

REGULATION OF THE GERMAN CAPITAL MARKETS – PRESENT SITUATION, PROBLEMS AND OUTLOOK

EBERHARD SCHWARK *

1. Introduction

The legal structure of a national capital market may be based on various principles. The connecting factor of the substantive rules may be the market institutions as such and, through a law on economic supervision, may provide for certain requirements to be fulfilled by the person acting in the market and with respect to the securities offered in the market; they may also provide for rules governing the course of the market. From a somewhat different perspective, the rules may originate in company law and may regulate the rights of shareholders, bondholders and the public interested in the acquisition of stock and bonds in a manner corresponding to the needs of the capital market. Finally, a legal system may to a large extent do without legislation by the state and leave it to the institutions operating in the capital market to develop market order by self-regulating rules established by the institutions themselves, protecting the interests even of those finding themselves on opposite sides of the market.

A first glance at the German capital market gives a diffuse and confusing impression. German law has a detailed, uniform company law; it contains market-related rules in the form of statutes and, in addition, a number of conceptions that must be regarded as belonging to the self-regulation of the economy. The present state is the result of a development beginning at about the end of the 19th century. By successive steps company law evolved in the direction of increased disclosure by companies and improved protection of shareholders, subjected institutional investors and market institutions to legal rules and state supervision and forced the institutions operating in this sector of the economy to take measures by themselves that must be regarded as parts of a valid capital market law. However, this legal development, which has not been analyzed scientifically in its entirety, has not led to a uniform picture of the law on the capital market in the Federal Republic of Germany. Sometimes civil law, company law, capital-market-related law and self-

* Regierungsdirektor in the Federal Ministry of Justice, Bonn; Member of the Law Faculty of the University of Bonn.

regulatory rules apply all at the same time. It is said that company law does not take enough account of the needs of the capital market. It is also said that the capital market related rules do not sufficiently relate to the order and inner structure of the issuing companies. Finally, it is said by some that the body of law applicable to the market and its participants is ineffective. In Part 3 of this paper this criticism will be dealt with briefly.

The lack of uniformity in German capital market law is more apparent if one realizes that there is a fragmentation of the organs of control. Whereas a partial supervision of the issuing institutions' duties under company law is a matter for the judge keeping the register, the Federal Minister of Finance decides on the approval of the issue of bonds. Institutional investors (such as banks, investment companies, life insurance companies, and building and loan associations) are supervised by various authorities of the Federal Government and, in addition, in certain fields even partially by state (*Länder*) authorities. Certain types of investment are subject to supervision merely under industrial law (*Gewerberecht*) by decentralized offices. Supervision of the eight stock exchanges existing in the Federal Republic of Germany (Frankfurt, Dusseldorf, Berlin, Hamburg, Munich, Hanover, Stuttgart, Bremen) is a matter for the *Länder*.

2. Present situation

We shall try to introduce a certain order into this impression of confusion by describing in three sections the rules for the forms of investment, the markets and the self-regulation of the economy.

A. Provisions on different types of securities

(i) Shares of stock corporations

There is no general governmental supervision of the stock market in the Federal Republic of Germany. Shares may be offered and sold publicly, and no publication of any business data at the time of the issue or any administrative approval is required. Only if trading in stocks is to be effected through an "official" market institution (the stock exchange) do the detailed control provisions of the stock exchange law apply (*cf.* B(i), below). Even the stock corporations themselves, which in the German view are companies open to the public, have not been subject to administrative restrictions since the abolition of the concessional system that was in force until 1870. The legislature thought that by enacting mandatory provisions of corporate law instead, the relation of the company to its shareholders and creditors and the organization of the company could be sufficiently provided for. Some rudimentary functions of supervision are exercised by the courts of registration.

The Stock Corporation Act, most recently fundamentally amended in 1965, contains the following provisions which are material to a consideration of the legal

aspects of the capital market and can here only briefly be referred to. It first requires the incorporators of a stock corporation to make a report on the circumstances of its formation. If members of the managing board or of the supervisory board are involved in the process of formation or if the company accepts the contribution of assets other than money for the acquisition of shares, this formation report must be examined by court-appointed auditors (Secs. 33, 34 of the Stock Corporation Act). The formation report and the audit report must be submitted to the Commercial Register which is open to inspection by the public (Sec. 9, para. 1 of the Commercial Code). The examination and disclosure of the formation report were essentially provided for as early as the 1884 amendment. Their obvious purpose is the protection of the capital market from fraudulent formation of corporations. The publicity of the register is accompanied by the register court's power of examination for obvious violations of the law and disproportionate valuations of assets other than money to be contributed to the corporation (Sec. 38 of the Stock Corporation Act). This does not mean, however, that the court has the duty to enter into a detailed substantive examination of the matter. Rather, it is to pursue doubts it may have whilst taking into account that there is considerable latitude in the valuation of contributions other than money [1]. The legal provisions on the formation of a corporation consequently do not prescribe any detailed material examination of the corporation in the interests of the capital market.

Nor does the German Stock Corporation Act provide for current supervision of corporations by administrative authorities or the courts during the life of the corporation. The most important instruments of control are, rather, the legally required annual publication of the balance sheet, the profit and loss statement, and the business report (Sec. 177 of the Stock Corporation Act) as well as certain provisions protecting the rights of minority shareholders.

Rules mandating the form of accounts (as well as valuation standards) apply to the annual statements of corporations which, according to the intentions of the 1965 legislature, were to give effect to the principle of "transparent pockets", *i.e.* were to give the public a complete insight into the financial and earning position of the enterprise. Whether this legislative aim has been realized is disputed by learned writers [2]. Because of the latitude in valuation alternatives and the non-disclosure of profits subject to taxation, there is much to say for the opinion that the profits listed might sometimes be at great variance with the profits actually made. In addition, in Germany, as opposed to Anglo-Saxon countries, there is a tendency to try to present a continuous balance sheet picture by concealing particularly high profits or losses by the accumulation or dissolution of hidden reserves.

