FACULTY OF LAW AND CRIMINOLOGY

FINANCIAL LAW INSTITUTE

WORKING PAPER SERIES

WP 2018-05

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SHAREHOLDER GOVERNANCE

GHENT UNIVERSITY

WP 2018-05

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The final version of this paper will be published in *Liber Amicorum L. van den Berghe*.

The entire working paper series can be consulted at http://www.law.ugent.be/fli/.

The Shareholder Rights Directive II, of 17 May 2017, which will enter into force on June 10, 2019[1], deals with matters that in many aspects touch upon the governance of listed companies. Although its title indicates that it relates to the position of shareholders in listed companies, in fact its aims at bending the relationship of the boards to the shareholders' views. Its underlying policy objective consists of giving more power to shareholders to reduce the full discretion of boards to deal with company affairs. This initiative is reportedly related to the weaknesses in governance which led to dramatic consequences during the 2008 financial crisis and caused considerable damage to the citizens' belief in reliable of company management. The intervention of the European legislator in matters such as "say on pay" to somewhat curb the remunerations of the company leaders by implicating the shareholders or the provision on "related party transactions": both are instrument for avoiding controlling shareholders, or powerful directors taking advantage of the position within the company to their personal benefit or that of the company they represent: shareholders should be considered as countervailing powers leading to better, especially stricter management and more responsible governance[2]. Restoring trust was sometimes mentioned.

Of a more procedural nature are the provisions on shareholder voting and engagement: here the objective consists of activating the shareholders[3] to be able to express their opinion on subjects proposed for company decision making, essentially by organizing and facilitating their participation in the general meeting. As a corollary, companies will be able to obtain the identity of their individual shareholders allowing them to communicate with them on company matters.

Institutional investors will be invited to engage with the company in order to ensure their better understanding of the company's business, and adapt their investing strategy to long -term value creation thereby avoiding the short termism that is considered to have been one of the root causes of the financial crisis[4]. Activating the voting rights of institutional investors and asset managers for influencing corporate behavior is part of a wider drive, related to the behavioral objectives assigned to large companies in the context of ESG objectives. Sustainability if one of the core concepts in this viewXX Engagement is the more active instrument, in comparison to disclosure.

To what extent these objectives will be attained by this directive is a subject of discussion. Some of the obligations of the directive were already applicable in several Member states, often in a stricter format. This is especially the case for the Related party transactions[5], but also for the Say on pay rule. On shareholder voting and institutional investors, its practical effects will only become visible in xxx 2021. Moreover, the implementing regulation have not been adopted by the Commission.

Assessing this directive in terms of its contribution to improve the governance of listed companies, it is too early to judge. The new regime the directive introduces is quite flexible, allowing Member states to derogate from its stricter requirements, while reducing the content of some of the obligations to a strict minimum or to an essentially formal procedure. For many of the EU member states, these requirements will constitute a considerable change in present practices,

The title of the directive refers to the encouragement of long-term shareholder engagement. "Greater involvement of the shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors, in particular as referred to in the Principles of Responsible Investment supported by the

[1] Article 2; but the provisions on shareholder identification and voting will only apply 24 months after the adoption of the implementing acts.
[2] http://europa.eu/rapid/press-release_MEMO-17-592_en.htm
[3] All shareholders may have to be identified, but States may introduce a minimum allowing only shareholders holding more than 0,5% of the capital to be subject to identification.
[4] The Commission press release mentions that on average their portfolio holding period is 8 mo. Portfolio are entirely turned over every 1,7 years.
[5] See for an overview: see L. Enriques and T. Troeger, The Law and (Some) Finance of Related Party Transactions: An Introduction, SSRN 3214101

United nations" [6]. This overarching objective is translated in more specific provisions allowing investors to exercise their rights in a more effective way, and to engage with the company and its leadership. At present, most shareholders in listed company are usually quite remote from the activities and development of the company, while the latter has difficulty in establishing contact with them. Therefore, this directive aims at activating the relationship between listed companies and their shareholders from today's rather passive and financial approach, to some form of more active dialogue of the company's behavior and management.

