

1987

Foreign Bank Secrecy and Disclosure Blocking Laws As a Barrier to SEC Policing of Transnational Securities Fraud

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Recommended Citation

Yvonne G. Grassie, *Foreign Bank Secrecy and Disclosure Blocking Laws As a Barrier to SEC Policing of Transnational Securities Fraud*, 65 WASH. U. L. Q. 259 (1987).

Available at: https://openscholarship.wustl.edu/law_lawreview/vol65/iss1/11

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RECENT DEVELOPMENTS

FOREIGN BANK SECRECY AND DISCLOSURE BLOCKING LAWS AS A BARRIER TO SEC POLICING OF TRANSNATIONAL SECURITIES FRAUD

Increased capital mobility, expanding multinational corporations and improved telecommunications and data processing systems allow investors to transact worldwide business with relative ease. As a result, U.S. securities markets have become increasingly internationalized. This phenomenon has significantly complicated the Securities and Exchange Commission's (SEC) task of "insur[ing] the maintenance of fair and honest markets."¹

The SEC faces many enforcement problems when trying to prevent transnational fraud in United States securities markets.² This Development will consider the nature of foreign bank secrecy and disclosure blocking laws and the problems they pose to pre-trial discovery in securities fraud cases.³ It will then turn to current judicial and administrative

1. Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78(b) (1976).

2. Before the SEC can engage in pre-trial discovery to investigate transnational securities fraud allegations, it must establish both personal and subject matter jurisdiction. This aspect of transnational securities fraud regulation is beyond the scope of this article. However, for a general discussion of this issue see Fedders, *Waiver by Conduct—A Possible Response to the Internationalization of the Securities Markets*, 6 J. COMP. BUS. & CAP. MARKET L. 1, 17-21 (1984) (summarizing earliest bases for court jurisdiction, minimum contacts test and application of these theories to transnational securities transactions); Note, *The SEC's Waiver by Conduct Proposal: A Critical Appraisal*, 71 VA. L. REV. 1411, 1428-29 (1985) (hereinafter *Critical Appraisal*) (discussing various doctrines as well as case law defining the limits of U.S. jurisdiction); Thomas, *Extra-Territoriality in an Era of Internationalization of the Securities Markets: The Need to Revisit Domestic Policies*, 35 RUTGERS L. REV. 452, 456-59 (1983) (discussing "conduct" and "effects" tests as applied by courts in finding subject matter jurisdiction); Note, *Predictability and Comity: Toward Common Principles of Extra-territorial Jurisdiction*, 98 HARV. L. REV. 1310 (1985) (hereinafter *Common Principles*) (discussing the American Law Institute's proposed "standard of reasonableness" to determine the proper scope of U.S. jurisdiction); Note, *Subject Matter Jurisdiction over Transnational Securities Fraud: A Suggested Roadmap to the New Standard of Reasonableness*, 71 CORNELL L. REV. 919 (1986) (hereinafter *Roadmap*).

3. See generally, Fedders, *Policing Internationalized U.S. Capital Markets Methods to Obtain Evidence Abroad*, 18 INT'L LAW. 89 (1984) (discussing the SEC's investigatory duties and powers).

The scope of this article is limited to transnational securities fraud perpetrated by foreign investors. It does not extend to foreign issues. For a discussion of that aspect of the SEC's regulatory task see Thomas, *supra* note 2, at 468-71.

efforts to deal with such laws and these efforts' shortcomings. This Development will conclude by examining the relationship of both bilateral treaties⁴ and the "waiver by conduct" doctrine⁵ to a system which could enable the SEC to fulfill its regulatory duties.

I. SECRECY AND BLOCKING LAWS

In order to effectively preserve the integrity of United States securities markets, the SEC must be able to thoroughly investigate all instances of securities fraud which either impact on or take place in those markets.⁶ The SEC encounters problems when transactions are carried out through foreign financial institutions protected by bank secrecy and disclosure blocking laws. Usually foreign banks maintain accounts with U.S. brokers who then transact bank clients' business.⁷ Profits and losses are credited through the banks to individual clients whose anonymity is guaranteed by the secrecy and blocking laws.

Secrecy laws prohibit disclosure of bank account details, including bank client identities, thus protecting personal privacy.⁸ In contrast to secrecy laws, blocking laws protect national sovereignty from foreign judicial and administrative encroachment.⁹ These laws constitute part of foreign privacy rights, violation of which could give rise to foreign civil and criminal liability.¹⁰

4. See *infra* notes 28-45 and accompanying text.

5. See *infra* notes 62-87 and accompanying text.

6. As Congress stated in 1970:

"Secret foreign bank accounts and secret foreign financial institutions have permitted a proliferation of 'white collar' crime . . . [and] have allowed Americans and others to avoid the laws and regulations concerning securities and exchanges . . . The debilitating effects of the use of these secret institutions on Americans and on the American economy are vast."

H.R. REP. No. 975, 91st Cong., 2d Sess. 12, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4394, 4397.

7. *Hearings on H.R. 15073 Before the House Comm. on Banking and Currency*, 91st Cong., 1st & 2d Sess. 12 (1969-70) (statement of Pierre Leval).

8. Fedders, *supra* note 2, at 30-35. Bank secrecy laws have been in existence since the sixteenth century and are in force in over twenty countries. *Critical Appraisal*, *supra* note 2, at 1414-15 and accompanying notes.