The annual balance sheet of a stock corporation is examined by a certified public accountant who certifies its correctness (Secs. 166, 167 of the Stock Corporation Act). His examination is primarily to determine whether the bookkeeping is proper and the statements in the business report are correct. The actual correctness of statements, however, is tested by the certified public accountant only by sample checks [3]. The annual financial statements have to be filed with the court

of registration and published in the publications designated in the corporation's articles.

The most important rights of control to which a public investor is entitled are his rights to sue for the avoidance of resolutions passed at shareholders' meetings in violation of the law or the articles of incorporation or on account of refusal by the corporation to give information, and the right to demand the appointment of special auditors for the review of the annual balance sheet or the business report (Sec. 258 of the Stock Corporation Act) [4]. For the protection of minority shareholders in controlled enterprises German company law contains detailed provisions on "groups of enterprises" (*Konzernrecht*). If an enterprise controls a stock corporation by reason of a "control agreement" or an "agreement to transfer profits", the so-called outside shareholders are, at the time of the conclusion of the agreement, entitled in accordance with Sec. 305 of the Stock Corporation Act to demand an indemnity (*Abfindungsanspruch*) in the form of shares in the controlling company or in cash [5]. If they want to remain in the corporation, they must be paid an adequate annual compensation (*Ausgleichsanspruch*) which must be equal to at least the prospective earnings of the controlled enterprise at the time of the control agreement. In the case of *de facto* control of another enterprise the controlling enterprise must pay compensation if any disadvantageous measures of influence have been taken (Sec. 311 of the Stock Corporation Act).

(ii) Bonds

In contrast to the issuance of shares, bearer bonds and negotiable bonds drawn up in the Federal Republic of Germany may be marketed only with official approval. The legal bases for such approval are Secs. 795, 808 (a) of the Civil Code and the Act on Official Approval of Bearer Bonds and Negotiable Bonds of June 26, 1954 [6]. It is the purpose of the approval proceedings of the Federal Ministry of Finance to examine whether payment of interest and principal appear to be sufficiently ensured (from the standpoint of protection of the saver), whether the functions of the capital market are preserved and whether dangers for the currency might arise by an overflowing of the market with money-like securities [7]. It is disputed how effective such proceedings are in furthering a policy in the face of the influence of the situation in the capital market, especially the interest level [8]. The declared purpose of the law to terminate direct government control of the capital market during the post-war period is best realized by restricting the government's power of interference to cases involving substantive disturbances that impair the functioning of the capital market. Such disturbances, however, may be imminent if approval of conditions not in conformity with the market are applied for or if the number of applicants at any one time becomes excessively large. To get a picture of the actual importance of the approval proceedings for bonds one must realize that investment in bonds exceeds investment in shares many times over [9].

(iii) Certificates issued by investment companies

A distinction has to be made between certificates issued by domestic investment

companies and those issued by foreign companies. The Act Concerning Capital Investment Companies of April 16, 1957 (as amended) [10] contains provisions on the organizational structure of German companies investing their property in securities or real estate as well as on their investment policy. Legal separation of the assets of the investment company from the unit holders' securities collected in an incorporated pool (investment trust) guarantees the safety of investors from the time they acquire a share (*cf.* Sec. 6 of the Act) [11]. The investors do not become corporate members of the investment company. Moreover, there is a segregation of the unit holders' securities by the mandatory administration of these particular securities by a custodian bank.

In contrast with the stock corporation law, the Investment Company Law does not provide investors with a right to be heard, or for rights of control, with respect to the company's business policy [12]. But the law contains detailed provisions on the investment companies' investment policy, serving to minimize the risk to investors. Investment funds may acquire only securities admitted to official trade and quotation at the stock exchanges (Sec. 8 of the Act); only up to 5 per cent of the shares of any one issuer may be accepted into the portfolio; and securities of any one issuer must not exceed 5 per cent of the net asset value of the investment fund. Real estate investment funds may acquire vacant parcels of land only to a limited extent; the value of a single piece of real property is to be determined by an expert committee before acquisition and must not exceed a certain part of the net asset value (principle of risk spreading) (Secs. 27, 28 of the Act). The management of the investment company is supervised by the custodian bank (Secs. 12, 26 of the Act) as well as by the Federal Banking Supervisory Office (Sec. 2 of the Act; Sec. 33 of the Banking Act).

The requirements for current disclosure by the company occupy a prominent position in the law. At least semi-annually, accounts must be rendered, including the state of the assets of the fund; they must be published in the Federal Gazette (Sec. 25 of the Act). These published accounts make it easier for the investor to decide whether he wants to avail himself of the right (which he always has — except in the case of real property funds where there is a certain waiting period) to have his share in the investment trust paid to him in cash against surrender of his share certificate (Sec. 11, para. 2; Sec. 36 of the Act).

The Act Concerning the Distribution of Foreign Investment Shares of July 28, 1969 [13] does not transpose to foreign funds the protective provisions of substantive law provided by the Act Concerning Capital Investment Companies because the legal systems are too different. The application of several rigid ideas of German law would lead to a virtual prohibition of the distribution of foreign investment shares in the German market: the assets of the investment company would have to be strictly separated legally from the investors' securities and the administration of the assets of the fund would have to be supervised by a custodian bank with well-defined rights and duties. The Act Concerning the Distribution of Foreign Investment Shares is, therefore, confined to providing for certain special requirements

that must be met before the Federal Banking Supervisory Office will grant permission for the distribution of foreign shares.