Several tools are used to obtain this objective: the first one relates to shareholder identification, the second to the obligation of institutional investors to take a more active part in the company's oversight. In both cases, company governance practice may be quite substantially affected.

1. Shareholder identification

The first and quite conspicuous obligation relates to right of the listed companies to request the identification of their shareholders: once shareholders are known to the company, it might start the dialogue with shareholders and engage directly with them on company affairs, but also facilitate the exercise of their – voting and other - rights.

The identification of shareholders was already practised in certain Member States and usually takes places through the securities holding chain involving at the apex the Central Securities Depositary where the shares have originally been deposited and from there further transmitted through the chain of intermediaries, where the shares have been booked[7]. This quite complex mechanism which is also adopted in the directive, is first intended to allow companies to inform their shareholders and activate their voting rights. But at the same time, it will allow the issuer company to determine which parties are holding shares, but - often more importantly- who is buying or selling shares, and so keep a certain control of its shareholder constituency. One could also analyse this provision as a device for identifying third parties building up a stake which may result in a controlling block – in which case a takeover bid might become mandatory – or more common these days, start an activist campaign against the incumbent management. The purpose of the provision is not only to allow the company to communicate with the shareholder, but also to "facilitate shareholder engagement with the company"[8] alluding here to two sides of communication. Issues of confidentiality have been eliminated: the communication will not breach any restriction on disclosure of information[9]. GDPR would therefore not apply.

This identification system is quite ambitious and will result in considerable costs. The question has therefore been raised whether the identification requirement should not be limited to companies where the shareholder population is very dispersed, as in most European companies, shares are often held in concentrated ownership which is perfectly known to the company's management[10]. The requirement can be limited by the member states, provided all holdings above 0,5 % will have to be reported. The rule applies to shares registered in a non-EU account: it is expected that the CSD will be able to request information from the foreign depository[11].

[6] Recital 14, see the six PRI, including the ESG, as developed by investors with a view of developing a more sustainable a global financial system, https://www.unpri.org.
[7] The communication will follow the existing standards for Transparency of Holdings (ISO 20022) and Markets Standards for Corporate Actions processing, 2015 and for general meetings. Previously a regime for the notification of major holdings was already applicable: see article 9 of the COMMISSION DELEGATED REGULATION (EU) 2015/761 of 17 December 2014 with regard to certain regulatory technical standards on major holdings and supplementing Directive 2004/109/EC of the European Parliament and of the Council Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC
[8] Article 3a (4)
[9] Article 3a (6)
[10] See ECLE, Shareholder Engagement and Identification, February 2015, https://europeancompanylawexperts.wordpress.com/shareholder-engagement-and-identification-february-2015/
[11] This seems the meaning of article 3e of the directive relating to "third-country intermediaries". This notion would include UK intermediaries after Brexit.

It should not further be possible to hold shares secretly, at least as far as the name of the account holder - different from the beneficiary[12] - is concerned.

The identification system constitutes the framework within which information will be circulated to and from shareholders, most important about the votes they have cast. The pre-meeting information to be addressed to shareholders will be whether directly circulated by the issuer companies to the known shareholders, or through one of the intermediaries for shareholders which were only identified in their accounts. Companies may also limit themselves to posting the information on their website. This information mainly relates to the pre-AGM documentation. Conversely intermediaries will transmit information to the issuer but only if it relates to the exercise of the investor's rights, in practice mainly for the exercise of his voting rights. There is no obligation to engage in an active discussion with shareholders.[13]

In addition, intermediaries should facilitate shareholders to exercise their rights especially with respect to casting their votes. There is no mention of voting platforms organised by the issuers or third parties. Shareholders have a right to obtain confirmation as to the valid recording of their votes. The same applies to votes cast electronically. Electronic voting was still not widely practised in the mid 2010s but would not be contrary to the directive.
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2. The engagement by institutional investors and asset managers.

