

RESPONSE TO FEDDERS' "WAIVER BY CONDUCT"

Werner de CAPITANI *

1. General remarks

As a member of the legal staff of a Swiss bank that is involved in two pending SEC insider investigations [1], I welcome the continuing discussion on transnational problems affecting the securities markets and appreciate the opportunity to make a comment on the proposed "waiver by conduct" approach. Obviously, the Fedders article examines the whole range of fraudulent securities transactions. For practical reasons, I limit my focus to insider transactions only.

I agree with Mr. Fedders and his co-authors in many respects. In particular, I agree that (1) there is a common interest in protecting securities markets from fraudulent conduct; (2) non-U.S. institutions or individuals effecting transactions on U.S. securities markets should submit to the jurisdiction of the United States; and (3) fraudulent securities transactions should be prosecuted and punished wherever they occur [2].

Misuse of insider knowledge is not commonly recognized as criminal in most European countries because transactions of this kind have so far not posed an acute problem [3]. Only France, Great Britain, and Denmark have enacted penal provisions to cover trading on inside information. Norway requires registration of transactions in a company's shares whenever these transactions involve the company's top executives. Germany and the Netherlands have relied on rules of professional ethics in this area, an approach which is also envisaged by the EEC [4]. In Switzerland, a report on an insider trading sanction provision, amending the Penal Code, has recently been released for public comment [5].

Even though I fully support the fight against insider transactions, I do not concur with Mr. Fedders' opinion that the waiver by conduct approach constitutes an appropriate measure for coping with the problem. I will not attempt to refute Mr. Fedders' claim that the principle of waiver by conduct does not imply extraterritorial application of U.S. law; for notions of territoriality differ widely [6]. Nevertheless, a law which aims at setting aside (at least

* Head of the Credit Suisse legal department.

partially) obligations created under the laws of another country has, in my opinion, an extraterritorial tinge [7]. Setting those disagreements aside, I endorse Commissioner Longstreth's opinion that:

advances in communications have rendered traditional notions of "extraterritoriality" about as useful a tool for developing law and policy as semaphore is for signaling in modern warfare. The question can no longer be one of whether a nation's laws should extend beyond its boundaries. We must ask how best to accommodate the legitimate application of the laws of various nations to transactions that significantly touch them all [8].

Accordingly, I will confine myself to arguing that Mr. Fedders' proposal would not serve its purpose and would hamper international cooperation.

2. The waiver by conduct approach is an unsuitable instrument in the fight against insiders

The waiver by conduct approach creates a presumption whose value depends entirely on its acceptance abroad. If the country in which the financial institution operates does not recognize the principle, little or nothing is gained, even though the procedural posture of the SEC before the U.S. courts would be improved. But enforcement – access to the identity of the insider abroad – would be as difficult as it is today. We would also be confronted with the same conflicts existing today. Taking into account the numerous discovery blocking statutes (which were enacted mainly as counter-measures against discovery statutes of the kind under discussion), there is little reason to hope that foreign countries will sympathize with the waiver by conduct concept. For example, I simply cannot imagine that a Swiss court would find a presumption created by foreign law sufficient to repeal Swiss secrecy provisions [9].

Accordingly, the waiver by conduct approach would not equip the SEC with its desired universal all-purpose tool. It would merely equip it with yet another instrument it can use against certain foreign financial institutions, namely those which, due to their presence in the United States, can be pushed into a dilemma. The dilemma is that of having to choose between lethal sanctions by the United States or violation of the laws of their home country [10]. It is a remarkable euphemism to label a procedural tactic luring a defendant into such a trap as "one of the most significant achievements... in combating foreign secrecy laws" or as "a successful example... to use litigation to obtain information and evidence" [11].

The sanctions proposed by Mr. Fedders as the "sixth step" – dividend freeze, revocation of voting rights, and transfer suspension [12] – are also likely to be blunt weapons. A smart insider would get rid of the shares in time to enjoy the profits of his illicit dealings. Blocking measures would not hurt him.

The situation would be quite different if we could assume the existence of an international recognition of the waiver by conduct principle. In my opinion, this will not occur in the near future.