These requirements concern principally the administration of assets by the foreign investment company (Sec. 2, item No. 2 of the Act) and the terms of the contract between the investment fund and the investor (Sec. 2, item No. 4 of the Act). Sec. 2, item No. 2 of the Act requires that the investor's assets be in the safe keeping of a custodian bank or, in the case of real estate, be supervised by such a bank, thus providing the investor with security in a way comparable to Sec. 12 of the Act Concerning Capital Investment Companies. This means that in cases where the assets of the company are not legally separated from the investors' securities and where the custodian bank appears as trustee or mere depositary for the company, the custodian bank's comprehensive custody of both the investors' cash and non-cash assets must be established in the contract with the bank. Other legal provisions applicable to the custodian bank need not correspond to those enumerated in Sec. 12 of the Act Concerning Capital Investment Companies, but by the functions of the foreign custodian bank and by other measures the investor must be safeguarded at a level corresponding to domestic law [14].

The Act also places great weight on regulation of marketing and disclosure by the foreign investment company. The company must have a paying agent and a representative in the Federal Republic of Germany and persons interested in the purchase of shares must be given a sales prospectus the contents of which are legally prescribed (Sec. 3 of the Act Concerning the Distribution of Foreign Investment Shares). The company must issue an accounting report at least semi-annually (Sec. 4 of the Act) and announce the prices of issue and redemption daily (Sec. 4, para. 1, item No. 3 of the Act). The observance of these duties of disclosure is supervised by the Federal Banking Supervisory Office.

Both investment acts, particularly the Act Concerning the Distribution of Foreign Investment Shares, mark a stage in legal development where the company law regulations of the issuing enterprise recede and market-related measures combined with official supervision assume greater importance.

B. Regulation of markets, persons and institutions having market functions

(i) "Official" trade on stock exchanges (listed securities)

"Official" trade in securities (*i.e.*, trade in listed securities) on German Stock Exchanges is governed by the Stock Exchange Act, which has repeatedly been amended, the latest amendment dating from April 28, 1975 [15]. It contains provisions for the organization of the stock exchange, the licensing of persons admitted to the stock exchange and the admission of securities and commodities to trade on the stock exchange, the legal position of certain people participating in the market (exchange specialists and floor traders), the settlement of exchange transactions and, above all, future dealings. The stock exchanges of the Federal Republic of Germany are established as institutions of "public law" administered by the bodies of

the exchange themselves [16]. Quotations are fixed by public-appointed exchange specialists in proceedings regulated by public law (Sec. 29, *et seq.* of the Stock Exchange Act). All activities at the stock exchange are subject to supervision by the *Länder* (Sec. 1, para. 2 of the Stock Exchange Act) and by a specially appointed state commissioner (Sec. 2 of the Stock Exchange Act). The licensing of persons admitted to the stock exchange by the board of governors (Sec. 7 of the Stock Exchange Act) and the admission of securities and commodities to official quotation on the stock exchange (Sec. 36, *et seq.* of the Stock Exchange Act) [17] have been provided for in detail in the form of proceedings before an administrative authority.

The introduction of securities to official stock exchange trade (*i.e.*, listing) is effected as follows: the admission of a sufficient number of securities suitable to be dealt with on the stock exchange must be applied for by a bank. A detailed prospectus, the contents of which are prescribed, must be attached to the application [18]. The application is examined by the stock exchange's board of admission. The board may demand additional information. The board's duties under Sec. 36, para. 3 of the Stock Exchange Act are to insure that all relevant information is furnished to the public by the prospectus and to prohibit the issue of securities that may endanger important public interests or that may lead to significant disadvantages for the purchasers. After the application has been granted and the stock exchange prospectus published, the securities are introduced to trade on the exchange.

This trade is effected between the banks and merchandisers admitted to the stock exchange through the agency of exchange specialists and floor traders. The "official" quotations are fixed, in the case of securities with a large turnover, by the notification of every deal; in the case of securities without a large turnover, by the computation of a uniform quotation at which the largest possible number of orders may be carried out. The quotation can be effected only by the exchange specialists or the board of governors. In the Federal Republic of Germany there is no compulsion to channel clients' orders through the stock exchange at officially quoted rates. However, in their standard contract terms the banks have undertaken that they will always submit clients' orders of officially quoted securities to the stock exchange, in order to widen the market at the exchange and to enhance the guarantee that the established quotations are correct.

(ii) Regulated and unregulated trade in unlisted securities

In addition to the official trade in listed securities on stock exchanges, there is the unofficial regulated market both on and off the stock exchanges in securities that are not admitted to official trade (unlisted securities). Although there is a considerable market for these securities, their trade is not governed by the Stock Exchange Act. In this field there is, however, self-regulation of the market participants (see C (iv), below). Another market covers so-called nonregulated unlisted transactions, *i.e.* trade off the stock exchange in securities not included in the unofficial

regulated market. There is only a rudimentary examination of the quality of such securities prior to their inclusion in the price list by dealers engaged in this trade [19].

(iii) Institutional investors

The term "institutional investors", in its wider meaning in the Federal Republic of Germany, is understood to mean all enterprises where long-term funds currently accumulate and are available for investment in the capital market. Among these investors are primarily the private insurance companies and the social insurance institutions, but banking institutions, building and loan associations, and investment companies are also included.

The business activities of the investment-oriented *insurance companies*, i.e. mainly the life insurance companies, are made subject to the supervision of the Federal Insurance Supervisory Office by the Act Concerning Supervision of Insurance Companies. This authority approves the business plans of the enterprises and, in case the potential claims of the insureds are imperiled, intervenes to prevent losses and failures (Secs. 80, 81(a) of the Act Concerning Supervision of Insurance Companies). The investment policy of the insurance companies is regulated by provisions on the investment of liquid assets, which are intended to limit and spread the risk as well as to regulate the profitableness of the investment (Sec. 54(a)-(d) of the Act Concerning Supervision of Insurance Companies). The strict investment provisions in force at an earlier date have been relaxed by the 1974 amendment [20], which gradually widened the room for investment. The life insurance companies are also required to provide current disclosure corresponding to that of the Act Concerning Joint Stock Companies [21].

