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THE U.S. SECURITIES LAWS – BANKING LAW OF THE WORLD? (A REPLY TO MESSRS. LOOMIS AND GRANT)

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As a Swiss lawyer, my attitude toward securities laws generally is entirely different from that of a U.S. securities lawyer. Accordingly, I will try to evaluate the positions stated in the article by Messrs. Loomis and Grant [1] from the point of view of a non-U.S. lawyer whose clients are affected by the extraterritorial application of the U.S. securities laws by the U.S. Securities and Exchange Commission ("SEC") and the U.S. courts.

My comments should help U.S. lawyers understand better the points of view of those non-U.S. financial institutions which are strongly opposed to the SEC's actions in the international field. I am convinced that the serious problems posed by the existence of the U.S. securities laws should be solved on the basis of mutual respect and understanding and not on the basis of a mere assertion of power.

1. The U.S. securities laws viewed from abroad

The difficult problems created by the extraterritorial application of the U.S. securities laws cannot be sufficiently understood unless one realizes the distinctly U.S. character of these laws. For most non-U.S. persons, in particular for Europeans, the U.S. securities laws constitute an incomprehensible bulk of infinitely complicated rules which are totally strange to them. Many look at them simply as one of the bases for that great U.S. pastime of suing one another.

Those persons who know better may recognize the goals which the U.S. legislator and the SEC want to achieve through the U.S. securities laws and their administration, but even those better-informed persons do not believe in the means by which these goals are sought to be achieved by the SEC.

To Europeans, the basic burden of judging an investment is on the investor; Europeans do not believe that full disclosure greatly helps him in making his decision. They rather place emphasis on the functioning of competition in the capital markets, on professional control by banks and investment adivsers and, finally, on

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the general criminal provisions of the European criminal codes prohibiting fraud in the form of "obtaining monies through willfully false pretenses" with the intent to damage the investor.

Of course, this is not the place to discuss these fundamental differences of opinion. The important thing at this point is to keep in mind that Europe has no securities laws because it does not *want* to have securities laws, and in particular because it does not want to have an SEC.

A typical example of the difference in viewpoints is the non-U.S. opinion concerning the margin requirements. For European bankers, statutory rules which tell them how much credit they are allowed to advance against the pledge of securities constitute a severe infringement on their commercial liberties. They are convinced that they are in the best position to judge what is a reasonable percentage, and they do it at their own risk. Furthermore, the notion that someone can sue his banker because the banker gave him too much credit is considered to be absurd.

But most of all, non-U.S. persons are afraid of the enormous administrative complications connected with the issue of securities and the regulation of the securities markets in the U.S. European taxpayers would simply not be willing to pay the budget of institutions similar to the SEC for the sole purpose of protecting the interests of people who have enough money to invest in stocks and bonds.

This is the background on which the extraterritorial application of the U.S. securities laws falls. It is the background of a fundamentally different philosophy. Every attempt to apply the U.S. securities laws against this background must necessarily create resistance. The jealous safeguard for national sovereignty which European countries show in general, and in particular in reaction to what they consider to be U.S. interference, adds to this resistance and makes the mutual positions almost unreconcilable.

2. International fraud artists and international bankers – is there a difference?

Messrs. Loomis and Grant emphasize at several places in their article that the broad assertion of power by the SEC is mainly designed to inhibit international fraud artists and persons seeking to evade the regulatory and disclosure requirements of the U.S. securities laws. They claim that the result of the assertion of extraterritorial power under the U.S. securities laws "should not inhibit the banks from serving the legitimate needs of their customers". [2]

Unfortunately, the expansive view the SEC takes of the transnational application of the U.S. securities laws leads to substantially different results, and jeopardizes to a considerable extent the free flow of capital which the SEC pretends to be advocating. If the basic theory of Messrs. Loomis and Grant and of a number of U.S. court decisions following the SEC's assertions of jurisdiction is correct, *i.e.*, that *any* use of the jurisdictional means (even a mere preparatory or incidental use) is sufficient to give subject matter jurisdiction to U.S. courts, then the consequences of this view can hardly be overestimated. Thousands of everyday business transactions will become unlawful. There is no room here to give a comprehensive view of all adverse effects on normal international financial business which the SEC's position would have, if it became generally accepted. Nevertheless, it is necessary to indicate some of the problems which are created for non-U.S. financial institutions by such an extremely broad application of the U.S. securities laws.

