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## An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland

James H. Freis Jr.

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# An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in *Finanzplatz Deutschland*

James H. Freis, Jr.\*

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The views expressed in this Article are the personal views of the author and do not purport to represent any of the institutions with which the author is affiliated. Except where otherwise expressly noted, all German source materials cited in the Article have been translated solely by the author and do not purport to be official translations.

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I. INTRODUCTION

As the visible frontiers along borders within Europe are being dismantled, equally significant movements to remove less visible barriers are occurring all over the continent. Although a tourist might more

readily recognize the dismantling of border checks,<sup>1</sup> the Member States of the European Union ("EU") are also moving forward in lowering barriers to the movement of capital and financial services across state borders. Germany stands at the crossroads of both of these changes, as the geographic center as well as the economic engine and largest economy of Europe. Germany is actively moving to expand its role as a major force in the financial markets not only within Europe, but throughout the world. The movement to strengthen Germany's financial markets vis-a-vis international competition is embodied in the concept of *Finanzplatz Deutschland*.

The process of integration of the Member States of the EU has shaped much of the recent reforms in Germany. Both changes mentioned above, the dismantling of barriers and the movement of persons and capital, are designed to promote the "fundamental freedoms" of the EU.<sup>2</sup> In the economic arena, the EU Council has relied upon a program of harmonization of the economic and financial policies of the Member States. A series of directives of the Council of the EU have established the framework by which the Member States shall implement this harmonization.

Germany occupies a special position in this process, not only due to its central location and postwar leadership in pursuing European integration, but also from its status as the Member State with the largest population, the largest economy, and the strongest currency. In effect, the continued success of economic and financial harmonization within the EU is largely dependent on one of two options: (1) the ability of other countries to adopt German-style policies, or (2) the reform of practices within Germany to reflect union-wide or international standards. This Article discusses a number of recent reforms in which Germany has taken the latter approach.

The reforms in Germany reflect not only the aspirational goals of the ideal concept of *Finanzplatz Deutschland*, but also reflect the current strengths and weaknesses of the German markets, some of which stem from before the World War II era. For this reason Part II of this

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<sup>1</sup> As of March 26, 1995, 7 of the 15 European Union members formally dismantled border controls: Germany, Luxembourg, Belgium, the Netherlands, France, Spain, and Portugal. Austria shall join in April of 1995. See Alan Cowell, 7 *European Union Nations Form a Passport-Free Zone*, N.Y. TIMES, Mar. 27, 1995, at A6.

<sup>2</sup> The goal of the common market is defined as follows: "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured . . ." TREATY ESTABLISHING THE EUROPEAN ECONOMIC UNION art. 7a (as amended by TREATY ON EUROPEAN UNION (1992)) [hereinafter EEC TREATY].

Article examines not only where Germany wants to go with its reforms, but also provides an overview of the current status of German markets, in order to facilitate a deeper understanding of the reforms.

Part III of this Article briefly discusses the most direct forces from outside Germany shaping these reforms. Over the past few decades, financial markets have become internationalized, and competitive forces loom not only from across town, but from across oceans. To a large extent, the standards for securities markets were established by the United States, home of the world's largest financial markets, and were followed by the rest of the world. Although individual western European countries had implemented some of these standards to varying degrees, the EU has officially adopted many of the established U.S. standards with the promulgation of a number of directives. By their nature, however, EU directives require the individual Member States to implement the provisions of the directives through their own domestic legislation. This Article focuses upon recent German laws which have implemented EU directives concerning the regulation of insider trading, transparency in the securities markets, the disclosure of holdings in stock exchange-listed companies, and rules of conduct for companies engaged in investment services, among others.

The centerpiece of the recent reforms in Germany is the Act on Securities Trading and for the Modification of Regulations Governing the Stock Exchanges and Securities (*Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften*), commonly referred to as the Second Financial Market Promotion Act (*Zweites Finanzmarktförderungsgesetz*),<sup>3</sup> which went into full effect as of

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<sup>3</sup> Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften, BUNDESGESETZBLATT [BGBl.] I, 1749 (July 26, 1994) [hereinafter *Zweites Finanzmarktförderungsgesetz*]. The text of this Article will refer to the Second Financial Market Promotion Act as well as concepts from it in an English version where readily translatable. Except where otherwise noted, all translations in this Article are the sole work of the author, who shall bear all responsibility for any mistakes.