9. Fedders, *supra* note 2, at 35-39.

10. *Critical Appraisal*, *supra* note 2 at 1414, n. 23. See also Fedders, *supra* note 2, at 33. See also *United States v. First Nat'l Bank of Chicago* 699 F.2d 341, 344-45 (7th Cir. 1983) (bank's release of information requested in the Internal Revenue Summons would subject bank employees to risk of imprisonment under Greek law); *United States v. Vetco, Inc.*, 691 F.2d 1281, 1286-87 (9th Cir. 1981) (Swiss release of confidential information to foreign governmental agencies does not preclude enforcement and sanctions for failure of summons to comply issued to obtain Swiss records).

II. CASE LAW

The SEC is charged with implementing the federal securities laws so as to "insure the maintenance of fair and honest markets."¹¹ This task largely depends on its investigatory powers. Under the securities laws, the SEC has subpoena powers over both witnesses and documents.¹² If either domestic or foreign parties refuse to obey a subpoena, the SEC can invoke the aid of district courts to obtain orders requiring the production of documents.¹³

If the person or documents subpoenaed are in the United States, the SEC encounters few service barriers. However, subpoenas cannot be served outside the United States without the consent of the foreign governments involved.¹⁴ Consent is necessary in order for the practice not to impinge on national sovereignty or violate international law.¹⁵

The SEC runs into this consent barrier when it attempts to obtain pre-trial discovery from foreign banks. In *S.E.C. v. Banca Della Svizzera Italiana*¹⁶ the District Court for the Southern District of New York confirmed the SEC's power to obtain discovery from foreign banks in connection with enforcement proceedings. In this case, Banca Della Svizzera Italiana (BSI) refused to provide the SEC with information about bank clients suspected of insider trading.¹⁷ The court ordered BSI to either disclose the information (despite Swiss secrecy laws) or face a \$50,000/day fine and a ban on trading in United States securities mar-

11. Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1976).

12. Securities Act of 1933 Sections 19(b), 22(b), 15 U.S.C. §§ 77 s (b), 77 v (b) (1976); Securities Exchange Act of 1934 Section 21(a)-(c), 15 U.S.C. § 78 u (a)-(c) (1976).

13. See *In re Grand Jury Proceedings United States v. Bank of Nova Scotia*, 691 F.2d 1384 (11th Cir. 1982) (Despite Bahamian bank secrecy law, the court affirmed an order enforcing a grand jury subpoena served on a Miami branch of a Canadian bank to obtain documents held in a Bahamian branch.); *Securities and Exchange Comm'n v. Minas De Artemisa, S.A.*, 150 F.2d 215, 218 (9th Cir. 1945) (The SEC obtained enforcement of an administrative subpoena, pursuant to section 19(b) of the Securities Act.).

14. Fedders, *supra* note 2, at 7, citing *Federal Trade Commission v. Compagnie De Saint Gobain—Pont-a-Mousson*, 636 F.2d 1300 (D.C. Cir. 1980) (Direct service of U.S. subpoenas overseas is legal under international law when the foreign government consents by subscribing to an international convention allowing service of compulsory process on its citizens).

15. Fedders, *supra* note 2, at 7.

16. 92 F.R.D. 111, 112 (S.D.N.Y. 1981) (The Court balanced the interests at stake and concluded that compelling discovery was necessary to maintain the integrity of the securities markets).

17. *Id.* at 113. BSI bought call options and common stock of a target corporation immediately prior to the public announcement of a cash tender offer for all St. Joe common stock. Following the announcement, BSI closed out the purchases of options and sold two-thirds of the common stock shares for a two million dollar profit. *Id.* at 112-113.

kets.¹⁸ Faced with this choice, BSI disclosed the information requested.¹⁹ In making its decision, the court balanced U.S. and Swiss national interests, the hardship on the defendant, and the degree of good faith exercised by the resisting party.²⁰ The court determined that the “vital national interest in maintaining the integrity of [U.S.] securities markets” outweighed Swiss secrecy laws.²¹

In a second effort to obtain information, the SEC requested Swiss court assistance under the U.S. Switzerland Treaty on Mutual Assistance in Criminal Matters (1977 Treaty).²² In *SEC v. Certain Unknown Purchasers of Santa Fe Stock*, defendants made over five million dollars by

18. *Critical Appraisal*, *supra* note 2, at 1418, n.43, citing SEC, *Request for Comments Concerning a Concept to Improve the Commission's Ability to Investigate and Prosecute Persons who Purchase or Sell Securities in the U.S. Markets From Other Countries*, Securities Exchange Act of 1934 Release No. 21,186 at 15. (July 30, 1984), reprinted in 16 SEC. REG. & L. REP. (BNA) 1305 (1984) [hereinafter *Release*]. The *Release* was announced in 49 Fed. Reg. 31,300 (1984). See also *Matter of Mare Rich & Co., A.G.*, 707 F.2d 663 (2d Cir.), *cert. denied*, 103 S.Ct. 3555 (1983) (court imposed coercive fine of \$50,000 per day to compel a foreign corporation to comply with grand jury subpoena).

19. 92 F.R.D. at 113. The bank secured a waiver of confidentiality and reported to the court.