First, however, let us have a short look at the commercial background against which the SEC activity occurs. This background consists of a network of exceedingly extensive international business relations. Taken together, they form the international banking system. Its undisturbed functioning is an essential condition of the functioning of the world's economy. Nobody is likely to profit if this complicated and delicate international network is put in jeopardy or even destroyed.

Let us look at a few parts of this financial world:

(a) Hundreds of millions of dollars of working capital of U.S. multinational corporations are raised outside the U.S. Seventy-seven U.S. corporations have their stock listed on the Zurich stock exchange, and an even larger number have off-shore bonds in dollars or other currencies listed on European and other non-U.S. exchanges. Through these mechanisms, U.S. corporations have access to the capital markets of the entire world.

(b) European and other non-U.S. financial institutions account for a considerable share of the total trading volume of the U.S. stock exchanges. In particular, the Swiss banks account for a percentage of the trading volume of the New York Stock Exchange which some people estimate as high as 20%. This means that huge foreign investments in the U.S. economy are channelled through the European, and in particular through the Swiss, banking system.

(c) Thousands of U.S. nationals and residents have bank and security accounts with European banks, mainly for investing in the non-U.S. markets.

It goes without saying that the functioning of this financial market place is of enormous importance for the welfare of the U.S. and, indeed, the world's economy.

It is equally clear, however, that the strict enforcement of the SEC's view of the transnational reach of the U.S. securities laws would prohibit a large number of European banks from contributing to the functioning of the entire system. If any use of the jurisdictional means is enough to make European financial institutions subject to the reach of the U.S. securities laws, then such banks would be unable to continue with their everyday securities business with U.S. clients unless they register as broker-dealers and investment advisers under the U.S. securities laws. For reasons of their national legislation, such registration is practically impossible because it would require the reporting of the names of the securities clients. In particular, in Switzerland this would be in violation of the strict banking secrecy laws.

The irony of this situation is that Swiss branches of U.S. banks that are engaged in the exact same business as their Swiss competitors are exempt from registration as broker-dealers by virtue of the definitions contained in Sections 3(a) (4) and (5) of the Securities Exchange Act of 1934 ("Exchange Act").

Let us look at a hypothetical case. Mr. Smith, resident of the U.S., has a securities deposit with a Swiss bank. The deposit contains 100 shares of X Corporation, a major European company. X Corporation announces an increase of its capital by way of a rights offering. The new shares are, of course, not registered in the U.S. The bank writes to Mr. Smith's residence in the U.S. asking if it should exercise his rights. Mr. Smith writes back and says yes. The bank, therefore, subscribes to 10 new shares for Mr. Smith. Within the next six months the stock of X Corporation drops 25%.

What possible justification could there now be for allowing Mr. Smith to sue the New York branch of his Swiss Bank for aiding and abetting the sale of an unregistered security or giving him causes of action under the civil liability provisions of the U.S. securities laws, in particular Section 12 of the Securities Act of 1933?

Is the bank serving Mr. Smith's legitimate interests if it does not inform him of the rights offering? Is the legal situation different if Mr. Smith's account is a discretionary account and if the bank exercises his rights without asking, but sends him a statement of account at the end of the year? If the SEC's position is to allow transactions of this nature, then I think it should say so. Criteria could then be developed to distinguish between Mr. Vesco and reputable bankers whose only fault consists of not being U.S. nationals.

Since it is practically impossible to avoid the use of the jurisdictional means completely, a strict application of the U.S. securities laws would mean that European banks would probably have to give up their securities business with U.S. residents. Also, such an application of the U.S. securities laws to non-U.S. financial institutions in every case in which there is even an incidental use of the jurisdictional means would come close to prohibiting U.S. residents from investing outside the U.S. and from holding securities on deposit in non-U.S. financial institutions. It should come as no surprise that some non-U.S. bankers feel that this is precisely the purpose of the SEC's broad assertion of power.

But even if one does not take such harsh a view, it becomes clear that the SEC's position has the inherent effect of making the free flow of capital a one-way street. Non-U.S. persons are welcome to invest in the U.S., but U.S. persons are "protected" against investing in non-U.S. financial markets. If this comprehensive application of the U.S. securities laws to non-U.S. financial institutions is taken together with the liberal exemptions granted by the SEC to U.S. corporations from registering their off-shore financings under the Securities Act of 1933,[3] it is hard to believe that all this is only ancillary to a vigorous fight against international fraud artists.

