takeover. This view is, however, only taken rarely and is confined to large scale corporate finance, excluding SMEs. Mostly, convergence means true convergence on a hybrid or a middle mixture.

A convergence in the sense of a meeting in the middle can already be discerned in real life since the late 1990s. The Swiss system of corporate financing can be regarded as such a hybrid combining strong features of both the bank-oriented and the capital-market-oriented system and obviously drawing benefits from both systems. Here, it seems, a convergence to an optimum has taken place.


Empirical facts of convergence

With regard to the European Union the hypothesis of convergence has meanwhile been confirmed by empirical facts which leave no doubts that the predominantly bank- and credit-oriented systems of corporate finance of Germany, France, Spain, Italy and other Continental European Economies have already shifted remarkably in the direction of a capital-market orientation, whilst at the same time the credit market for corporate bank-loans has lost territory. This development commenced in the 1990s. Perhaps surprisingly, it has not been provoked by regulatory interventions of the European Economic Community.

It is mainly due to national legislation on company law, securities and investment law and stock exchange law in Germany, France, Italy, Spain and other countries that the importance of bond and equity markets has notably increased in Continental European economies. In order to compete with the City of London as centre of finance, many of the former restrictions have been loosened. The deregulation process has certainly been accelerated since and by the introduction of the Euro. In some countries cross-shareholding is now being unwound. A privatisation of pensions and a creation of government funded pension schemes are on their way or are being projected and will enforce the process. In the last decade the Continental European legal and regulatory framework has produced milestones for a change from bank-orientation to more capital-market-orientation of corporate financing. The role of securities markets in financing of Continental European companies has clearly increased, although the U.S. and the U.K. are still most advanced. One of the vehicles is the discovery of shareholder protection in Continental Europe by shareholder protection law with high accounting standards and with disclosure duties.

It is fair to say that Germany has taken the lead in this development. In Germany signs of a restoration of the country’s equity markets can already be discerned since the German reunification of 1990.26 The almost 17 years following this historical event have seen important legal and institutional developments toward more vivid equity markets and toward a more

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shareholder-friendly company law. Major steps forward in the modernization of German finance were the Securities Act passed in 1994 and the Corporation Control and Transparency Act (KonTraG) of 1998, followed shortly by the Takeover Act. The reform strengthened the supervisory board, shareholders rights and shareholder equality; it blocked, on the other hand, cross-shareholding and mandatory divestment of equity stakes, and eliminated traditional takeover defences. The effects set in promptly: the acquisition of Mannesmann by Vodafone in 2000 was the first successful hostile takeover of a German company. It was in 2005 that the question has expressly been posed, if Germany is “on the way to a capital market-based system?”

Other Continental European countries, particularly France, Spain and Italy, initiated similar reform projects for their company and capital market law and moved in the same direction. Some of these reforms aimed mainly at the modernization of corporate governance, but had a direct impact on corporate finance. The lifting of capital controls produced convergence in more and more areas and aspects of the national systems of corporate finance as well as of corporate governance - convergence not in the sense of a full adaptation of or total assimilation to the Anglo-Saxon model, but in the sense of a middle mixture and of a hybrid system, as it had been predicted in much of the literature two decades ago. The bank-based model has not at all been totally pushed aside or defeated; Germany in particular continues to rely on loans as the favourable instrument of corporate financings for SMEs.

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One of the reasons and driving forces for the convergence is the shareholder value doctrine in corporate law and what has been called “The End of History for Corporate Law”. Not that there will be no Corporate Law any more, but its historical development is considered to have come to an end because of a widespread normative consensus that companies and their managers should act exclusively in the economic interest of shareholders, including non-controlling shareholders. This consensus on a shareholder-oriented model of the corporation is the outcome of a failure of alternative models like the manager-oriented model that gained territory in the U.S. in the 1950s and 60s, the state-oriented model that has been sustained until recently in France and much of the Asian countries, and also the labour-oriented model which has been favoured dominantly in Germany and had reached its peak with the notorious German co-determination regulations. Many factors account for the superiority of the shareholder-value-approach: the obvious and evident competitive success of contemporary British and American companies in the 1990s, the diffusion of share ownerships in the most developed countries, and the activities of shareholder representatives and interest groups in shareholder assemblies and finally in jurisdictions. Today, there is hardly any serious competitor to the idea that corporate law should first of all strive to increase long-term shareholder value. Due to this almost unchallenged dominance and triumph of shareholder primacy in current corporate theory and practice, the “end of history” for corporate law has been declared. This, of course, unfolds a clear tendency toward similar rules of corporate governance and corporate finance. Continuing convergence and eventually a high degree of uniformity is insofar only a reasonable expectation.

It is noteworthy that the process and progress of developing efficient capital markets in the EU member states was, at the beginning, hardly assisted by activities from the European Commission or the Council in Brussels or from the European Parliament in Strasbourg. The Council Directive of 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, the Investment


Services Directive of 1993\textsuperscript{34} or the Codified Banking Directive of 2000 relating to the taking up and pursuit of the business of credit institutions\textsuperscript{35} did not lead to a substantial decrease of regulatory standards in the Member States.