The *social security institutions* of laborers and employees (which, on account of the advanced social security system of the Federal Republic of Germany, accumulate considerable amounts of money) need to use the bulk of their assets to satisfy current obligations of the pension system. In the capital market they merely invest reserves of liquidity as well as any surpluses that may have accrued [22] and to this extent are subject to statutory investment regulations. As bodies corporate under public law they are, moreover, subject to current supervision by governmental authorities.

Since the time of the Weimar Republic, *credit institutions*, whether under private or public law [23], have been subject to governmental supervision under the Banking Act. This Act has been repeatedly amended and, after the failure of the Herstatt bank, made stricter [24]. It is the purpose of the Act to make provision against abuses which are apt to endanger the safety of assets entrusted to credit institutions (Sec. 6, para. 2 of the Banking Act) thereby impairing the functions of an economic sector regarded as vital to the economy. Any banking transaction, especially the receipt of deposits, requires a license by the authority, which will especially examine the professional qualifications of the managers and the capital basis of the enterprise. Through provisions on liable funds [25] and the liquidity of

the institutions, which, *inter alia*, are the statutory framework for granting and dispersal of loans, the soundness and solvency of the institutions are to be guaranteed (Secs. 10–12 of the Act).

It is noteworthy that the Act contains no requirement that a particular loan be subject to governmental approval and no provision for governmental allocation of loans to particular sectors of the economy; the Act provides only for general limitations justifiable by principles of good banking practice. Nevertheless Sec. 23 of the Act contains the possibility, presently not used, of governmental determination of interest on loans and deposits and thus of governmental influence on essential features in the operations of these institutions. Credit institutions are subject to a duty of disclosure which is limited compared with the provisions of company law (Secs. 26(a), 26(b) of the Act) but are subject to wide governmental rights to demand information and to make investigations. Likewise, the 1976 amendment increased the authority's powers to interfere in cases of serious danger to an institution; through the authority's exercise of these powers, bankruptcies of credit institutions may possibly be avoided in the future (Sec. 44, *et seq.* of the Act).

In addition to the provisions of the Banking Act, special provisions of governmental supervision apply to the public-law credit institutions, which play a significant part in the volume of banking business as a whole. Any bankruptcy of such an institution is precluded by the guarantee of the public authority backing it.

In addition to the Banking Act, the Building and Loan Associations Act 1972 [26] furnishes special provisions for building and loan associations and the Mortgage Bank Act [27] for mortgage banks. They deal especially with the refinancing of these banks and require that loans be made for set purposes. They deal also with the relationship between customer and bank. Although the two last mentioned groups of banks are special banks, German banking law in principle recognizes no separation of the functions of deposit banks on the one side and of underwriters and the brokerage business on the other. Rather, banking institutions may receive a so-called full charter; the all-purpose bank is the predominant type in the Federal Republic of Germany.

(iv) Supervision under industrial law (Sec. 34(c) of the industrial code)

As an answer to the increasing offer of "business shares" (interests in limited partnerships and foreign issues) which are not subject to any detailed provisions oriented to the capital market and are traded outside the organized capital market, the German legislature, by enacting Sec. 34(c) of the Industrial Code [28], has subjected persons who negotiate the purchase of such shares to an examination by the industrial supervisory authorities. This examination extends to the personal trustworthiness and the financial circumstances of the traders, which must be unobjectionable. In the interest of the protection of investors, traders are further required to give information before making sales and are subjected to certain duties of conduct with respect to investors' assets. The attempt to use industrial police law to secure the reliability of traders and thereby indirectly the quality of the investment

may, however, be easily circumvented by the issuer or the promoter by distributing the shares in its own name. Moreover, control by a sort of special police is hardly an adequate way to safeguard the quality of an unorganized market.

C. Self-regulation of the industry

Self-regulation of conditions in the capital market by private business institutions is not extensive in Germany. One reason may be that the enforcement of public interests in Germany is traditionally effected by law enacted by the State. Therefore, in many cases self-regulation appears as a preliminary step to statutory provisions. On the other hand, legal [29] and public opinion regard the setting of rules by economic associations as being insufficient to regulate effectively the interests of the general public or even of parties on opposite sides of the market. Nonetheless, some institutions and procedures have recently been established that may claim for themselves a regulative function in the capital market.

(i) Deposit guarantee funds of the banking business

The three major groups of the German banking business (private banks, savings banks, and credit co-operatives) maintain differently organized deposit guarantee funds financed by their member institutions, the purpose of which is, in case of the impending insolvency of a bank, to give help in the interests of depositors and, in case of the bankruptcy of a bank, to compensate depositors for losses. Thus, according to the statutes of the Fund of the private banks, non-banks are compensated for losses of wage, salary, pension and sight-accounts up to an amount of 30 per cent of the liable capital of the credit institution in question. In the case of the other groups of institutions the payments from each fund are not limited in amount, but bankruptcy of such an institution has not occurred for a long time. Membership in an organization designed to safeguard deposits is coupled with the obligation of the institution to submit to a periodic internal audit by the appropriate bankers' association. Special risks in the business of a bank are thus sought to be recognized at an early time. There is no question that such an audit will tend to equalize conditions between banks and impair competition. For this and other reasons [30] the voluntary safeguarding of deposits by the banking industry is disputed as a legal matter.

(ii) Directives governing insider transactions

Following the recommendations of the Exchange Expert Committee convoked by the Federal Minister of Economics the head organizations of business have advised potential insiders employed with listed companies and credit institutions to submit voluntarily to the so-called insider directives and the rules for dealers and advisers [31]. Under these rules the persons concerned pledge themselves by contract to abstain from insider transactions and to look solely after their customers' interests when making recommendations. The profits from insider transactions are

to be paid over to the corporation whose securities have been the subject of the transaction. Investigation of cases of insider trading is conducted by supervisory panels set up at the stock exchanges. The directives governing insider transactions and the rules for dealers and advisers have been accepted by the majority of potential insiders and by almost all credit institutions. Nevertheless, by the weight of opinion in legal scientific literature, these rules have been criticized because of substantive loopholes and because the procedures are administered privately, within the industry, rather than by judicial or other independent public bodies [32].