The second layer of obligations introduces the engagement obligation for institutional investors (pension funds, insurance companies) and asset managers. These investors are considered important monitors of the company action which would take place as part of investor engagement. The directive states that these investors should develop an "engagement policy" and report annually how the policy has been implemented, mainly by informing the public on how they have exercised the voting rights attached to the shares in their portfolios. What this "engagement policy" contains is described in very wide terms in the directive: " the policy shall describe how [the institutional investors or asset managers] monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement"' [14]

The directive is more modest as to reporting on actual voting, as this only relates to the voting behavior in general and to the most significant votes as these have been cast by or on behalf of the investor. In principle, by publishing how votes have been cast, investors could assess how much the asset manager has been able or interested to influence the investee 's behavior. The disappointed investors have few instruments to influence the company's behavior: he could sell his portfolio in whole or in part, or the asset manager may have to face a negative rating. It seems difficult to apply this reasoning to insurance companies or pension funds, where the ultimate investor will have no influence on the voting behavior, not even indirectly.

From the governance point of view, the development of an active engagement action may significantly influence the way the investee company is managed. Disclosure serves as a potent tool: these large investors have to publish how the engagement policy has been implemented, especially by indicating that they have voted according to their policy. This would include disclosure e.g. of how their investment strategy supports

[12] Unless under the regime of the Ultimate beneficial owner.
[13] Article 3b (4). Shareholder democracy remains limited to the participation in the AGM. But article 3a (4) seems to open the door to a broader interaction by shareholders with the company: the system will "facilitate shareholder engagement with the company"
[14] Engagement Policy: investors would have to describe, *inter alia*, how they integrate shareholder engagement in their investment strategy, how they intend to vote in general and to what extent they intend to retain the services of proxy advisers. The Engagement Policy must also include detailed conflict of interest rules. Once a year, institutional investors and asset managers must publish a document on their website detailing how they have implemented such policy. Pursuant to the principle of "comply or explain", investors may also refrain from such annual publication if they give a reasoned explanation as to why this is the case.

the long-term nature of their investments, how they have engaged to improve the performance of the investees, and on which elements investment decisions – including non-financial performance- have been based. Similar obligations apply to asset managers. Information on the use of proxy advisors in the context of their engagement activities will also be relevant. These requirements apply on a "comply-or-explain" basis[15]. The UK FRC has undertaken engagement actions for several years, based on its "stewardship code" published in 2010 on the basis of which investors would develop their responsibilities as owners of the companies[16].

The effectiveness of these instruments deserves to be further analysed and this in the context of the different ownership structures as exist in the EU. From a legal point of view, the very wide and specific formulation may raise questions as to the nature of the possible intervention of these investors which if pushed too far, may be qualified as "de facto directors", possibly triggering their possible liability for not having paid sufficient attention to e.g. the financial position of the company. On the other hand, from the side of the company directors, these rules may increase their liability if they have not paid attention to critical remarks published by some of these investors.

The possible disciplining action developed by these large investors is best illustrated by referring to the case of the activist investors who have several times obliged companies to modify their policy, their governance or the structure of the investee group, leading corporate boards to develop best practices for responding to shareholder activism. Similar but less structured action relate to companies put under pressure for respecting gender equality, human rights and other sustainability objectives[17]. Until further notice, action in these fields remains outside the scope of the engagement definition as formulated in the directive.

3. Proxy advisors

The role of the proxy advisors is generally considered an important bridge in the shareholders' governance as they frequently determine the way the votes – especially the institutional votes - are cast at the general meeting. They fulfil an essential function in making the voting system work, as shareholders – including institutional investors and assets managers – are very dispersed, and in the past have shown not to be able to cast their votes, or were not willing to be involved in this aspect of the governance system. The soliciting of proxies was originally the American approach to solve this issue, both for supporting the position of individual shareholders, e.g. candidates for board seats, as for supporting contested votes especially by activists. The advisory function was added later, as the proxy advisors have developed procedures to vote in accordance with the shareholder's views, and this in line with the characteristics of the company and the specific agenda for each meeting. Up the now, the action of proxy advisors was not subject to regulation, although a voluntary code of conduct called 'Best Practice Principles for Providers of Shareholder Voting Research and Analysis' has been developed by the proxy advisors in 2014[18].The directive further builds on this practice, formally requesting that they adhere to a code of conduct and report on its application. The code will apply on a "comply-and- explain" basis.