20. *Id.* at 117-119. The court relied on section 40 of the RESTATEMENT (SECOND) FOREIGN RELATIONS LAW OF THE UNITED STATES (1965) in coming to its decision. Section 40 reads as follows:

[W]here two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as

- (a) vital national interests of each of the states,
- (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
- (c) the extent to which the required conduct is to take place in the territory of the other state,
- (d) the nationality of the person, and
- (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed, by that state.

In addition, the court determined that BSI had acted in bad faith in making use of the Swiss nondisclosure law to evade U.S. laws against insider trading. See also *Societe Internationale Pour Participations Industrielles et Commerciales, S.A. v. Rogers*, 357 U.S. 197 (1958) (Sanction of dismissal without prejudice is unjustified where plaintiff acted in good faith in seeking to comply with discovery order and where Swiss law prohibited such compliance. Noncomplying party's good/bad faith is an essential factor).

21. 92 F.R.D. at 112. See also *United States v. First Nat'l City Bank*, 396 F.2d 897 (2d Cir. 1968) (Court held Citibank in contempt for failing to comply with a subpoena duces tecum in a grand jury investigation into alleged antitrust violations. The court balanced the section 40 Restatement interests, focusing on U.S. and German national interests and the hardship compliance would place on Citibank); *But see In re Westinghouse Electrical Corp. Uranium Contracts Litigation*, 563 F.2d 992 (10th Cir. 1977) (court used § 40 balancing factors and *Societe* good faith test in lifting contempt sanctions where Canadian law forbade document production).

22. 1977 Treaty on Mutual Assistance in Criminal Matters May 25, 1973, 27 U.S. T. 2019, T.I.A.S. No. 8302 [hereinafter 1977 Treaty]. The treaty provides for cooperation in locating wit-

engaging in insider trading.²³ The Swiss court rejected the SEC's first request for information because the U.S. failed to show that the unknown defendants had committed a crime under Swiss law, thus failing to satisfy the 1977 Treaty's "dual criminality" requirement.²⁴ The SEC filed a second request which satisfactorily alleged that the unknown defendants had committed a crime under Swiss law as defined in the 1977 Treaty.²⁵ The Swiss court compelled the bank to reveal the unknown defendants' identities and the SEC ultimately indicted them.²⁶

III. BILATERAL TREATY OPTIONS

Rather than rely exclusively on the courts to deal with foreign secrecy and blocking laws,²⁷ the SEC has initiated some bilateral treaty negotiations to improve international securities fraud regulation. In 1982 the United States and Swiss governments negotiated the Memorandum of Understanding on Insider Trading (MOU).²⁸

The MOU utilizes the procedures set forth in the 1977 Treaty which facilitates bilateral cooperation in criminal investigations and prosecutions.²⁹ Under the 1977 Treaty's dual criminality requirement, the activity under investigation must be a crime in both jurisdictions before assistance will be granted.³⁰ Because insider trading is not yet a crime in Switzerland,³¹ and the 1977 Treaty covers only criminal matters,³² the

nesses, obtaining statements and production and authentications of judicial and administrative documents.

23. 81 Civ. 6553 (S.D.N.Y. 1981), *reprinted in* [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P99,424, July 25, 1983 (unknown investors purchased securities in a target corporation through a Swiss bank immediately before the announcement of a merger and tender offer).

24. To invoke the Treaty, the invoking party must show that the alleged offense is a crime under Swiss law. Under Swiss law, insider trading is not a crime. 1977 Treaty, *supra* note 23 at art. 4, para. 2(a).

25. 16 Sec. Reg. & L. Rep. (BNA) 861 (1984).

26. *Id.*

27. *See* AVC Nederland B.V. v. Atrium Investment Partnership, 740 F.2d 148 (2d Cir. 1984) (court held that it could properly exercise jurisdiction over securities fraud action brought by Dutch citizen against Dutch partnership but that the action was properly dismissed pursuant to a forum selection clause in the agreement calling for application of Dutch law).

28. 14 Sec. Reg. & L. Rep. (BNA) 1737 (1982), *reprinted in* 22 I.L.M. 1 (1983). Section I, para. 1 of the MOU states the purpose of the treaty to be that of "establish[ing] mutually acceptable means for improving international law enforcement cooperation in the field of insider trading."

29. *Id.* at § II.

30. 1977 Treaty, *supra* note 22 at art. 4, para. 2(a).

31. MOU, *supra* note 28 at § I, para. 2.

32. *Id.* at § III, para. 1. *See generally* Recent Developments, *International Agreements: United*

SEC cannot ask for Swiss assistance under that Treaty. For that reason it became necessary to negotiate the MOU to cover insider trading.

The first section of the MOU contains an "exchange of opinions" regarding the 1977 Treaty.³³ In this section the parties agree that under specified circumstances insider trading could constitute "fraud," "unfaithful management" or "violation of business secrets" under the Swiss Penal Code, thus rendering assistance under the 1977 Treaty compulsory.³⁴

The second part of the MOU consists of a "Private Agreement" among members of the Swiss Bankers' Association.³⁵ The Agreement recognizes that the SEC may not always be able to prove a violation of the Swiss Penal Code.³⁶ The Agreement provides for the creation of a Commission of Enquiry (Commission) to decide if SEC assistance requests are "reasonable."³⁷

The SEC may establish reasonableness in two ways. First, it can show significant volume and price fluctuations in the traded security occurring prior to the public announcement of "a proposed merger, consolidation sale of . . . assets or other business combination."³⁸ Second, if these threshold criteria are not met, the SEC can show that the activity vio-

States-Switzerland Investigation of Insider Trading Through Swiss Banks, 23 HARV. INT'L L.J. 437 (1983) (detailed discussion of the MOU).

