

## RESPONSE TO FEDDERS' "WAIVER BY CONDUCT"

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### 1. Introduction

It is useful to place John Fedders' imaginative proposal of "waiver by conduct" in the broader context of increasing interaction among national regulatory systems. This increase in interaction is the inevitable consequence of the internationalization of business, with its intensive use of fast transportation and telecommunication. It has exhibited itself in a variety of areas.

For example, in the more traditional area of conflict of laws, legal orders tend to implement each others' public policy rules with greater frequency. Art. VIII, 2(b) of the IMF Treaty, and Art. 7 of the EEC Treaty of 1980 concerning the private international law of obligations [1], illustrate a growing awareness of the interdependence of legal systems.

In criminal law, however, treaties of mutual assistance are often inapplicable to violations concerning the economic policies of other states, despite the fact that they have been in force for a long time. This is due to the fact that the violated rules are often too specific, transient, and alien, if not antagonistic in their aims, to the policies of the enforcing state. Understandably, states are loath to assist in the implementation of other states' economic or foreign relations policies, especially when those are at variance with their own.

Insider trading is a good example in point. Whereas in the United States it constitutes a serious violation of important public policy rules, in many West European states it is a mere violation of the rules of ethics or of market-place fairness. Thus, in those states, even today, a violation of these rules is not generally frowned upon by the law. In fact, it would be considered quite unacceptable for a judge in such jurisdictions to set aside the jurisdiction's public policy, such as the one concerning bank secrecy, and give precedence to rules which in his system belong to an inferior non-legal order.

Conflicts between legal systems, arising from differing public policy rules, have been solved mainly in one of two ways: by treaty or by extraterritorial application of these rules. The latter alternative is often used against the will of

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other states since extraterritorial application is often viewed as an intrusion, especially where sensitive areas such as foreign relations or economic policy are involved. For example, the enforcement of the American policy with respect to the Siberian pipeline has caused much concern in Europe.

In a world of interdependent nations and friendly collaboration, the use of extraterritorial application should be left as an "ultimum refugium", to be used only when other methods have failed. Therefore, other approaches will be suggested here. These are probably less effective, but they follow the principles of comity that nations should preferably observe before taking matters into their own hand [2].

The legislative proposals made by Fedders are undoubtedly effective, but they amount to the imposition of a sanction without proof of a crime. The ultimate sanction, resulting in the confiscation of a security, menaces uncooperating banks without making a distinction between cases where this lack of cooperation is due to the bank, and cases where it is due to the laws to which the bank is subject. It would seem that these harsh measures do not sufficiently balance the interests involved. Predictably, they will lead to very serious diplomatic incidents if allowed to take effect against, for example, a subsidiary that has refrained from showing its records to American authorities.

It is advisable that the two problems of insider trading and disclosure of public records be dealt with separately because the second could lead to several unanticipated complications. For example, where a parent company is too willing to cooperate, a later liquidation or bankruptcy of its subsidiary can spawn new problems. A local judge may hold the parent company jointly liable with its subsidiary, due to the former's involvement in the latter's affairs. In other words, the willingness to cooperate may open the parent company to the challenge that its subsidiary is not a separate entity.

For such reasons, sections 2 and 3 will focus only on the problem of insider trading. In particular, they will focus on insider trading of U.S. securities on U.S. stock exchanges. Insider trading of U.S. securities on European markets (e.g. the ASA – shares in Amsterdam) [3], and of European securities on U.S. markets will not be dealt with.

## 2. International coordination

Extraterritorial application of insider trading laws, along with other aspects of extraterritorial enforcement, may be dealt with in an international treaty, whether multilateral or bilateral. John Fedders is very skeptical of the feasibility of this approach. His reluctance can be easily understood. It certainly would be a very lengthy, time-consuming, and highly uncertain enterprise to convince the nations involved to adhere to such a treaty. Moreover, the efficiency of the treaty approach rests upon the participation of all nations

involved in the common enforcement effort. It is highly doubtful that such will be the case, and one can easily imagine why several states may refuse to participate. As long as unregulated havens exist, enforcement will be plagued with loopholes. Stock exchange orders are too easily transmitted, from one state to another, to avoid the use of such loopholes by intermediaries from "unsuspected" states. Therefore, although the treaty approach certainly best preserves national sovereignty, it cannot be used as the single most effective technique. This does not mean that coordination at an international level is unnecessary.

Under present circumstances, international coordination could be useful in well-defined areas such as insider trading and other forms of market manipulation. This is especially true of the EEC. For a few months now, the EEC Commission has resumed its activities to develop a common standard for curbing insider trading. But these activities have had a rather difficult start. Several Member States were doubtful of the need for rules in this area. In the meantime, however, the United Kingdom has adopted legislation on insider trading violations, and others are considering such legislation (for example, Belgium; but compare with pending proposals in Switzerland, not an EEC member). In its ongoing attempts to develop these standards the EEC working party, whose activities are confidential, should pay special attention to the transnational aspect of the enforcement difficulties of insider violations. This problem is not restricted to United States-European relations; it exists within the EEC as well.