(iii) Take-over bids

Most recently the Exchange Expert Committee has published recommendations concerning take-over bids [33]. According to these recommendations, a bid should include any relevant information to be taken into account for its evaluation, in particular elements that were of importance for the fixing of the take-over price. The bid should provide for a reasonable time for review and should obligate the purchaser, in case of a new and higher bid during a period of eighteen months, to give equal treatment to all shareholders who intend to sell. New facts occurring during the duration of the bid which may have unfavorable consequences for the take-over price assessment should be disclosed by the purchaser. The offerer should refrain, during the duration of the offer, from any transactions on his own account involving shares of the company concerned.

The recommendations are not binding but are considered by the Commission as a reflection of correct and responsible commercial conduct. In this way, they could become at least partially binding rules by way of commercial practice (see Sec. 346 of the Commercial Code). As to the substance of the recommendations, the criticism could be made that they reduce the period for adjusting former bids to eighteen months, thus possibly counteracting prior practice under which the price commitment was often applicable for a period of three to five years. Moreover, the obligation to adjust the price does not cover subsequent measures taken under the law on enterprise groups (*Konzernrecht*) and their review by the courts. For example, if, after the close of the take-over procedure, the purchaser and the other company enter into an agreement to transfer profits or into a control agreement, and if the settlement fixed therein for the minority shareholders is improved in court proceedings (Sec. 306 of the Stock Corporation Act), the shareholders who sold their shares under the take-over procedure are not entitled to equal treatment in terms of the court decision.

(iv) Regulation of the unofficial market

Panels governing the unofficial market formed by the market participants decide in proceedings patterned after the Stock Exchange Act whether a security is to be included in unofficial trade. Trade is conducted in accordance with usages determined by a committee established by the Federal Association of German Banks. The regulation of these unlisted transactions, which may be compared with the

over-the-counter market, is therefore completely in the hands of the securities business. However, this market does not have the safeguards provided by the law on official trade. Publication of a prospectus is not compulsory; there is no statutory liability for the correctness and completeness of a prospectus, nor is there any fixing of prices by independent, government-supervised persons. In the case of the unlisted transactions there is only an incompletely regulated market without any genuine outside control.

(v) Voluntary disclosure

Finally, the rendition of semi-annual interim reports by the majority of companies and the publication by the stock exchanges of the turnover of the most important securities traded on the exchanges are based on a voluntary arrangement. Both measures are in accordance with the opinion that better information should be provided to investors and to all those who are interested in the condition of the capital market. As to the contents of the interim reports the stock exchanges have worked out various schemes for different sectors of industry, providing for a minimum of statements [34]. As in the case of all voluntary arrangements, they are not enforceable; if violated, there is no legal sanction.

(vi) Central capital market committee

As early as 1957 the major issuing banks set up a committee to meet, usually monthly, with representatives of the German Central Bank and the government to discuss the situation of the bond market. Taking account of market conditions recommendations are made on the order, the terms, and the timing of loan issues to prevent any bunching of issues and consequent excessive strain on the market [35]. Although these recommendations are not binding they are generally followed by the participants and are understood to be a substitute for state supervision of the capital market. The Council of Economic Trends for the Public Authorities occupies the same position in relation to the public sector as the Central Capital Market Committee does to the private sector.

3. Problems

A. Company law versus regulation of the market

In the Federal Republic of Germany the law relating to the capital market flows essentially from two sources: (1) provisions referring to the market process (in the case of certain forms of trade in securities) and to the administration of the assets of investors by certain enterprises and (2) the company law, which is largely the law applicable to the organization of a community joined in a certain legal form. So far both legal fields have been regarded much too separately and not sufficiently in their functional interrelation [36]. When the Stock Corporation Act of 1965 was enacted, it was recognized that one of the objects of the Act was regulation of the

corporation's function of capital accumulation from a great number of investors for the purpose of financing large enterprises [37], but when the Act was formulated this function of capital accumulation was not taken sufficiently into account. When a group of controlled enterprises is created by contract, it is true, outside shareholders are granted compensation or indemnity, but company law does not regulate the process of development of power by one corporation over another, for instance, by take-over bids. So far the German company law contains no provisions to protect shareholders from insider transactions.

On the other side, the capital market law covers only a part of the field of the capital market. Trade in shares in limited partnerships, which has considerably increased in recent years, is supported neither by market regulations nor any detailed provisions of company law. One of the aims of the capital market approach that has been developing recently is to close the gap between company law and capital market regulations and thus to create a uniform system with due regard to the existing situation.

The existing legal situation outlined briefly in Part 2, above, reveals, however, that the regulations relating to the capital market are increasingly realized by public supervision of institutional investors (Act Concerning Capital Investment Companies, Act Concerning the Distribution of Foreign Investment Shares, Insurance Supervisory Act, Credit Institutions Act) and by organization of markets under public law. Traditional company law, on the other hand, recedes into the background (if the further extension of the disclosure principle which is derived from the company law is put to one side). The reason for this development may be that the good order of the capital markets and their institutions is increasingly regarded as a public responsibility in the interest of a great number of investors and the smooth financing of the economy.