The directive's provision should be situated in the context of the recognition of this advisory business with a view of activating this part of shareholder governance. In the past there have been concerns about proxy advisors exercising too strong influence on boards, acting without sufficient knowledge of the company's business, not adapting to the specific agenda of the AGM, and more delicate, to offer their services to the

[15] Article 3g (1)
[16] See https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf
[17] See about these: Commission Action Plan: Financing sustainable growth, 8 March 2018. Comm (2018) 97 Final Report 2018, and the Commission proposed delegated regulation amending Delegated regulation 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.; Report by the High-Level Expert Group on Sustainable Finance . 180131-sustainable-finance-final-report_en.pdf
[18] See D. Zetzsche, Best Practice Principles for Proxy Advisors and Chairman's Report, Best Practice Principles for Proxy Advisors and Chairman's Report, 23 Aug. 2014

companies from its shareholders. ESMA analysed their action and concluded that although there no clear evidence of market failure, concerns were raised regarding their independence, the accuracy and reliability of their advice" [19]. The US congress has introduced regulation and supervision for proxy advisors[20]. It is unclear why the EU did not develop a stronger policy on this topic, the more as proxy advisor develop a significant influence on many aspects of company decision making, such as appointment of directors, setting the level or structure of remuneration level, etc.

It is important to note that the EU requirement also applies to non-EU proxy advisors, the two internationally active firms being based in the US.

4. The remuneration policy: "Say-on-pay"

The remuneration of directors and managers has been the subject of quite some controversy. Increasing attention and criticism is being formulated to very high remunerations, and this from the angle of fairness and relative contribution to the company's management[21]. Gender discrimination in remuneration has become one of the most controversial items in the gender debate. Procedures such as involving the employees in determining remuneration have been introduced. Remuneration has also become a decisive factor in the relocation context.

In the banking sector, the remuneration of directors and senior management is subject to restrictions, several of which are risk related[22]. In the non-banking sector, the remuneration of directors and senior managers is not regulated, being freely determined by the general meeting. In some jurisdictions, the remuneration should conform to the generally formulated remuneration policy as approved by the general meeting. The directive builds further on this approach by requiring companies to establish a policy on remuneration, which is approved by the AGM. The policy is binding, although companies can make it advisory, stating the main lines of the policy[23].

The policy shall i.a. indicate how this policy supports the long-term strategy and sustainability of the company and how it takes into account the pay and labor conditions of the employees in general[24]. This provision would not mandate a formal pay ratio to be set, nor require that this information would have to be published[25] . Special conditions apply to variable remuneration.

However, the directive provides for quite some flexibility: on the one hand Member States may derogate by declaring that the general meeting may declare the policy to be "advisory", while temporary derogations may be adopted by companies in certain "procedural" circumstances, which are needed in a perspective of serving then long-term interests or the sustainability of the company or insure its viability. The latter case would allow

[19] Follow-up on the development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis, 18 December 2015,ESMA 2015/1887 https://www.esma.europa.eu/press-news/esma-news/esma-publishes-report-proxy-advisors'-best-practice-principles

[20] The Corporate Governance Reform and Transparency Act 2017 providing for registration with the Securities and Exchange Commission (SEC), disclosure of potential conflicts of interest and application of the codes of ethics, and make publicly available their methodologies for formulating proxy recommendations and analyses. See T.M. Doyle, The conflicted role of proxy advisors, Harvard Mat 22, 2018. See CNBC, A Congressman call these Wall Street proxy advisory firms "Vinny down the street" for their power to pressure companies, 28 June 2018,

[21] Comparative studies are important in this context: see Executive Directors' Remuneration in Comparative Corporate Perspective, *Edited by* Christoph Van der Elst, 2015, Kluwer L.I. ; for the banking sector; see: AFME, Review of the Reward Environment in the Banking Industry – May 2017, by McLagan Aon Hewitt https://www.afme.eu/en/reports/publications/afme-prd-review-of-the-reward-environment-in-the-banking-industry--may-2017/; see also the Swiss Minder initiative on executive pay, 2013, adopted by referendum.