33. MOU, *supra* note 28 at § II.

34. *Id.* at § II, para. 3(b).

35. *Id.* at § III. This agreement applies only to signatory banks and 'business combinations' and 'acquisitions.' Business Combinations refer to "a proposed merger, consolidation, sale of substantially all of an issuer's assets or other similar business combination." Acquisition refers to "the proposed acquisition of at least 10% of the securities of the issuer by open market purchase, tender offer or otherwise." *Id.* at Agreement XVI, art. 1.

36. *Id.* at § III. In keeping with the double criminality requirement (*see supra* note 24 and accompanying text) under the 1977 Treaty, the alleged offense must be a crime under both Swiss and U.S. law before Swiss authorities will assist U.S. investigators.

37. *Id.* at Agreement XVI, art. 2. The Board of Directors of the Swiss Bankers' Association will appoint the Commission composed of three members and three deputies. These appointees are bound by Swiss secrecy laws.

38. *Id.* at art. 1. As specified in the Private Agreement,

"the Commission shall be satisfied in *all* cases in which the daily trading volume of such securities increased 50% or more at any time during the 25 days prior to "an announcement of an Acquisition or Business Combination, above the average daily trading volume of such securities during the period from the 90th trading day to the 30th trading day prior to such announcement or the price of such securities varied at least 50% or more during the 25 days prior to the announcement."

Id. at art. 3.4. The parties to the Agreement note that these thresholds are set at high levels in order to clearly define the instances in which the Commission "shall" determine that the SEC has reasonable grounds to make the request. *Id.* at § III, para. 3.

lated U.S. insider trading laws.³⁹ In such cases, the Commission must still decide if this constitutes "reasonable" grounds for requesting assistance.⁴⁰

If the Commission accepts the SEC's request, it will call for a bank report on the pertinent transaction(s)⁴¹ and may order the bank to freeze the client's account in the amount of the profit made or loss avoided.⁴² All this information goes to the Swiss Federal Office for Police Matters which, in turn, transmits it to the SEC.⁴³ Depending on the outcome of the eventual U.S. litigation, the Commission will either remit the funds to the SEC or unblock the account.⁴⁴ This Private Agreement will continue in force until Switzerland makes insider trading a crime under its penal statutes.⁴⁵

IV. SHORTCOMINGS OF THE BILATERAL TREATY APPROACH TO INTERNATIONAL SECURITIES FRAUD REGULATION

Treaty negotiation and implementation is most successful when parties

39. *Id.* at Agreement, art. 3.4.

40. *Id.* at § III, para. 3. The MOU clearly states that SEC failure to satisfy the specified threshold criteria will *not* result in any presumption that the SEC's request is unreasonable.

41. *Id.* at Agreement, art. 4.1-4.4. As soon as it receives the informational request from the Commission, the bank must inform its customer and invite him or her to voluntarily furnish the information. This report is filed with the Commission within 45 days of the request. If these conditions go unfulfilled, the Commission shall give the Federal Office for Police Matters a written explanation, to be forwarded to the SEC. *Id.* at art. 7. If there is any doubt as to the material adequacy of the report furnished, either the Commission or the SEC may request the Federal Banking Commission to ascertain whether the report conforms to the facts. *Id.* at art. 8.

42. *Id.* at art. 9. The bank shall place such amount in an interest bearing account at the Commission's disposal.

43. *Id.* at art. 5. The MOU contains a large loophole which allows the Swiss Federal Office for Police Matters to determine that a report submitted by a bank may not be transmitted to the SEC when transmission would harm Swiss national interests or a third person's interests with no connection to the alleged offense. However, in such cases, it is agreed that the Federal Office will adapt the report to provide useful information to the SEC without harming any protected interest. *Id.* at § III, para. 6.

44. *Id.* at Agreement, art. 9.2-9.3. The Commission will remit the amount held to the SEC if the amount requested is no higher than the unlawful profit *and* either the U.S. court proceedings have ended in a final judgment against the bank customer or the customer consents in writing. The account will be unblocked if by the thirtieth day after the federal office forwarded the bank report to the SEC, no request is received or no amended report pursuant to Article 8 is issued or the U.S. court proceedings end in favor of the bank customer or the SEC consents in writing.

45. *Id.* at art. 11. See *Critical Appraisal*, *supra* note 2 at 1414, n.27 and accompanying text. In 1984, 73% of Swiss voters rejected a proposal to relax Swiss secrecy laws. Thus, even if insider trading is made a crime in Switzerland, the overwhelming popular sentiment is against any weakening in bank secrecy protection.

share common policy goals and regulatory setups. Substantive differences among nations' insider trading laws and regulatory philosophies are, however, common in the securities fraud area.⁴⁶ These differences complicate U.S. efforts to negotiate cooperation treaties with foreign nations whose citizens engage in securities transactions in U.S. markets.