B. Protection of the individual versus safeguarding of functions

Seen from a scholarly viewpoint, the principal legal question relates to the direction which is to be taken by protective legislation. Some people emphasize the individual protection of the investing public. Others stress the good functioning of transactions on the capital market and the sound structure of the capital market institutions, hoping to realize the protection of the investor at the same time. Advocates of the first opinion prefer the enlargement of civil law precautions through the development of company law; representatives of the second view incline towards an economic legal system with governmental supervision. In my opinion, this dispute, which has aspects not only of legal policy but also of fundamental economic policy, should be solved on a pragmatic basis. Whoever favors legal provisions serving the individual's protection, especially contractual claims and compensation sanctions, will have to prove their effectiveness and, if necessary, will have to accept supplementary provisions for the safeguarding of market functions that require no individual activity. On the other side, it must be conceded to those

who place the safeguarding of market functions first that the protection of the interests of investors can also be achieved thereby. This is so because a sound system of investment enterprises with a capacity for competition improves the investor's chances; a well-developed organized market guarantees the liquidity of assets at any time and at fair prices. The dispute as to where the crucial points are to be placed has not ended. Dealing with certain kinds of securities, the 1976 Conference of German Jurists resolved on a proposal favoring the safeguarding of market functions rather than, specifically, the protection of individual investors [38].

C. Fragmentation of capital market authorities

The survey of German capital market law in Part 2, above, has revealed a fragmentation of supervisory authorities. German law knows neither central capital market supervision nor supervision over all the phenomena relevant to the market. Central agencies certainly involve the danger that a super-bureaucracy, remote from the problems of reality, may be developed. It appears, however, that synchronization and the sharing of experience among the various authorities suffer from the present fragmentation and that some of the examinations prescribed by statute are not actually being carried out. The partial legal regulations and the correspondingly limited organs of control must, moreover, create a situation where the capital market – which despite certain phenomena should be seen as interdependent and uniform – is not viewed as a whole. As a result, from the point of view of the investor, the security level of the investment varies; on the part of the offerer there appear distortions of competition; on the part of the authority there is a tendency to over-emphasize the requirements of the sector for which it is competent. It is one of the tasks of jurisprudence to achieve more systematization and unification of legal thought in the direction of a uniform capital market law. The extension to the Federal Banking Supervisory Office to a central supervisory authority might be a means to that end.

D. Loopholes in the capital market law

In the historical development of German capital market law some regulations containing loopholes were knowingly tolerated; some were discovered only after new factual developments. For instance, the Stock Exchange Act of 1896 did not provide for concentration of trading in securities on the stock exchange; the legislature assumed that, because of the safeguards provided for in the Stock Exchange Act (listing procedure, prospectus, ascertainment of official market rate), the public would naturally prefer to acquire securities quoted on the stock exchange. However, securities have been and still are also traded in Germany to a large extent outside the official market and even the unofficial regulated market; this is true especially of foreign shares and external loans. This gap in the system has recently led to

substantial losses by German investors purchasing foreign securities. A further loophole appeared recently when many partnership interests were sold by public offer without sufficient disclosures about these investments to prospective buyers or without investors being able to exercise an influence in their administration. The development of this so-called grey capital market has only recently led to legal scientific proposals for regulation and to the submission of a draft for a parliamentary bill dealing with such investments (see Part 4, Section B, below).

E. Lack of effectiveness of the self-regulation of the business community

The forms of self-regulation of the business community mentioned in Part 2, Section C, above, are increasingly subject to criticism [39]. Although it is a good thing that industry makes up for recognized deficiency in regulation, there often remain doubts whether these dispositions are correctly construed from a legal point of view and whether the goals aspired to can be attained. Moreover, the conflicts of interest usually inherent in such arrangements make the enforcement of effective sanctions more difficult.

4. Outlook

A. Initiatives of the European Economic Community

As a result of the membership of the Federal Republic of Germany in the European Economic Community the development of German capital market law is increasingly affected by the endeavors of the Commission of the Community to harmonize and liberalize the investment sector. Although only a small part of the work undertaken at the Community level has so far been successfully completed, the fact that the Commission takes up a problem often causes the national legislature to wait and see before enacting regulations of its own.

The basis of a uniformly organized and regulated capital market is the free flow of capital within the Community as provided by Article 67 of the EEC Treaty. After two directives concerning capital movement were issued in 1960 and 1962 [40], the process of further liberalization of capital movement came to a standstill; a third directive concerning capital movement that was planned has not so far been issued. However, the freedom of establishment of institutional investors in the Community has meanwhile been evolved by the European Court of Justice as direct law in force [41].

On the other hand the work of harmonizing substantive capital market law and capital market supervision is continued in almost all fields. In the process, matters are taken up for which German law so far has not made provision, such as interim reports of issuers and prohibition of insider trading. The directives, a few of which have already been issued [42], are concentrated on the law of stock corporations

and the stock exchange law and on provisions regarding the supervision and investment policy of institutional investors. The intended extension of disclosure requirements under company law and stock exchange law and the emphasis laid by the present drafts on the basic interrelation of the operations on the capital market are noteworthy but cannot be dealt with in detail here. It may rightly be assumed that, under the influence of Community initiatives, legal scholars will be forced into an awareness of the interdependence of the regulations of capital market law in Germany and will thereafter occupy themselves more with this field of law.

B. Bill on the investment of capital

In response to a demand by the public and by legal scholars, the government has recently submitted the draft of a statute subjecting essential parts of the unorganized capital market, especially the market for capital interests in limited partnerships, to a regulation of the marketing process [43]. The bill provides that issuers shall submit a prospectus enclosing a scheme of accounts certified by auditors, and that issuers offering their shares publicly to a large group of persons must register with the Federal Banking Supervisory Office. The bill contains no provisions, however, for the merely embryonic secondary market.

The bill is of special importance for the development of capital market law because for the first time legally different types of securities are dealt with, not according to legal form, but from an overall market point of view. This clearly expresses the aims of regulation by capital market law, *i.e.*, that there shall be no misappropriation of economically necessary capital by investment in business undertakings that are unsuitable for the market and, secondly, that the investing public shall be protected.