A few items could be submitted to the working party. The insider should be defined along criteria comparable to the ones used internationally. Noting that criminal matters have been left outside the ambit of the EEC treaty, it could be suggested that the use of inside information on any organized market be made a criminal offense. The offense would be committed by the person giving the order either at the place of execution or at the location of the bank or broker where the order is received and put in the regular process of execution. Offenders who are European residents would then be made liable, regardless of the origin or destination of the order; and a similar rule would apply to American residents transmitting orders via EEC securities markets. Under this suggestion, where a violation is at issue, secrecy laws could be lifted and relevant information revealed. This result follows directly from the provisions of existing treaties and procedures which lift the veil of secrecy when criminal activity is involved.

Cooperation among control authorities [4] has proven relatively successful in the past, at least in cases where clear violations were involved (*e.g.* in the IOS affair [5]). This cooperation should be strengthened. The extremely cautious rules adopted in EEC Directives on disclosure should be broadened in the field of insider trading. Measures should be introduced to lift secrecy vis-à-vis control authorities, so that appropriate criminal discovery procedures

could be initiated. It should, however, not become the responsibility of these authorities to investigate cases of insider trading, collect evidence, or prosecute before a court unless a violation has been committed within their territory. Of course, it goes without saying that reciprocity should exist.

One can presume that other nations could be convinced to follow a similar course of action, and would be willing to introduce comparable rules into their legal systems. In this way, areas "free of insider trading" could emerge. Orders coming from other areas could be subjected to some form of taxation, a premium to be paid unless the name of the principal is disclosed. Although not a sufficient bar to insider trading, this levy could help identify suspect orders. It seems clear, however, that international cooperation, while fruitful in some aspects, does not cover the entire subject.

### 3. The use of private law techniques

Another approach to curbing insider trading and related market manipulations is that of basing the waiver of secrecy rules upon private contract. The United States could declare it a public policy rule that no U.S. broker be permitted to accept orders from correspondents abroad unless they promise to impose the requisite waiver on their clients operating in U.S. markets. To facilitate acceptance of this approach, the waiver could be further narrowed to investigations of market manipulations.

Technically, the solution may prove satisfactory to many states. Not only would it enable American authorities to bar from access to their markets all parties not complying with their rules, but it would also enable a correspondent to impose the waiver on all parties, whether U.S. nationals or foreigners.

This approach raises a question as to the interests protected by secrecy laws. Are they those of the bank's client alone, those of the client and the bank, or those of the financial system in general? Only in the first case could the waiver be effective. In practice, it appears that there is very little case law on this point, and that in some states there is a reasonable possibility that this approach could be fruitful.

Supplemental measures are worth considering. Computerized telecommunications, giving direct access to the marketplace, make additional rules desirable. Subscribers to such services could be required to adhere to rules of fair and honest trading on U.S. markets; otherwise, trading on these markets could be jeopardized by charges of insider trading.

Also, European national regulatory bodies are being pressured into forming a network connecting the various European securities trading systems. Such a network would render these systems mutually accessible, necessitating common standards of conduct in these markets [6].

Finally, a partial lifting of anonymity in the securities markets may also be helpful. The names of the principals would, of course, not be disclosed. Instead, they would be stored in a separate computerized file. Orders would not be processed or executed unless the final identity of the principal is known and registered. This rule would greatly enhance transparency in markets. Being a condition for access, it could not be considered as having an extraterritorial effect. At the same time, it could prompt other trading systems to introduce a comparable rule.

In conclusion, I would like to submit that the enforcement of the SEC's policy may be effectuated by techniques other than "waiver by conduct". The proposed approach would be felt as an unfriendly intrusion on the freedom of other nations.

## Notes

[1] Art. VIII, 2(b), declares unenforceable contracts contrary to the foreign exchange regulations of other member states. Art. 7 of the EEC Treaty of June 19, 1980, on the private international law of obligations, *Off. Journal*, 1980, nr. L. 266/1, also provides that, when applying the law of a country in a given situation, account should be taken of the "mandatory rules of the law of another country with which [such] situation has a close connection".

[2] A comparable attitude was taken in the 1979 Belgian bill on insider trading. It attempted to bar access to Belgian markets, foreign banks, or brokers that refused to cooperate in the enforcement and discovery of insider violations. The bill has been modified, and the idea dropped.

[3] These are original American registered shares, dealt with in U.S. dollars on the Amsterdam Stock Exchange, while on the other continental exchanges dealing takes place in locally issued bearer certificates representing American shares. In practice circulation and trading of these certificates is restricted to the state where they have been issued. Quotes are labelled in local currency. Markets in these bearer certificates are somewhat separated from the main market.

[4] In Western Europe, supervision of the securities market is exercised both by state agencies (e.g. the French Commission des Opérations de Bourse) and by private bodies, especially the stock exchanges. Under the present harmonization philosophy of the EEC, both categories of "authorities" are put on the same footing.

[5] In the efforts to liquidate in an orderly fashion the investment funds managed by Investor Overseas Services, direct cooperation between the SEC and control authorities (especially the Luxemburg Commissaire au Contrôle des Banques) was organized. Similar forms of cooperation exist in the field of disclosure between the French, Belgian and Luxemburg bodies, and function on a rather informal basis.

[6] In May 1984 the Committee of European Stock Exchanges, in liaison with the Commission of the EEC, announced its determination to launch IDIS for intermarket data transmission on prices and quotes.

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