This Act is called the *Second* Financial Market Promotion Act, because it does have a predecessor, the Act for the Improvement of the Overall Conditions of the Financial Markets (Financial Market Promotion Act). Gesetz zur Verbesserung der Rahmenbedingungen der Finanzmärkte (Finanzmarktförderungsgesetz), BGBl. I, 266 (Feb. 22, 1990). This earlier Act consisted of six articles; the majority of its provisions went into effect on Mar. 1, 1990, with the full Act in effect as of Jan. 1, 1992. Finanzmarktförderungsgesetz, art. 6. The major changes in this earlier Act stem from Article 3, which amended the German Investment Company Act to expand the range of allowable investment activities. See *infra* notes 332 to 339 and accompanying text (further amendments to the Investment Company Act by the Second Financial Market Promotion Act). Article 2 of the "first" Financial Market Promotion Act amended the Act Concerning the Sale of Shares in Foreign Investment Funds and the Taxation of Gains from Such Funds (*Änderung des Gesetzes über den Vertrieb ausländischer Investmentanteile und über die Besteuerung der Erträge aus*

January 1, 1995.<sup>4</sup> This Act is actually a compilation of twenty articles which promote broad reforms throughout the German financial markets, primarily by amending existing laws in furtherance of ongoing regulatory and market improvements.

The most celebrated changes in the Second Financial Market Promotion Act, however, appear in the first article promulgating the Securities Trading Act (*Gesetz über den Wertpapierhandel*),<sup>5</sup> which represents an entirely new addition to German federal jurisprudence. Among other things, this article creates the Federal Securities Trading Supervisory Authority (*Bundesaufsichtsamt für den Wertpapierhandel*), the first German federal agency responsible for oversight of securities trading activities. The Securities Trading Act also makes insider trading criminally punishable in Germany for the first time, imposes a broad range of reporting and disclosure requirements to promote the overall transparency of the German financial markets, and imposes Rules of Conduct for investment service companies in dealing with their customers. The new Supervisory Authority shall oversee these new obligations.

The next most important changes from the Second Financial Market Promotion Act occur in Article Two, which amends the existing German Stock Exchange Act (*Börsengesetz*)<sup>6</sup> significantly. Part V of this Article will detail the provisions of the Second Financial Market Promotion Act, with an emphasis on the first two articles in Parts V.A and V.B followed by an overview of the other articles in Part V.C.

To fully comprehend the goals of reform, one must not only have the proper background information, but must also understand the legislative process in Germany which shaped the Second Financial Market Promotion Act. To this end, Part IV.A discusses the German legislative process from a political standpoint, while Part IV.B examines

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*ausländischen Investmentanteilen*”, BGBl. I, 986 (July 28, 1969), last amended in BGBl. I, 1545 (Aug. 20, 1980)). See Finanzmarktförderungsgesetz, art. 2. The amendments of the “first” Act do not nearly approach the scope of the Second Financial Market Promotion Act in terms of the reforms discussed *infra* in Part V of this Article.

<sup>4</sup> Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 20.

<sup>5</sup> Gesetz über den Wertpapierhandel, art. 1, Zweites Finanzmarktförderungsgesetz, *supra* note 3, at 1749–60 [hereinafter Wertpapierhandelsgesetz]. Due to the importance of the Securities Trading Act and the repeated references to it in this Article, it shall be cited separately. The same is true for amendments to the Stock Exchange Act in Article 2 of the Second Financial Market Promotion Act. See *infra* note 6. References to Articles 3–20 shall be cited under the more common format, as articles of the Second Financial Market Promotion Act.

<sup>6</sup> Börsengesetz (June 22, 1896), printed in BGBl. III, Gliederungsnummer 4110- 11, as amended by Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 2. Hereinafter, unless stated otherwise, all references to the Stock Exchange Act shall include the most recent amendments of the Second Financial Market Promotion Act, and shall be cited as “Börsengesetz.”

the history of the Act. As in the United States, a study of the legislative history of a law can reveal a great deal not only about the meaning of individual provisions, but also about the purposes of the law in general. The draft bill (*Gesetzentwurf*)<sup>7</sup> is especially of interest where provisions have been changed prior to promulgation. One other very important document in the legislative history of the Second Financial Market Promotion Act is the official government explanation of the Act (*Begründung*),<sup>8</sup> sent to Parliament with the draft bill and detailing the meaning behind the text, provision by provision. This Article will refer repeatedly to both documents in analyzing the significance (and at times the shortcomings) of the reforms of the Act.

Part VI analyzes the Second Financial Market Promotion Act in the context of German reforms designed to increase the overall attractiveness of *Finanzplatz Deutschland*. In some respects, an Article such as this makes one aspect of the reforms self-fulfilling in that the reforms are designed to increase the transparency of the German markets, just as this Article examines those reforms and sheds light upon the underlying markets and participants affected by these reforms. This Article reveals that many aspects of German regulation and market activities, as well as market protections in particular, have reached international standards, in part as a result of these specific reforms and other ongoing changes, some of which are discussed in Part VII. Taking the German goal of greater transparency one step further, this Article reveals gray areas where the success of the reforms remains to be seen, the difficulties and ambiguities of implementation, further steps necessary to implement some of the legal reforms, and additional changes yet to be enacted.