In Europe, only France and the United Kingdom (U.K.) have enacted legislation regulating the improper use of insider information.⁴⁷ The French statute is rarely enforced,⁴⁸ apparently because "such activities were a tradition on the part of most respectable directors and officers and . . . tipping was even a social duty expected of relatives and friends."⁴⁹ The U.K. considers U.S. laws which allow class actions, contingency fees and liberal discovery in connection with securities fraud investigations to be biased in favor of plaintiffs.⁵⁰ Neither the U.K. nor Switzerland recognizes a cause of action for failure to state a material fact, and Germany requires a deceptive or misleading representation to state a cause of action.⁵¹ French and Swiss courts require plaintiffs to affirmatively prove that their losses were caused by defendants' misrepresentations, while U.S. courts presume causation.⁵²

The MOU itself suffers from several serious shortcomings. First, it was a product of necessity.⁵³ Second, the MOU applies only to securities fraud in connection with "acquisitions" and "business combinations."⁵⁴ Furthermore, the MOU is binding only on those Swiss banks which sign it,⁵⁵ and even then, if a signatory bank refuses a Commission informa-

46. See *infra* notes 47 and accompanying text.

47. Cruickshank, *Insider Trading in the EEC*, 10 INT'L BUS. LAW 345, 346 (1982).

48. See *Roadmap*, *supra* note 2, at 936 nn.111-112 citing MULTINATIONAL APPROACHES—CORPORATE INSIDERS, 50 (L. Loss ed. 1975) (In the four years after the French statute was adopted, the *Commissioin de Bourse* (COB), responsible for regulating securities trading, undertook 105 inquiries into possible insider trading and referred only seven cases for prosecution). See also Macquerou, *Developments in French Law on Disclosure and Trading of Securities*, 5 J. COMP. BUS. & CAP. MARKET L. 71,74 (1983) (in 1979 the Paris criminal court handed down only two convictions for insider trading out of only four cases referred by the COB).

49. Tunc, *A French Lawyer Looks at American Corporation Law and Securities Regulation*, 130 U. PA. L. REV. 757, 762 (1982).

50. *Piper Aircraft Co. v. Reyno*, 454 U.S. 235, 252 n.18 (1981). See also Taylor & Head, *Representing Collective Interests: A Comparative Synopsis*, 58 J. URB. L. 587, 595 (1981) (in Canada only Quebec allows class actions).

51. See *Roadmap*, *supra* note 2, at n.106 and accompanying text.

52. *Id.* at nn.107-08 and accompanying text.

53. See *supra* text accompanying notes 31-32.

54. See *supra* note 35.

55. MOU, *supra* 28 at § III para. 2.

tional request, that bank will simply be excluded from the Agreement.⁵⁶ Moreover, because this Treaty is only between the U.S. and Switzerland, other states' secrecy and blocking laws remain unaffected by the MOU.⁵⁷

The shortcomings of the MOU are the product not only of divergent regulatory philosophies but also of different market conditions, goals and strategies.⁵⁸ U.S. courts and administrative agencies cannot assume that all nations opposed to fraud will have compatible regulatory schemes.⁵⁹ For this reason, the only viable way to contend with divergent national policies (or lack thereof) on insider trading is through bilateral treaty negotiations. The SEC, however, has stated that despite the apparent success of the MOU, multilateral negotiations have little chance of success given the "large number of nations with secrecy laws and the diversity of their interests."⁶⁰ Furthermore, bilateral agreements are "time consuming to negotiate" and of limited applicability.⁶¹ As a result, the SEC has considered unilateral solutions to facilitate its enforcement efforts.

V. WAIVER BY CONDUCT DOCTRINE

In 1984, the SEC proposed a "waiver by conduct" statute to replace its

56. See MOU, *supra* note 28, at Agreement, art. 10 (The Board of Directors of the Swiss Bankers' Association will first issue a warning to the non-cooperating bank before excluding it from the Agreement).

57. See generally Fedders, *supra* note 2, at 30-39 (overview of secrecy and blocking disclosure laws presently in force around the world).

58. See generally Krauss, *Securities Regulation in the United Kingdom: A Comparison with United States Practice*, 5 VAND. J. TRANSNAT'L L. 49 (1971); Note, *Disclosure Requirements in France: Problems in the Development of Effective Securities Regulation*, 12 VA. J. INT'L L. 358 (1972); Krauss, *Securities Regulation in Germany? Investor's Remedies for Misleading Statements by Issues*, 19 INT'L LAW 109 (1984).

59. See, e.g., *Grunenthal Grub H v. Hotz*, 511 F. Supp. 582, 587 n.7 (C.D. Cal. 1981) (There is no need to consider foreign national interests because "every civilized nation doubtless has this [antifraud rule] as part of its legal system), *rev'd on other grounds*, 712 F.2d 421 (9th Cir. 1982). *But see supra* note 10 (courts do take into consideration the fact that foreign laws may subject persons to criminal liability in determining whether to compel information production); *Timberlane Lumber Co. v. Bank of Am.*, 749 F.2d 1378, 1384 (9th Cir. 1984), *cert. denied*, 105 S.Ct. 3514 (1985) (absence of specific regulation by foreign state does not necessarily reflect a lack of conflict with U.S. policies). See also RESTATEMENT (REVISED) OF FOREIGN RELATIONS LAW § 403 (1985) [hereinafter REVISED RESTATEMENT] (In determining whether the exercise of jurisdiction is reasonable or unreasonable, the court must take into consideration factors such as "the extent to which another state may have an interest in regulating the activity" and "the likelihood of conflict with regulation by other states." When both states have regulatory interests each state is expected to "defer to the other state if that state's interest is greater").