3. The waiver by conduct approach overshoots the mark and jeopardizes international cooperation

Irrespective of legal subtleties [13], let us admit that the SEC usually has no access to the name of the principal behind the bank and is therefore unable to determine whether or not that principal is an insider. Does this situation warrant the introduction of a device permitting the indiscriminate disclosure of the identities of all purchasers and of the details of every transaction on a U.S. stock exchange? Leaving aside the fact that the implementation of this idea would ultimately produce the same undesirable results associated with proposed Rule 17a-3(a)(9) [14], I believe that the demand is excessive, that it ignores an essential element of comity, and that it thwarts efforts for international cooperation.

3.1. The demand is excessive because it goes far beyond what is necessary and reasonable. Certainly, the SEC must be able to ascertain the names of insiders. This does not mean, however, that the SEC needs unlimited and unconditional access to the identity of all participants in U.S. markets, regardless of whether they are (alleged) wrong-doers [15]. A more considerate approach, producing the desired result while protecting noninvolved participants from unnecessary disclosure, should be adopted. Convention XVI provides a model of such an approach [16]. This view, of course, implies that total disclosure is not the only solution, and that secrecy when not misused to cloak fraudulent transactions may be justifiable [17]. I tend to believe that this is an insight which is slowly gaining recognition in the United States. A look at Convention XVI corroborates this optimistic prognosis. There, the SEC consented to an examination of potential insider information cases by a neutral Swiss Commission of Inquiry. A finding by the Commission, concluding that a customer was not an insider, is binding on the SEC [18]. The consequence is that the identity of a noninsider need not be disclosed.

3.2. Even in the absence of such an agreement, comity counsels acquiescence to a foreign law which, though unfamiliar, is considered important by the country enacting it. It commands restraint where foreign law diverges from the domestic.

3.3. Finally, waiver by conduct legislation is irreconcilable with existing patterns of international cooperation. For the Swiss, Fedders' proposal is

especially objectionable. Switzerland has clearly demonstrated its willingness to assist the United States in the enforcement of its laws. Instead of asking the United States to accede to the European Convention on Mutual Assistance in Criminal Matters of 1959, to which Switzerland has been a party since 1966, the Swiss agreed to negotiate the Mutual Assistance Treaty [19] which, to a large extent, makes allowances for peculiarities of U.S. law. This was hailed as "a pioneering effort" [20] and as "a useful and significant tool in combating crime and bringing offenders to justice" [21]. Switzerland has strived to facilitate the SEC's legitimate fight against insiders by adopting highly unusual and innovative legal procedures such as the Memorandum of Understanding [22] and Convention XVI. The Swiss have also demonstrated their continued readiness for cooperation by immediately setting insider legislation into motion [23]. In light of these facts, the waiver by conduct proposal is resented not only for its flagrant disregard of obligations assumed under a treaty, but also for being a very unfriendly gesture [24]. The credibility of the United States as a partner in international agreements is at stake. *Pacta sunt servanda*.

4. Conclusion

So far, my comment distinguishes itself by its predominantly negative tone. Since only constructive criticism is beneficial, I shall try to provide some.

I cannot avoid the impression that the main incentives for Mr. Fedders' proposal were (1) the threat of blocking statutes, and (2) disappointment with the complexities of foreign legal assistance and the resulting loss of time.

I have tried to show that one should not delude oneself by expecting that blocking statutes of one country can be overcome by a presumption created under the domestic law of another. Apart from this, the idea of countering blocking laws with other blocking laws is destructive and unlikely to produce satisfactory results. The waiver by conduct presumption, if not accepted by a foreign country, will probably not lead to the actual discovery of insiders. Also, the proposed sanctions (like earlier ones) are likely to hurt noninsiders as well as financial institutions caught between conflicting legislations, a discouraging result from which the U.S. stock markets would not benefit.

In conclusion, what I endorse is the neither new nor ingenious idea of increased international cooperation. Unilateral attempts will not produce real progress in this matter. True, the prospect of negotiating individual disclosure agreements with several nations along the lines of Convention XVI is not attractive. A more attractive alternative might consist in the conclusion of a multilateral agreement. Such endeavors would greatly be promoted if "a forum of regulators for the organized, systematic and continuous search for reason and fairness in dealing with transnational issues of securities regulation" [25] would be created.