C. Committee to study the structure of credit institutions.

After the failure of the Herstatt Bank the Federal Minister of Finance set up a committee charged with a critical examination of the German banking system and the submission of proposals for the removal of faults. The terms of reference of the committee include observations on the suitability of the universal bank system, banks' participation in business corporations outside the banking business, the conduct of banks in securities transactions, and bank representation of clients at companies' shareholders' meetings [44]. The report of the committee has recently been published.

D. Development of company law towards a law of enterprises

It is important to point to a legal trend that increasingly leads to a change of the conventional understanding of German company law. Especially because of the recent introduction of co-determination of employees with management on the

supervisory bodies of large enterprises, there is an emerging change in the notion that company law deals primarily with the organization of the firm's management as appointees of the providers of capital, the influence of shareholders in the company, and the rights of creditors of the company [45]. In a phrase, the enterprise is called "a value adding organization built on plural interests"; when it is given a legal order, special attention must be given not only to interests of capital and to management functions but also to concerns of employees and to the public interest in the functioning of the enterprise. Such a view would make it possible to include in the legal considerations relevant to that enterprise even those processes taking place on the capital market that concern persons who are not associated with the company as shareholders. In this way, for instance, provisions for the protection of persons acquiring securities from insiders, as well as the articulation of legal consequences resulting from the formation of blocks of shares on the market by individual shareholders, may be included in the enterprise law. It is not impossible that in the course of the development of an enterprise law matters which otherwise would have been provided for by governmental interference and public supervision may be covered by mandatory provisions of civil law.

E. Projections to have large groups of the population participate in the productive property of the economy

Finally we shall briefly mention how our problem is affected by the legislative platforms of the major political parties calling for a wide distribution of productive property through the participation of large groups of the population [46]. The intention to make practically the whole working population investors in the capital market in one form or another by operation of law will certainly increase the need for safeguarding investors. The fact that a vast number of persons will then appear as investors alters the significance of important occurrences on the capital market: they become quasi political events that affect everybody. The realization of plans for the participation of large groups of the population in the productive property of the economy will therefore tend to create an increase in capital market regulation.

Notes

[1] Baumbach-Hueck, *Aktiengesetz* §38, notes 4, 5 (13th ed. 1968); Barz in *Grosskommentar zum Aktiengesetz*, I, 1, §38, annotation 6 (1973).

[2] See, especially, Leffson, *Bilanzanalyse* VII, 46 *et seq.*, 106 *et seq.*, 217 (1976); Gessler, *Der Bedeutungswandel der Rechnungslegung im Aktienrecht in 75 Jahre Deutsche Treuhand-Gesellschaft 1890-1965*, 129, 158 (1965).

[3] See, in particular, Adler-Düring-Schmaltz, *2 Rechnungslegung und Prüfung der Aktiengesellschaft* §162, marginal notes 22, 312 (1971); Claussen in *Kölner Kommentar zum Aktiengesetz* §165, marginal note 13 (1971).

[4] The application requires a quorum of one twentieth of the basic capital or one million DM nominal amount. Aktiengesetz §258, para. 2.

[5] By a "control agreement" the controlled enterprise submits the company to management by another enterprise under certain safeguards; by an "agreement to transfer profits" the controlled company undertakes to transfer all its profits to another enterprise (see Aktiengesetz §291).

[6] Bonds issued by the federal government or the states (*Länder*) are not subject to the approval proceedings.

[7] See 1954 Bundestags-Drucksache II, 272 for the reasons given for the bill.

[8] See Bettermann, *Verfassungswidriger Emissionsstop – Zur Verfassungsmässigkeit des §795 BGB*, 1969 Betriebsberater 699, and Ungnade, *Die Zulässigkeit der staatlichen Einflussnahme auf den primären Rentenmarkt* (1972) at pp. 97, 131.

[9] 1973 3,581 shares (quotation value) (in millions of DM)
 45,960 bonds (nominal value)
 1974 3,525 shares (quotation value)
 51,020 bonds (nominal value)
 1975 6,010 shares (quotation value)
 76,080 bonds (nominal value)
 1976 6,081 shares (quotation value)
 73,757 bonds (nominal value)

Source: Statistische Beihefte zu den Monatsberichten der Deutschen Bundesbank, Reihe (series) 2, 1a column 1, 1b column 17.

[10] 1957 Bundesgesetzblatt I, 378; 1970 Bundesgesetzblatt I, 127.

[11] This separation of assets remains effective even in the bankruptcy of the investment company.

[12] However, councils of investors may be set up by internal arrangement. See Baur, *Investmentgesetze* §10, annotation III, 2 (1970).

[13] 1969 Bundesgesetzblatt I, 986.

[14] So-called level theory. See Flachmann and others, *Investmenthandbuch* (loose-leaf ed. 1977); Act Concerning the Distribution of Foreign Investment Shares §3, annotation 18.

[15] 1975 Bundesgesetzblatt I, 1013.

[16] One consequence of characterizing the stock exchanges as institutions of "public law" is the allocation of the jurisdiction of courts respecting the governance (*Leitung*) of the exchanges; another would be the applicability of the Federal constitution to the exchanges in ways it would not be applied to "private law" companies.

[17] The Notice Concerning the Admission of Securities to Stock Exchange Trade, July 4, 1910 (1910 Reichsgesetzblatt 917) was enacted to supplement §§36 *et seq.* of the Stock Exchange Act.

[18] The contents of the prospectus as well as the procedures for admission to an exchange are to be harmonized in the Community by two directives which are at present before the Council of Ministers. See text at Part 4A.

[19] See Schwark, *Börsengesetz* §43, marginal note 4 (1976).

[20] 1974 Bundesgesetzblatt I, 3693.

[21] Ordinance of July 11, 1973, 1973 Bundesgesetzblatt I, 1209.

[22] 1972 Monatsberichte der Deutschen Bundesbank 16, 19 *et seq.*

[23] The savings banks and their credit transfer (*giro*) centers, as well as a number of special credit institutions, belong to the category of institutions of public law.

[24] Promulgation of the new version of May 3, 1976. 1976 Bundesgesetzblatt I, 1121.