60. See *Critical Appraisal*, *supra* note 22 at 1421, *citing Release*, *supra* note 18 at 20-21.

61. *Id.*

case-by-case approach to transnational securities fraud investigations.⁶² The proposed statute would apply the doctrine of implied consent⁶³ to the idea that “the act of trading securities in the U.S. whether directly or indirectly [should] serve as a waiver by conduct of the applicability of foreign secrecy laws.”⁶⁴ Once notice about such a waiver statute is imputed through agency principles from the U.S. broker to the foreign investor, evidence of a securities transaction would be interpreted to mean that the investor waived secrecy law protection.⁶⁵ When an investor

62. Mr. John M. Fedders, Director of the Division of Enforcement of the SEC has acted as the SEC's main spokesman in promoting the “waiver by conduct” concept. On March 30, 1984, Fedders wrote to Sen. D'Amato and Rep. Dingell suggesting that Congress adopt legislation to codify the concept. The SEC considered the concept on May 31, 1984 and requested public comments on it on July 30, 1984. After receiving overwhelmingly negative comments, the SEC postponed any final decision. *Critical Appraisal*, *supra* note 2 at p. 1412 nn.10-11. See also Fedders, *supra* note 2 and Fedders, *Policing Internationalized U.S. Capital Markets: Methods to Obtain Evidence Abroad*, 18 INT'L LAW 89 (1984).

63. See *Hanson v. Denckla*, 357 U.S. 235, 253 (1958) (One who purposefully avails himself of the benefits of conducting business in a state thereby involving the protection of its laws, must submit to its jurisdiction.).

64. *Critical Appraisal*, *supra* note 22 at 1421, citing *Release*, *supra* note 18 at 7. Also note that the concept addresses only secrecy laws, leaving disclosure blocking legislation intact. For further discussion see *infra* note 72 and accompanying text.

65. *Critical Appraisal*, *supra* note 2 at 1421, citing *Release*, *supra* note 18 at 30-31. The issue of the court's subject matter jurisdiction is beyond the scope of this article. However, a short discussion is in order here. In determining whether subject-matter jurisdiction exists, courts have traditionally looked to either the conduct or the effects test as set out in section 17 and 18 of the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW (1965). The conduct test [in Section 17] is as follows:

A state has jurisdiction to prescribe a rule of law:

- (a) attaching legal consequences to conduct that occurs within its territory whether or not such consequences are determined by the effects of the conduct outside the territory, and
- (b) relating to a thing located, or a status or other interest localized, in its territory.

Section 18 of the Restatement contains the effects test:

A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either:

- (a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or
- (b) (i) the conduct and its effect are constituent elements of activity to which the rule applies, (ii) the effect within the territory is substantial, (iii) it occurs as a direct and foreseeable result of the conduct outside the territory, and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

In 1985, the American Law Institute adopted a standard of “reasonableness” by which to weigh competing national interests. See also *supra* note 59. For relevant case law applying the conduct and effects tests see *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208 (2d Cir.), modified on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert denied sub. nom. *Manley v. Schoenbaum*, 395 U.S. 906 (1969) (effects test first applied to transnational securities transaction); *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326, 1333-39 (2d Cir. 1972) (“significant conduct” in the

chooses to venture outside the jurisdiction whose secrecy laws she claims to be protected by, she cannot reasonably expect that protection to follow her to other jurisdictions—or so the theory goes.

Deferring to foreign secrecy laws sets up a double standard on U.S. securities exchanges under which insider trading is protected if carried out by a foreign investor but forbidden to domestic investors.⁶⁶ Indiscriminate application of secrecy laws threatens U.S. sovereignty by impinging on its vested interest in protecting the integrity of its securities markets and shielding investors from securities fraud. However, adopting a waiver by conduct statute as the exclusive remedy to address these issues could cause more problems than it would solve.

VI. SHORTCOMINGS OF A WAIVER BY CONDUCT STATUTE

The waiver conduct doctrine is a unilateral approach to an international problem. It goes against the spirit of negotiated agreements and threatens foreign nations' rights to regulate domestic banking relationships.⁶⁷ The statute would attempt to deprive foreign bank customers of their secrecy rights and subject their personal information to U.S. scrutiny.⁶⁸ Although the SEC believes its doctrine will promote comity and international cooperation, the proposal could instead cause an international backlash in the form of less cooperation and tighter secrecy protection.⁶⁹

United States by a nonresident defendant is enough for U.S. jurisdiction); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir.) cert. denied sub. nom. *Bersch v. Arthur Andersen & Co.*, 423 U.S. 1018 (1975) (absent fraudulent conduct, U.S. jurisdiction exists only in cases of direct injury to person in whom the U.S. has an interest); *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980) (absent domestic effects, the fraudulent conduct must have occurred primarily in the U.S.); *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041 (1983) (followed *Cornfeld* in finding that both the conduct and effects tests were satisfied because the essential conduct necessary to complete the fraud occurred in the U.S.).