In addition, the SEC's position on the extraterritorial application of the U.S. securities laws would mean that European banks would have to determine the applicability of the substantive rules of the U.S. securities laws in numerous transactions. There would be almost total confusion in this regard. Non-U.S. financial institutions would be confronted with an enormous body of law with which they are totally unfamiliar and with which they could only comply at the expense of an unrealistic effort. They would have to staff their legal departments with lawyers knowledgeable in the field of U.S. securities law, which would lead to a substantial expansion of their legal departments. They would have to use outside counsel extensively, something which they do not normally do. They would have to train their personnel in the application of the U.S. securities laws, something which is difficult to achieve not only for reasons of language but also for reasons connected with the fundamental training of European bankers. All this effort would have to be expended in order to comply with a body of law which they consider to be at least unusual, which they do not mentally accept and which all their customers regard as being unimportant to them. As a consequence, non-U.S. financial institutions may try to create services which completely avoid the use of the jursidictional means or which otherwise escape the attack of the SEC.

It seems to me that these consequences can be desirable only to those who take the U.S. securities laws as an absolute and regard their international enforcement as a mere question of power. I suggest that this way of looking at the problem does not do justice to the delicacy of the international capital markets. It tends to destroy what – according to Messrs. Loomis and Grant – the U.S. wants to encourage: the free flow of capital.

3. Extraterritorial application – a problem of balancing

In their article, Messrs. Loomis and Grant answer the frequent criticisms of the SEC "for failure to give weight to such factors as sovereignty, international comity and the welfare of international business". [4] They seem to say that these interests are best served by a vigorous assertion of the SEC's powers because this "can lead to international cooperation and can help to foster a climate of certainty, trust, and confidence for international business". [5] Perhaps Messrs. Loomis and Grant are trying to say that these critics of the SEC should be glad that they are forced to abide by the U.S. securities laws because this, the U.S., way of protecting international business serves them best. At least, Messrs. Loomis and Grant seem not to claim that the SEC gives sufficient consideration to the requirements of international trade, international comity and the sovereignity of foreign nations.

My suggestion is that the interests of the non-U.S. financial institutions should be carefully considered: first, in formulating general rules; and second, in each individual case. This sort of balancing would mean that the commercial position of the non-U.S. defendants, the impact on international business and the respect for the laws of other countries would be weighed against the interests of the U.S. in the enforcement of the U.S. securities laws in a particular case.

It seems to me that this balancing of interests would produce at least the following results:

(1) The SEC would abandon its case by case approach to the question of the international application of the U.S. securities laws and would formulate its policy in abstract rules. This would help to overcome the almost complete confusion which now exists in international banking circles.

The case by case approach has undoubtedly proven to be the soundest way of developing the U.S. securities laws internally. It has helped to adapt the rules to new situations in a flexible and subtle way. But it must be borne in mind that this result was possible only because this approach could be used against the background of a legal community highly trained in this field of law and in the methods of interpretation and application used by the SEC and the U.S. courts.

However, to use the same methods in order to make these laws applicable to people living under entirely different legal systems contains an element of unfairness which can only be avoided by the announcement of clear rules. It would be for the U.S. to decide whether this task can be performed by the SEC or whether it requires legislation. Whatever the answer may be, non-U.S. financial institutions are at least entitled to certainty. They should not be exposed to the risk of finding themselves dragged into court some morning by the SEC for something which they did not even know was unlawful and which on the same day is announced in the newspapers of the world as a new case of international fraud. [6]

The announcement of a set of rules would also help the SEC to evaluate its own position. The discussion of all the aspects of the international reach of the U.S. securities laws which would precede the announcement of such rules would bring the issues into light and would grant the financial world an opportunity to state its position.

(2) The SEC would abandon its attempt to regard all parts of the U.S. securities laws as equally important, and would concentrate on those cases which have a genuine influence on the U.S. securities markets or in which U.S. investors are really damaged.

This would mean, for example, that the SEC would recognize that certain securities transactions with U.S. residents are governed by other laws; namely, by the law governing the contractual relationship between the bank and its customer. This law is normally chosen by the parties to the contract. In particular, the question of the bank's liability to its customers should be governed exclusively by such non-U.S. laws. On the other hand, it would be understood that certain substantive rules of the Exchange Act, such as insider trading provisions, would have to be observed in all cases in order to prevent attempts to avoid those rules.