Notes

[1] *SEC v. Certain Unknown Purchasers of the Common Stock of, and Call Options for the Common Stock of, Santa Fe International Corporation*, 81 Civ. 6553 (S.D.N.Y. 1983) (court denied SEC's request for information regarding suspect transactions because the requirement of "dual criminality" was not met. To satisfy the requirement it must be shown that the conduct under consideration was a criminal offense in both the United States and the foreign country); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) (the case involves alleged violations of securities laws by defendant bond traders. Defendants traded on nonpublic material information concerning tender offers by a law firm's corporate clients. Defendants were "tipped" by the law firm's manager of the office services department. In this decision, the court granted the SEC's motions for (1) a preliminary injunction barring defendants from future violations of the securities laws, and (2) a temporary freeze on profits realized from trades in the securities at issue.) The SEC alleges that Musella had an account with Credit Suisse over which he executed insider transactions.

[2] Fraudulent conduct, including securities fraud, is an offense in Switzerland, see Art. 148 Penal Code StGB, C.P. COD. PEN.; see also item 19 of the Schedule of the Mutual Assistance Treaty. However, the Swiss Federal Tribunal recently ruled that fraud requires a personal relationship between the defrauder and his victim (BGE 109 Ib 54). This type of personal relationship is absent in securities transactions carried out "through" Swiss banks, see *infra* note 7. Therefore, the Federal Tribunal held that insider transactions do not fall within the scope of Art. 148.

[3] This would also partially explain why Swiss banks and officials did not expect the vigorous attack launched by the SEC against insiders.

Incidentally, there are still those who defend insider transactions as a welcome incentive to a lively securities market.

[4] Erläuterung zum Vorentwurf für eine Gesetzgebung über missbräuchliche Verwendung von Insiderwissen (Report of the Swiss Department of Justice on legislation about misuse of inside information) 2/3 October 1983.

[5] *Id.*

[6] For a depiction of the situation see Detlev F. Vagts, *The Scope of Application and Enforcement of U.S. Laws*, 35 *Wirtschaft und Recht* 72 (1983). See also Frank Vischer, *The United States Jurisdictional Concepts Viewed from Abroad*, 35 *Wirtschaft und Recht* 98 (1983).

[7] It should be mentioned that the Fedders article frequently uses imprecise language when it speaks of transactions "through" foreign institutions. Fedders, *Waiver by Conduct – A Possible Response to the Internationalization of the Securities Markets*, 6 *J. Comp. Bus. & Cap. Market L.* 1 (1984). See, e.g., pp. 4, 8. Under Swiss law, stock exchange transactions are governed by a particular type of contract, the so-called commission, Art. 425 et seq. of the Code of Obligations OR. The relevant sections read as follows:

Art. 425

(1) Any person who undertakes, against payment of a commission fee (commission), to buy or to sell personal property or financial instruments in his own name but for the account of another (the principal), is a buying or selling commission agent.

Art. 436

(1) A commission agent who is entrusted with the sale of goods, bills of exchange, and other financial instruments having an exchange or market value, is allowed, unless otherwise instructed by the principal, to deliver as a seller for his own account the goods which he is to buy, or acquire as a purchaser for his own account those which he is to sell.

(2) In these cases, the commission agent is obligated to account for the exchange or market price in force at the time of carrying out of the mandate, and is entitled to the ordinary commission as well as to the reimbursement of expenses normally incurred in connection with other transactions on a commission basis.

(3) In all other respects, the transaction shall be treated as a purchase contract.

A stock exchange transaction is therefore composed of two elements: the (internal) mandate of the principal to the commission agent to buy or sell, and the (external) purchase or sale by the commission agent on the stock exchange. Accordingly, the transaction on the exchange of stock is executed by the agent, not through him. The situation is the same in Germany (German Handelsgesetzbuch §§ 383 *et seq.*, in particular §§ 400 *et seq.*). The advantages of the system consist in its anonymity and in the fact that the customer is dealing with a counterpart (typically a bank) on whose due performance he can rely, particularly in forward transactions. Incidentally, this system had already been adopted by the Zürich Securities Exchange Act of 1912.