Comparisons with the system of securities regulation in the United States reveal some interesting insights. Germany now has a single federal regulator for securities and derivatives as opposed to the divided jurisdiction in the United States between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission. Nonetheless, fewer instruments fall under the German

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<sup>7</sup> *Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz)*, Bundesrat Drucksache 793/93 (Nov. 5, 1993), Bundestag Drucksache 12/6679 (Jan. 27, 1994) [hereinafter *Gesetzentwurf*]. All references in this Article shall refer to pages in the Bundestag publication.

<sup>8</sup> *Begründung to the Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz)*, Bundesrat Drucksache 793/93, 100–284 (Nov. 5, 1993); Bundestag Drucksache 12/6679 (Jan. 27, 1994) 33–93. This explanation is added to the back of the text of the draft bill. *Gesetzentwurf, supra* note 7.

definition of regulated securities, and the scope of German oversight is much narrower. Additionally, the mandate of the German agency appears to favor the marketplace and the promotion of *Finanzplatz Deutschland* over the investor protection goals central to the SEC. While the German system provides none of the private rights of action vital to United States securities regulation, the Germans have clearly defined "insider," rather than leaving this concept to the common law. Other issues such as the liability of third parties as well as knowledge and materiality requirements remain unclear. Early stages of implementation of the German reforms look promising, but the key to the future will be enforcement of the laws, especially when one considers the depth of SEC investigations. The establishment of the new German Federal Securities Trading Supervisory Authority has filled a significant gap in the overall financial regulatory structure; the reforms appear to have created a viable and working system of cooperation among the German regulators.

This Article provides a detailed analysis of the recent changes in Germany. The majority of the information contained herein stems directly from primary sources—texts of the laws, draft bills, official government statements and explanations of the provisions of the bills, and official reports of the exchanges and financial institutions in Germany. The author has examined all of these documents in their original German form. These written sources are supplemented by interviews with Germans directly responsible for the shaping, drafting, implementation, and ultimate success of these reforms as well as through the author's own experience working in the German and U.S. financial markets. This Article purports to serve as a guide to these reforms for the English-speaking reader and a lengthy affidavit of successful steps in Germany towards the goal of achieving *Finanzplatz Deutschland*.

## II. OVERVIEW OF THE GERMAN FINANCIAL SYSTEM

Germany is currently undergoing a period of growth and reform in its financial markets. The traditional German model for business financing consists of a reliance by businesses upon internal financing and borrowing from credit institutions as opposed to the equity financing relied upon by a large share of American corporations. As a result, the large German credit institutions dominate the economy, while the equity markets have been until recently relatively illiquid and dominated by the same credit institutions as institutional investors. The German universal banking model has also been called into question as both a result and a perpetuator of the position of banks in the control of industry.



The reforms discussed in this Article represent to some extent a new way of thinking in Germany. Most Germans have realized that a strong banking system alone cannot support the country's financial markets in a globally competitive environment. As a result, the German reforms discussed here focus primarily on raising the attractiveness of the securities markets in Germany for trading both on and off the traditional auction stock exchanges.

Although the outside pressures for change in Germany, such as the EU directives, are clear enough, the pressures for change from inside Germany are much less visible. The first five years since unification have brought many unforeseen strains within Germany<sup>9</sup> in addition to the costs and burdens of deeper integration within the EU. The costs borne by a social welfare state, increased unemployment levels throughout Europe, unexpected capital needs for the rebuilding of eastern Germany and eastern Europe, and the domestic costs of a rising Deutsche Mark in a trade oriented country have probably all had effects upon the desire of Germany to reform its financial markets.

The issues of reform are only sensible in the context of their goals and the starting points. The following Parts will address these opposite ends of the spectrum with a discussion of the specific goals of the concept of *Finanzplatz Deutschland* and overviews of the three major financial sectors in Germany—banking, securities, and only a very brief discussion of the insurance industry, which the most recent reforms only tangentially address. This summary includes historical background information that shaped the current structure, references to reform, and a few comparisons with systems in the United States or other third countries to lend perspective. This Article then describes the activities in Germany's financial capital, Frankfurt am Main, in greater detail, and offers a brief overview of the agencies responsible for monitoring the respective financial actors.

### A. *Finanzplatz Deutschland*

Just as Germany has begun to reassert itself on the world political stage, in the post-unification era, Germany has publicly claimed a position as an economic power. The clarion call came from Theo

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<sup>9</sup> The federal government has imposed a solidarity tax of an additional 7.5% of personal or corporate income tax due for all but low-income households. This surcharge purports to offset the costs of unification and raising the new Bundesländer to western levels. Solidaritätszuschlaggesetz 1995, BGBl. I, 944, 975.