66. If an individual executes securities transactions based on inside information through foreign banks shielded by protective secrecy and disclosure blocking laws that individual is also shielded from liability. Domestic investors do not benefit from such protection. See *Critical Appraisal*, supra note 2, at 1411; Fedders, supra note 3, at 92.

67. Nations jealousy guard their sovereignty and resent any encroachment by other nations. See generally REVISED RESTATEMENT, supra note 59, at § 403 reporter's note 1.

68. In general, those protected by secrecy laws are very reluctant to have that protection diminished in any way. See *Critical Appraisal*, supra note 2, at 1415 n.27 (Swiss and West German citizens overwhelmingly opposed proposals to relax secrecy laws).

69. See *Critical Appraisal*, supra note 2, at 1425-26 (notes paradox that waiver by conduct could also cause "a decline in the quality and integrity of the trading in U.S. Securities." It could drive foreign investors away, shift investments to offshore markets and impose undue burdens on U.S. brokers who would have to act as agents for service of process on foreign clients).

Foreign nations would be free to reject a waiver by conduct statute by refusing to recognize waivers and compelling their banks to abide by secrecy laws. In such cases, the SEC could resort to U.S. court orders compelling discovery.⁷⁰ If, however, the banks lack assets in the U.S. upon which to levy contempt sanctions, such court orders could prove useless.⁷¹ In any event, it is highly unlikely that any foreign bank would contravene governmental orders not to disclose any information.

The most serious shortcoming of a waiver by conduct statute would be that it would affect only secrecy laws and would leave disclosure blocking protections intact. "The right involved [in blocking statutes] is that of the government itself [and] it cannot be waived by a private person."⁷² Thus, SEC investigations in disclosure blocking jurisdictions would continue to suffer from a lack of foreign governmental cooperation.

VII. PROPOSAL

In order for the SEC to effectively enforce its securities regulations, the shortcomings of both the unilateral and bilateral approaches must be addressed. In so doing, one must consider the competing interests of the U.S. and foreign nations whose citizens transact business in U.S. securities markets.⁷³ Bilateral negotiation provides the best forum for achieving this. In negotiating workable treaties which will give the SEC access to the information it needs without threatening foreign state sovereignty, the SEC should consider several factors.

First, the SEC must avoid overzealous, chauvinistic application of U.S. law. This will only alienate foreign governments and defeat the purpose of bilateral negotiations. "[T]he more the relevant national interests and policies conflict, the more another state will perceive American regulation as an affront to its power to determine its own regulatory goals."⁷⁴ Of equal importance, however, is the goal of protecting U.S. securities markets and giving the SEC access to the information it needs.⁷⁵ Not only must a treaty be sensitive to competing national goals, but it must

70. See *supra* notes 13-15 and accompanying text.

71. See *supra* note 18 and accompanying text.

72. See *Critical Appraisal*, *supra* note 2 at 1423 n.88, citing *Release*, *supra* note 18, at 49.

73. See *supra* notes 20-21 and accompanying text. See also REVISED RESTATEMENT, *supra* note 59, at § 403(1) - (2)(h) and § 403(3). Section 403 imposes "Limitations on Jurisdiction to Prescribe" which shape U.S. decisions to exercise jurisdiction over a person or activity.

74. *Roadmap*, *supra* note 2, at 939.

75. See *supra* notes 1-3 and accompanying text.

also be predictable and uniformly applied.⁷⁶ Predictability will enable foreign investors to determine the scope of potential liability and conform their actions accordingly.⁷⁷ Furthermore, liability must be uniform in the interest of both predictability and fairness.

In balancing these factors, the SEC should implement a two-tiered approach which optimizes the strengths of the unilateral and bilateral options while minimizing their weaknesses. In the long run, bilateral negotiation is the only way to ensure that each nation's interests are protected.⁷⁸ This is, of course, more time consuming and costly in the short run than a unilaterally imposed solution.⁷⁹ Individually binding treaties are, however, the only feasible way to guarantee consistent, voluntary cooperation from foreign governments. At the very least, treaty negotiation leaves channels of communication open. Because each treaty must be tailored to fit national policies, market conditions and legislation of the foreign signatory, the SEC would have to engage in a case-by-case analysis during its investigations. On balance, however, protecting the integrity of U.S. securities markets justifies this cost.

While treaty negotiations are taking place, the SEC must establish short term regulatory procedures to control incoming transactions from countries with which the U.S. has no treaty.⁸⁰ Such short-term measures could be unilaterally imposed to affect investment orders as they enter the U.S.⁸¹ These regulations would require investors to either identify themselves or be denied access to U.S. markets. Thus, U.S. brokers would be required to ascertain their clients' identities before transacting

76. See *Roadmap*, *supra* note 2, at 939-40, citing Maier, *Extraterritorial Jurisdiction at a Crossroads: An Intersection Between Public and Private International Law*, 76 AM. J. INT'L L. 280, 316, 320 (1982). See also *Common Principles* *supra* note 2, at 1319-1323 ("Guaging the merit of jurisdictional standards according to the principles of predictability and comity will promote a system conducive to international business planning and cooperation among nations").

77. *Common Principles*, *supra* note 2, at 1321.