[22] See article 92 e.s. CRD IV

[23] Article 9a (3)

[24] Article 9a (6); "pay ratios "are calculated in US and UK companies.

[25] See e.g. https://www.shrm.org/resourcesandtools/hr-topics/compensation/pages/ceo-pay-ratio-prep.aspx. But the remuneration report should inform "about the change .. of average remuneration on a full- time equivalent basis of employees… over the last 5 years. ", and related to company performance. Article 9 b (1)

a higher remuneration in case the continued existence of the company is endangered: it is unclear whether national company law would have a favorable view on this approach.
For listed SMEs , the Member state may provide for a discussion in the AGM, rather than a formal vote.

A remuneration report will have to be drawn up containing detailed information on each director's remuneration and its components or conditions. It will be submitted to an advisory vote at the AGM.
This report will allow to verify whether the agreed remuneration respects the conditions of the policy. In practice this may lead to criticism of the overall remuneration structure, and more precisely to the remuneration of individual directors. In this debate, the proxy advisors often play a decisive role[26] indicating that disclosure may open the door to more substantive criticism.

The report will be posted on the company's website for a period of 10 years[27].

5. Related Party Transactions (RPTs)

Another very much debated subject relates to the "related party transactions"[28]: it refers to material [29] transactions with "related parties"[30], creating conflicts of interest. The simple case is the one of a director entering into a contract with the company, whether personally or through a separate legal entity. More complicated cases are met in the field of groups of companies where transactions between affiliated companies may raise concerns about the fairness of the transaction, or the interest for the group companies. Controlling shareholders, or powerful directors may also direct benefits from the company to themselves or to company in which they own an important stake.

Many countries have more or less elaborate regulation dealing with RPTs: these are often based on ex ante notification to the board which will designate a special committee in charge of assessing the transaction both in term of the fairness of its conditions[31], as to the policy elements that may be raised as the transaction may be prejudicial to the company's strategy or its future development. A special independent expert advisor may be appointed by the committee. The special committee will report to the full board, where the transaction may be approved, or not. In some jurisdictions the approval of the general meeting is also required. The conditions of the transactions will be publicly disclosed.

The directive follows by and large this approach: main differences are the provision that the expert may be the supervisory body of the company, if any, or its audit committee, or a committee of independent directors. Depending on the national legislator's choice, the transaction itself will have to be approved by the board of the company or submitted to its AGM, avoiding the related party to take advantage of his position. In principle the related party should not take part in the vote: however, that party may vote on the transaction if there is no opposition from the other shareholders of from the majority of independent directors. In addition, national legislation may exclude from this regime certain transactions which typically contain no specific risk of being unfair: these are the transactions between a company and its fully owned subsidiaries, specified transactions for which fair treatment and adequate protection of the company or its shareholders are guaranteed, but also

[26] Impact on Say-on-Pay and Influence of Proxy Advisors , Willis Towers Watson: Shareholders rights directive, Autumn 2017 https://www.willistowerswatson.com/en/insights/2017/12/implications-of-the-eu-shareholders-rights-directive-autumn-2017
[27] Article 9b (3)
[28] Luca Enriques, Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal), European Business Organization Law Review, 16, 27-31 (2015); M. Bianchi, L. Enriques and M. Milič. Enforcing Rules on Related Party Transactions in Italy: One Securities Regulator's Challenge, SSRN 3188063 M. Roth, Related party transactions: board members and shareholders The European Commission proposal and beyond, working paper, January 2016, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710128 (last accessed 23 August 2016); ICLEG, Report on the Recognition of the Interest of the Group, SSRN 2888863; see L. Enriques and T. Troeger, The Law and (Some) Finance of Related Party Transactions: An Introduction, SSRN 3214101 as the introduction to their the forthcoming book
[29] Materiality may have to be defined on the basis of quantitative ratio's, determining the "impact of the transaction on the financial position, revenues, assets, capitalisation, including equity, or turnover of the company or take into account the nature of transaction and the position of the related party" (article 9c (1)
[30] Defined as stated in the accounting standard IAS 24 on related party disclosures.
[31] Being "fair and reasonable' from the perspective of the company and its not conflicted shareholders