\section*{9 The future EU Market in Financial Instruments Directive}

It was not before the late 1990s that the European Commission woke up. The Financial Services Action Plan (FSAP) launched in 1999 by the European Commission (and extended in 2005 by the Commission White Paper on Financial Services Policy) fully realized that financial markets are critical for the future economic performance of the EU and for its competitiveness in a global world.\textsuperscript{36} It was based on three keywords: Openness, comprehensiveness and competitiveness. It has initiated an astonishing process of law making in the EU letting participate everyone: companies, service providers, intermediaries, consumers, trade-unions etc. This approach was supported by the so-called Lamfalussy-Report of 2001.\textsuperscript{37} After a long process of consultation, the cornerstone of the FSAP will be the future Market in Financial Instruments Directive\textsuperscript{38}, which has been agreed by all 27 Member States and the European Parliament, has been welcomed by the Committee of European Securities Regulators (CESR) and the vast majority of market participants.\textsuperscript{39}

The Market in Financial Instruments Directive, better known as “MiFID”, which will take effect on November 1\textsuperscript{st} this year (half a year to go) and will then replace the existing Investment Services Directive, will have notable impacts on firms, exchanges and investors. In fact, it is


\textsuperscript{38} Directive 2004/39/EU (draft version).

expected that this directive (provided a full, accurate and timely implementation by the member states) will - to use the words of former European Commissioner for Internal Market and Services, Charlie McCreevey - “transform the landscape for the trading of securities, and introduce much-needed competition and efficiency throughout Europe’s financial capital markets”.

The directive will increase the level of protection of the investors and ensure a uniformly high level of protection for them with regard to core investor protection topics like: information to clients, investment advice, order-handling suitability and best execution. It will accelerate market integration and increase competition across the borders. It will drive down the cost of capital, will generate growth and probably boost the European economies.

One of the innovative features of the directive is the so called “single passport”-regulation for investment firms. This denotes that a company will need only answer to one national regulatory body for the majority of its compliance questions. Once an investment firm has obtained the admission from the national regulator to operate union-wide, it will then be allowed to engage in a wide range of financial investments and investment activities; one single authorisation (“passport”) will be sufficient. The regulators in a host state have to acknowledge and recognize the “passport” of foreign investment firms and will be reduced to a very limited role of supervision.

Such a system could only be developed on the basis of harmonized strong protection rules for the investors in the Union. And indeed, investor protection regulations have been harmonized at a high level, so that European investors in using the services of European investment firms can rely on protection from being ripped off. Under the Market in Financial Instruments Directive, or MiFID, different types of investors enjoy different protection levels. Retail clients (level 1) are being treated differently from professionals (level 2), moreover: both firms and clients will be able to select, subject to certain conditions and constraints, under with regime they want to operate.

Further on, the Market in Financial Instruments Directive also deregulates and prizes open the markets for providing trading venues in Europe and particularly destroys the monopolistic

preserve of local exchanges. Multiple venues will compete for order flows. The trading will, in future, also be accessible to other trading facilities like so-called systematic internalisers, or can be performed my means of bilateral over-the-counter-transactions (OTCs). Moreover, exchanges will, in future, have no longer exclusive access to and control over the information flows concerning their members’ OTC trade. The transparency provisions of the Market in Financial Instruments Directive compel the banks to co-operate with regard to the publication of trading information.\textsuperscript{41} A coherent supervision of the pan-European financial markets will be organized which will be based on co-operation, information sharing and standardized transaction reports on a number of financial instruments. Investors will benefit from easier cross-border access to stock exchanges and multilateral trading facilities. In an overall perspective it can well be expected that the Market in Financial Instruments Directive, or MiFID, will increase remarkably the depth and the liquidity of the pan-European financial markets. The European securities trading landscape is being transformed with enormous domestic and global implications. The Commission is fully aware of the old dilemma that too much regulation can freeze innovation, deter market participants and create excessive administrative transaction costs, whereas too little regulation provokes instabilities “and undermines the main asset of the financial industry: confidence.”\textsuperscript{42}

The Market in Financial Instruments Directive, or MiFID, is rightfully expected to trigger the breakthrough toward a highly effective hybrid system of corporate finance for the internal market of the EU, a new pan-European system combining strong features of both the bank-oriented and the capital-market-oriented system.\textsuperscript{43} It remains to be added that the European Commission and the U.S. Securities Exchange Commission have, some years ago, entered into a transatlantic Financial Services Regulatory Dialogue and have achieved some notable success with respect to several aspects of convergence in corporate finance reporting and of the development of efficient and credible regulatory solutions that guarantee effective investor


\textsuperscript{43} Thomas Enz / Sébastien Kraenzlin / Cesare Ravara, Credit Suisse, Economic Briefing No. 30, Systems of Corporate Financing, 2005, p. 29.
protection and a high level of business efficiency.\(^{44}\) Perhaps the hybrid system of corporate finance will conquer the whole world.