78. See *The Bremen v. Zapata Off Shore Co.*, 407 U.S. 1, 9 (1971) (Burger, C.J.) ("[W]e cannot have trade and commerce in world markets . . . exclusively on our own terms, governed by our laws, and resolved in our courts").

79. See *supra* notes 60-61 and accompanying text.

80. See *Fedders*, *supra* note 2, at 27-28 (lists six specific ways to legislatively implement the waiver by conduct theory).

81. See *Critical Appraisal*, *supra* note 2, at 1416 (discusses proposed amendment to the Bank Secrecy Act of 1970 which would have "prohibited U.S. brokers from accepting orders for transactions in U.S. securities from foreign banks unless the orders disclosed the identity of all persons having any beneficial interest in the transactions or certified that no citizen or resident of the U.S. has any beneficial interest in the transactions").

any business for them.⁸² This information would be available to the SEC upon demand. Brokers who transacted business for unidentified clients would be subject to civil and criminal liability.⁸³

This unilateral approach implicates the international banking system through which most transnational securities business is transacted. The U.S. government would have to require banks handling such transactions for their clients to maintain U.S. assets which would be subject to contempt sanctions for not complying with SEC information requests or U.S. court orders.⁸⁴ If it would impose too great a hardship on banks to establish a U.S. presence, they could instead make a "security deposit" with a Federal Reserve Bank. This desposit could guarantee the bank client's U.S. transactions and could be subject to contempt sanctions and fines.⁸⁵

This proposed approach is preferable to a waiver by conduct statute in several ways. It would prevent enforcement difficulties by obtaining investor identities and securing bank assets before allowing foreign investors to transact business in U.S. markets. It would eliminate the need to deal with secrecy and blocking laws and would not be perceived as an unwelcome extraterritorial imposition of U.S. law.⁸⁶ Under a waiver by conduct statute, by its very nature, the SEC would have to be content with asserting a waiver *after* the alleged fraud has already been perpetrated.

Forcing foreign investors and banks to bear the financial and regulatory brunt of complying with these short term measures will give them some impetus to lobby their governments to negotiate treaties with the U.S. and cooperate with SEC investigations. Foreign investors have the luxury of choosing to transact business in U.S. security markets—they must therefore play by the rules. Once a foreign nation negotiates and implements a treaty with the U.S., the short-term regulations will expire for banks and investors from that nation. This two-tiered approach would best serve the aforementioned goals of effective enforcement of

82. In the process, these clients would be put on notice about U.S. law by imputing the broker's knowledge to the investor. See RESTATEMENT (SECOND) OF AGENCY § 9(3) (1957). Section 9(3) provides that "[a] person has notice of a fact if his agent has knowledge of the fact, reason to know it or should know it, or has been given notification of it."

83. Recall that secrecy and disclosure blocking laws are part of foreign privacy rights, violation of which could give rise to civil and criminal penalties. See *supra* note 10 and accompanying text.

84. See *supra* notes 12-16 and accompanying text.

85. See *supra* note 18 and accompanying text and text accompanying note 71.

86. See *supra* notes 67-69 and accompanying text.

U.S. securities regulation, sensitivity to competing national interests, sovereignty, predictability, uniformity and fairness.⁸⁷

Yvonne G. Grassie

ETHICAL CONFLICTS IN THE RECOMMENDATION OF POISON PILLS

The proliferation of corporate mergers and acquisitions has spawned law firms specializing in corporate takeovers.¹ These law firms generally counsel both targets and acquirors. This may confront firms with ethical conflicts of interests.² For example, in a recent newspaper account, New York's Skadden, Arps, Meagher & Flom was challenged for drafting over two dozen poison pill plans to repel hostile takeovers and, within a year, arguing in federal court against the constitutionality of similar plans on behalf of a hostile aggressor.³

This recent development considers the ethical repercussions of a single law firm recommending antitakeover poison pill plans to some clients and shortly thereafter contesting the constitutionality of similar plans on behalf of other clients. Part I reviews the American Bar Association standards governing concurrent and subsequent representation.⁴ Part II applies these standards to specialty firms who recommend then challenge similar antitakeover poison pill plans.⁵ This development concludes that

87. See *supra* notes 76-78 and accompanying text.

1. See Berner, *Conflict of Interest Case, Developments and Vicarious Disqualification*, in *Thirteenth Institute on Securities Regulation* 621, 623-37 (1981) (Berner chronicles the development of law firms from solo or small firms in 1910 when the largest New York law firm had 17 lawyers to large, multi-office firms of the 1980s).

2. See generally Miller and Warren, *Conflicts of Interest and Ethical Issues for the Inside and Outside Counsel*, 40 *BUS. LAW.* 631, 631-33, (1985); see *supra*, Berner note 1 at 623-27.

3. See, Waldman, *Skadden Arp's Poison-Pill Stance Raises Conflict of Interest Concern*, *Wall St. J.*, July 23, 1986, 2, at 1, col. 3. Skadden, Arps is cocounsel with two other law firms. The defendant's answer to the suit challenged the poison pill provisions as against state law, as overreaching the powers of the directors, and if the plan was authorized by state law, the plan impermissibly burdened interstate commerce and violated the United States Constitution. Skadden, Arps denied the representation conflicted with its drafting of poison pill plans for other clients.

4. See *infra* notes 6-25 and accompanying text.

5. See *infra* notes 26-43 and accompanying text.