The duality of the commission implies that the internal part is a matter of Swiss law while the external part is a matter of the law governing the stock exchange transaction. Accordingly, the proposed waiver would encroach upon a non-U.S. contractual relationship.

[8] Longstreth, *Toward Neutral Principles of International Securities Regulation*, 35 *Wirtschaft und Recht* 166 (1983).

[9] Another potential danger is one where an insider organizes a company outside the United States with bearer shares and with board members from the local community. There are many countries where such a company can be easily formed. If the company then conducts insider transactions through a financial institution in a different country, the insider's identity will remain undisclosed.

[10] *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981) [hereinafter referred to as the St. Joe case] (court held that defendant had deliberately courted legal impediments – the Swiss nondisclosure laws – and would not be heard to plead that compliance with SEC disclosure requirements would force defendant to violate foreign laws). This case is a telling example of this unsatisfactory result, though admittedly the facts were extraordinary.

[11] Fedders, *supra* note 7, at 14, 15.

[12] *Id.* § 6.3

[13] One could argue that because of the legal structure of stock exchange transactions under Swiss law, as described *supra* note 7, the waiver would only reveal what is already known, namely the name of the Swiss bank.

[14] Fedders, *supra* note 7, § 4.3.2.

[15] Wrong-doer is a strong word to use when the scope of the term is not even clear. Cases like *Chiarella v. U.S.*, 445 U.S. 222 (1980), *U.S. v. Newman*, 664 F.2d 12 (1981), *cert. denied* 52 U.S.L.W. 3240, and *Dirks v. SEC*, 103 S.Ct. 3255 (1983) evidence efforts to grope towards a reasonable demarcation line. They also evidence the danger threatening noninsiders of being entangled in litigation until their status is clarified. This danger is even more significant where investigations involve a group of unknown purchasers that is likely to include noninsiders. *See, e.g., Santa Fe case, supra* note 1.

The position of noninsiders is less than comfortable to start with, given the precedents established by the Swiss Federal Tribunal. According to these precedents, a foreign authority's request for legal assistance is formally sufficient if it itemizes who has allegedly committed what, and when.

[16] Convention XVI is reprinted in Green, *U.S., Switzerland Agree to Prosecute Inside Traders*, *Legal Times*, Oct. 4, 1982, at 19 and 27. *See also* 22 *I.L.M.*, No. 1, 7-12 (1983).

[17] The summary in Appendix A of Fedders' article, giving the background and rationale of Swiss bank secrecy, is excellent and fair.

[18] Fedders, *supra* note 7, §4.2.3.

[19] 27 U.S.T. 2019, T.I.A.S. 8302.

[20] Sen. Comm. on Foreign Relations. Treaty with the Swiss Confederation on Mutual Assistance in Criminal Matters. S. Exec. Doc. No. F, 94th Cong., 2nd Sess. V (1976) [hereinafter Message] (letter of submittal to the President by Robert S. Ingersoll, Dept. of State).

[21] *Id.* at III. When investigations are conducted under the Treaty, bank secrecy is essentially lifted. Other provisions, however, have been introduced to protect secrecy. See Art. 10 ¶2 in connection with Art. 3, ¶1(a) [Message 48] and Art. 15 [Message 52, 30/31].

[22] The Memorandum of Understanding (MOU) is reprinted in Green, *supra* note 16, at 17–19. See also I.L.M., *supra* note 16, at 1–12.

[23] See *supra* text accompanying note 5.

[24] The judge in the St. Joe case expressed an unacceptable nonchalant attitude when he dismissed a Swiss defendant's suggestion to use the treaty, as a proposal that would only "send the SEC on empty excursions".

[25] Longstreth, *supra* note 8, at 180.

Werner de Capitani (b. 1934) joined the Credit Suisse legal department in 1962. Educated at the University of Zürich Law School, he was elected in 1977 as a part-time judge at the Zürich Commercial Court (banking division), and participated in the Swiss working group that developed Convention XVI of the Swiss Bankers Association. His publications include *Internationale Rechtshilfe-eine Standortbestimmung* (international legal assistance - a statement of position) (1981) written upon the request for the Swiss Lawyers Association.

The opinions expressed in his contribution are his personal views and do not commit Credit Suisse.