[25] The term "liable funds" is (in a different manner depending on the legal form) defined in Art. 10 para. 2 of the Banking Act. In the case of stock corporations and limited liability companies, liable funds are the paid-up capital, less the amount of company owned shares, and

the reserves. Reserves are deemed to comprise only the amounts shown as reserves on the balance sheet. Net profit is counted as part of the liable funds; any losses incurred are deducted from the liable funds.

[26] 1972 Bundesgesetzblatt I, 2097.

[27] The March 11, 1974 version of the Mortgage Bank Act. 1974 Bundesgesetzblatt I, 675.

[28] Detailed provisions are contained in the June 11, 1975 Ordinance to Implement §34c of the Industrial Code. 1975 Bundesgesetzblatt I, 1351.

[29] See Hopt, *Der Kapitalanlegerschutz im Recht der Banken* 148 et seq. 160, 161 (1975).

[30] See Schwark, *Einlagensicherung bei Banken*, 1974 Neue Juristische Wochenschrift 1849, 1852.

[31] Published by Baumbach-Duden, *Handelsgesetzbuch* 770 et seq., annex III to §382 (22d ed. 1977); commented on by Schwark, *Börsengesetz*, annex II (1976).

[32] See, most recently, Hueck and others, *Verbot des Insiderhandelns* 16 et seq. (1976) (with references).

[33] See Finanznachrichten of the Federal Ministry of Finance, Jan. 31, 1979.

[34] See Beyer-Fehling-Bock, *Die Deutsche Börsenreform und Kommentar zur Börsengesetznovelle* 176 (1975).

[35] See Ungnade, *op. cit. supra* n. 8, at 35, 164.

[36] Hopt, *Vom Aktien- und Börsenrecht zum Kapitalmarktrecht*, 1976 Zeitschrift für das gesamte Handels- und Wirtschaftsrecht 140, at 201-02; Kübler, *Transparenz am Kapitalmarkt*, 1977; Die Aktiengesellschaft 85; Schwark, *Kapitalanlegerschutz im deutschen Gesellschaftsrecht*, 1976 Zeitschrift für Unternehmens- und Gesellschaftsrecht 274.

[37] Reasons for the enactment of the 1965 Stock Corporations Act are set forth in Kropff, *Aktiengesetz* 14 (1965).

[38] See Verhandlungen des 51. Deutschen Juristentages (Minutes of the 51st Congress of German Jurists), Gutachten G (Hopt) and Sitzungsbericht P (Munich, 1976).

[39] See, e.g., Hopt, *op. cit. supra* n. 29, at 148 et seq.; Schwark, *op. cit. supra* n. 30, at 1849 et seq.

[40] EC Official Gazette, No. 912/60, July 12, 1960; EC Official Gazette, No. 62/63, January 22, 1963.

[41] *Reyners v. Belgian State*, [1974] E.C.R. 631; *Van Binsbergen v. Bedrijfsvereniging*, [1974] E.C.R. 1299.

[42] Three company law directives have entered into force (EC Official Gazette, No. L 65, March 14, 1968; EC Official Gazette, No. L 26/1, January 31, 1977; and EC Official Gazette, No. L 222/11, Aug. 14, 1978), as well as liberalization directives for credit institutions (EC Official Gazette, No. L 194/1, July 16, 1973) and for insurance companies (EC Official Gazette, No. L 228/20, Aug. 16, 1973). There is also a directive applying to insurance companies on the coordination of supervision (EC Official Gazette, No. L 228/3, Aug. 16, 1973) and a directive on the coordination of laws relating to the taking up and pursuit of the business of credit institutions (EC Official Gazette, No. L 322/30, Dec. 17, 1977). The directives in force for insurance companies do not, however, apply to life insurance companies.

[43] A bill concerning the sale of shares in capital investments. Bundesrats-Drucksache 407/77, September 2, 1977.

[44] For the tasks and composition of the commission, see Starke, *Bankaufsichtsnovelle 1976 – Eilreform als Teilreform*, 1976 Wertpapiermitteilungen 366, 367, 368. A discussion of the commission's work will appear in an early issue of this Journal.

[45] See Raisch, 1 Unternehmensrecht 81 (1973); Raisch 2 *id.* 98 (1974); Ballerstedt, *Was ist Unternehmensrecht?*, Festschrift für Duden 15 (1977); Kunze, *Bemerkungen zu Inhalt und Methode einer Unternehmensrechtsreform*, Festschrift für Gessler 47 et seq. (1971). Cf. Act Concerning the Co-determination of Employees (Mitbestimmungsgesetz) of May 4, 1976, 1976

Bundesgesetzblatt I, 1153. A discussion of this Act will appear in an early issue of this Journal.

[46] For a survey of the plans that have received much discussion but are now temporarily deferred, see Raisch, 2 *Unternehmensrecht* 130, 154 *et seq.* (1974).

Eberhard Schwark (b. 1939) received his Dr. jur. degree in 1969 from the University of Bonn. He served as research assistant at the University of Bonn in 1968–69 and as a member of the Money and Credit Department of the Federal Ministry of Economics from 1969 to 1973. In 1972 he was attached to the International Monetary Fund, Washington D.C. He was appointed Regierungsdirektor in the Federal Ministry of Justice (Trade and Economic Law Department) in 1975 and has been a member of the law faculty of the University of Bonn since 1977 (civil law, commercial and economic law). His publications in the field of capital market law include *Kommentar zum Börsengesetz und zu den Insiderrichtlinien* (München 1976); *Kapitalanlegerschutz im deutschen Gesellschaftsrecht*, *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 1976; *Probleme der Unternehmenspublizität im Lichte der 4. und 7. gesellschaftsrechtlichen EG-Richtlinie*, *Die Aktiengesellschaft* 1978; *Anlegerschutz durch Wirtschaftsrecht* (München 1979).