agreements relating to the remuneration of directors, adopted in applying the above provisions on remuneration approval. The same applies to transactions at normal market conditions.

The level of safeguards provided by the directive's provision are not very restrictive: in Member states where no regime on RPT was in force, they may lay down the basic minimal arrangement for these transactions in accordance with the directive. But in most EU jurisdictions, higher level of protections already applies, especially as to their fairness and these conditions should remain applicable to the extent that they guarantee a fair treatment and adequate protection[32]. This does however not mean that the protection of investors in these jurisdictions is very much superior, as these national regimes often are applied in a purely formal way. The ultimate guarantee will be found in the judicial protection in case of unfair or prejudicial transactions. Also, the directive's requirements are not applicable in member states where for specific types of transactions which are protected by shareholders' vote, subject to a fairness test, protection the company and the shareholders[33].

The directive does not explicitly deal with issues of groups of companies where transactions between group entities often raise concerns about their fairness. The directive allows Member States to exclude transactions with a wholly owned subsidiary there are no other interests involved, or that these have been adequately protected[34]. Especially in the field of groups of companies, the assessment includes not only the financial conditions of the transaction, but whether the transaction may be pursued to serve the interest of the group above the interest of the individual party - usually a subsidiary – concerned. Different responses have been given to this core question of group law. They allow the transaction to be grounded on group motives, but require that parties whether commit to indemnify the subsidiary for the prejudice inflicted to it by the parent and this within the same accounting year. Another system allows the group interest as a valid motive for an intragroup transaction provided the parties have agreed to an adequate quid pro quo, - even if the balance between the two sides will only be determined in the long term -, and have secured that the transaction would not lead the subsidiary into insolvency[35].

Conclusion

Shareholder governance is part of general corporate governance: it introduces rules to ensure that shareholders can effectively participate in company decision making and development. It is presumed that by doing so, company boards will adopt a more long-term vision, and will better oversee their risks. Identification of shareholders, supporting their participation in the AGM and engagement by institutional investors are the tools to achieve this objective.

In addition, the directive contains some contriving rules in two fields where shareholders should fear to be confronted by damaging conflicts of interest: remuneration of directors and related party transactions. Here the safeguards are process and disclosure bound. On remuneration, the objective is to moderate its amount, or at least keep it within the boundaries of the agreed policy. On related party transactions, the safeguards have to be found in an explicit procedure, calling for ex ante disclosure, expert advice, and approval by the AGM.

The directive introduces these objectives without making use of supervisory instruments, but relies on ex ante policy statements, disclosure, internal procedures, but especially allowing shareholders to adopt decisions that they consider being in the interest of their companies.

[32] See for these conditions: article 9c (6) (b)
[33] Article 9c (6)
[34] E.g. that the creditors have been fully secured.
[35] These are the conditions of the so-called Rozenblum doctrine in which the French Cour de cassation stated: "the financial aid consented by the managers of the company which is part of a group in which they are directly or indirectly interested, should be motivated by the common economic interest in relation with the global policy of the group, should not be devoid of counterpart and should not provoke imbalance of the mutual obligations, nor exceed the financial capacity of the solicited company". Criminal Chamber, 4 February 1985, Rozenblum and Allouche, D. 1985, p. 478, n. D. Ohl, I-639, JCP 1986, II-20585, n. W. Jeandidier, Rev. soc. 1985, p. 648, n. B. Bouloc.

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