(3) The SEC would avoid giving even the slightest impression that the U.S. securities laws were being used for purposes which are not germane to them.

In particular, the U.S. securities laws should not be used as a tool to discourage non-U.S. competition with U.S. banks and securities dealers, and such laws should not have the effect of discouraging U.S. residents from holding accounts or investments outside the U.S. This is not to say that the SEC in the past has lent its hand to such abuses, but the agency should be aware of the fact that its actions have not always avoided the impression that their real purposes are different from those which it officially stated.

(4) The enforcement policy of the SEC and of the U.S. courts would reflect the same respect of non-U.S. laws as non-U.S. persons are expected to pay to U.S. laws.

At the present time, the SEC has little hesitancy in directly violating certain provisions of a non-U.S. law or in asking defendants and witnesses to breach the secrecy laws of their respective jurisdictions. [7] The SEC should understand that to most Swiss citizens the bank secrecy laws are as important as the securities laws are to citizens of the U.S. The fact that these non-U.S. laws may sometimes be an obstacle to the vigorous enforcement of the U.S. securities laws cannot in itself be an excuse for their violation.

If these principles were observed, many problems could be solved in a satisfactory way and a great deal of misunderstandings, emotion and hard feelings could be avoided. A concentration of the SEC's actions on international fraud artists would help to make the SEC's positions better understood throughout the world.

Unfortunately, as the article by Messrs. Loomis and Grant shows, we are far from an SEC policy which would give sufficient consideration to the interests of non-U.S. financial institutions. The entire article considers problems exclusively from the standpoint of the SEC. A prime example is the explanation which is given for the absence of rules under Section 30(b) of the Exchange Act. The only explanation given for the fact that the SEC has never announced rules under Section 30(b) is that it is satisfied with the narrow construction which U.S. courts have given to this section; that is, the present situation serves the SEC's purposes.

The real question, however, is a totally different one: is it fair to expose non-U.S. financial institutions to the incalculable risk of being caught someday in the nightmare of U.S. litigation for doing something which the SEC on that occasion determines to be within its reach? If the answer to this question is no, then the consequence should be that rules concerning the international application of the U.S. securities laws are issued, not only under Section 30(b), but also in other areas. The most important questions in this regard are posed by the application of the broker-dealer provisions to the everyday securities business of European banks with their U.S. clients. There are similar problems in the area of the sale of securities of non-U.S. corporations to U.S. residents.

Such rules should make it clear that the SEC's policy is basically directed against international securities fraud and is not supposed to hamper non-U.S. securities business. The problem with the SEC's approach to the extraterritorial application of the U.S. securities laws is that it defines this approach on the basis of cases like

Vesco, but it totally disregards the consequences of this position for normal international securities transactions.

Lastly, it seems to me that a new definition of the SEC's position should lead to a situation of certainty with which everyone concerned can live. This is a task for international cooperation and discussion. So far we have only seen the vigorous assertion of the U.S. point of view. It is time for an international approach which recognizes the fact that in this world nobody is alone and nobody is so powerful that he can exist without the respect of his friends.

Notes

[1] Loomis and Grant, *The U.S. Securities and Exchange Commission, Financial Institutions Outside the U.S. and Extraterritorial Application of the U.S. Securities Laws,* beginning at page 3 of this volume of J. COMP. CORP. L. AND SEC. REG., hereinafter referred to as Loomis and Grant.

[2] Loomis and Grant, text following n. 148.

[3] SEC Securities Act Release No. 4708 (July 9, 1964) permits the sale of securities outside the U.S. by U.S. corporations without registration under the Securities Act of 1933, if the offering is reasonably designed to preclude distribution of the securities within, or to nationals of, the U.S.

[4] Loomis and Grant, first paragraph under caption 9, "The commission position".

[5] *Id.*

[6] The liberal use of the term "fraud" by the SEC is an element of considerable psychological importance in international securities cases. To accuse a European banker of fraud is almost as bad as to accuse the Attorney General of the U.S. of obstructing justice.

[7] Loomis and Grant, discussion under caption "U.S. requirements that may violate foreign law", and text following n. 141.

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