10 **Summary**

Let me now conclude and sum up. What are the lessons to take home?

1) Corporate finance has evolved into a special subject for banking lawyers and for company lawyers. It deals mainly with the way in which companies finance their business by external sources. One way of external financing is raising money by issuing securities to investors in the market; this is the equity capital option by equity capital financing in the form of stocks or other equity rights. Another way is borrowing money from banks and other financial institutions; this is the option of debt capital financing.

2) The *Continental European* approach to corporate finance has developed in a way decidedly different from the *Anglo-Saxon* model (U.K., U.S., Australia, Canada, South Africa). The Continental European approach, particularly pursued by Germany, France, Spain and Italy, is called bank-oriented. Here bank loans constitute the most important means of external financing. *Long-termism* with regard to the banks’ controlling attitudes and strategies is a key feature of bank-based systems. Bank-dominated systems are *insider systems* and have a clear tendency to *cross-shareholding*. The decisive point of the banks’ intermediary activities is, however, that the market mechanisms of supply and demand do not work immediately and directly between the depositors and the companies (as it is the case in capital-market-oriented systems), but only *indirectly*, namely through the banks as intermediaries.

3) The capital-market-oriented system of corporate financing differs from the system of credit financing in that capital is accessed more easily and *directly* over stock and bond markets, whereas loans constitute a relatively small element of banks’ balance sheets. This explains the

so-called short-termism: The investors as stockholders have an immediate interest in the prosperity of the company. Information transparency plays a major role in the capital-market-oriented system.

4) The frameworks of bank-based and of market-oriented systems of corporate finance are first of all theoretical conceptions of model-character. They are helpful for the purpose of understanding, but neither finds, in its purity, an equivalent in economic and legal reality. The terms “bank-dominated” financial system and “capital-market-dominated” system denote and emphasize mainly the relative importance of the features described in an economy at a certain time.

5) The differences between the Continental European and the Anglo-Saxon way of corporate finance can be explained by different historical and cultural developments. The severity of legal and regulatory restraints on a dominant influence of large investors is one responsible factor for capital-market-oriented system. A plausible explanation for bank-orientation is the active suppression of non-bank finance over a long time of the post-war period in many Continental European countries, particularly through numerous impediments to security markets by taxation and accounting requirements. Another reason is the lacking of rigid discloser-requirements by companies desiring to issue securities to outside investors. In the light of the different advantages, disadvantages, merits and deficits of the two different systems of corporate finance the question remains open, whether one system is to be preferred over the other.

6) The theory of convergence postulates that corporate finance is converging on a hybrid model with an increasing role for institutional investors and capital markets and a declining role for banks. The movement of a convergence is usually attributed to globalisation, i.e. to the enhanced pressures of world-wide competition in deregulated markets for goods, services and capital. With regard to the European Union the hypothesis of convergence has meanwhile been confirmed by empirical facts which leave no doubts that the predominantly bank- and credit-oriented systems of corporate finance of Germany, France, Spain, Italy and other Continental European Economies have already shifted remarkably in the direction of a capital-market orientation, whilst at the same time the credit market for corporate bank-loans has lost territory. This is palpably the case with regard to large scale corporate financing, whereas for SMEs bank-loans will retain their importance.
7) It is mainly due to national legislation on company law, securities and investment law and stock exchange law in Germany, France, Italy, Spain and other countries that the importance of bond and equity markets has notably increased in Continental European economies. One of the driving forces is the widespread consensus on a shareholder-oriented model of the corporation in the wake of the failure of alternative models like the manager-oriented model, the state-oriented and the labour-oriented model. There is hardly any serious competitor to the idea that corporate law should first of all strive to increase long-term shareholder value. Due to the almost unchallenged dominance and triumph of shareholder primacy in today’s corporate theory and practice, the “end of history” for corporate law has been declared.

8) It is noteworthy that the process and progress of developing efficient capital markets in the EU member states was, at the beginning, hardly assisted by activities from the European Commission or the European Council in Brussels or from the European Parliament. It was not before the late 1990s that the European Commission woke up (Financial Services Action Plan of 1999). Now a major breakthrough is in sight: The Market in Financial Instruments Directive (MiFID), which will take effect on November 1st 2007, will have notable impacts on firms, exchanges and investors. It will accelerate market integration and increase competition across the borders. It will generate growth and probably boost the European economies. The Market in Financial Instruments Directive is rightfully expected to trigger the breakthrough toward a highly effective hybrid system of corporate finance for the internal market of the EU, a new pan-European system combining strong features of both the bank-oriented and the capital-market-oriented system.

9) With regard to corporate finance banks will never run out of business – and the same is true with banking lawyers.