Waigel, the German Federal Minister of Finance, to establish an internationally competitive *Finanzplatz Deutschland* with financial markets appropriate for the world's third largest industrial nation.<sup>10</sup> Such a financial metropolis would exhibit the generally recognized legal standards for insuring both investor protections and the functioning of the markets.<sup>11</sup> He delineated three elements of central importance for the future: (1) a solid and dynamic universal banking system, (2) internationally competitive stock exchanges, and (3) a business oriented insurance market with high capacity.<sup>12</sup> This Article discusses many of the reforms required to achieve these elements, with an emphasis upon the most recent reforms of the stock markets and securities industry in particular.

Waigel explained the reforms as an essential part of the development of the single European Common Market and the necessary free movement of capital.<sup>13</sup> Until the eventual completion of the economic and monetary union, the economies of the Member States must grow together and create competition for the international finance centers of New York and Tokyo,<sup>14</sup> while German markets must also rival those of London and Paris.<sup>15</sup> In recent years, London has been the most obvious competitor with Frankfurt in a contest for financial supremacy in Europe.<sup>16</sup> Some people already view the willingness of the large

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<sup>10</sup> Theo Waigel, Der Bundesminister der Finanzen, *Konzept Finanzplatz Deutschland*, Public Statement (Jan. 16, 1992), art. I(1) in 46 WERTPAPIER MITTEILUNGEN: ZEITSCHRIFT FÜR WIRTSCHAFTS-UND BANKRECHT [WM] 420, 420 (Mar. 7, 1992) [hereinafter Waigel, *Finanzplatz Deutschland*].

<sup>11</sup> See *id.* art. I(2), at 421.

<sup>12</sup> See *id.* art. I(1), at 420.

<sup>13</sup> See *id.* art. I(2), at 420. Recall that movement of capital is one of the four fundamental freedoms of the EU. See *supra* note 2 and accompanying text.

<sup>14</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. I(2), at 420.

<sup>15</sup> See *id.* art. I(3), at 421.

<sup>16</sup> In the banking sector, for example, there are over 500 banks from 70 countries operating in London, as opposed to half that many in Frankfurt. See Claus Geissmar, *London—Geldhauptstadt Europas*, BERLINER MORGENPOST, Oct. 23, 1995, at 26. For a discussion of Frankfurt as a financial metropolis with facts and figures, see *infra* Part II.E. In terms of foreign exchange trading, London is unquestionably the world leader. Frankfurt's daily turnover is only 10% that of London. Geissmar, *supra*, at 26. In terms of internationalization, London is also far ahead. Trading in foreign stocks accounts for 56% of the turnover on the London Stock Exchange. See *Die Londoner Börse kämpft gegen die Konkurrenz*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 1, 1995, at 28 [hereinafter *Londoner Börse*]. A more disturbing figure for Frankfurt is that 70% of all trading in German federal bonds takes place in London. See *Frankfurt kann im Wettbewerb der Finanzplätze nicht aufholen*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 8, 1995, at 30.

German banks to move operations to London as a type of capitulation,<sup>17</sup> but the competition is far from over.<sup>18</sup> Waigel posited that Germany had great success with previous measures to liberalize standards for financial services, and that this trend must continue in the future. The system should, therefore, strive to remove unnecessary measures limiting flexibility, innovation, and product competition in the development of financial instruments.<sup>19</sup>

Waigel found support for inner-German reform in the global integration of financial markets, reflected in international cooperation in deregulation and regulation. Outside of the EU, this has been reflected in bank reform in the United States and modernization in the field of financial services in Japan.<sup>20</sup> The goal of all these efforts is to increase both efficiency in the financial sector and the potential for economic growth. Additionally, the modernization of the economy in eastern Germany, which furthers the attractiveness of *Finanzplatz Deutschland* in terms of transactions costs, transparency, financial instruments, and quality standards, lends support for nationwide reforms. In the post-Cold War era, Germany will play a key role in financing the development of central and eastern Europe as well.<sup>21</sup>

From a competitive standpoint, Waigel outlined three factors necessary to achieve the goal of *Finanzplatz Deutschland*. First, the underlying economic environment must be in place—a growing economy based upon a stable currency and solid government financial policies. Sec-

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<sup>17</sup> The traditional three largest German private banks, Deutsche Bank, Dresdner Bank, and Commerzbank, have all moved their offices for the international coordination of new stock issuance and stock placements from Frankfurt to London. See Geissmar, *supra* note 16, at 26. Many of the other German banks have followed suit by setting up London offices or buying stakes in foreign investment banks. Commentators have criticized the German banks for such moves. The German banks play a key role in the growth of a stock culture in Germany and must be prepared to pursue their activities in *Finanzplatz Deutschland* and make their trades over German exchanges. See *Verknüpfung von Banken und Börsen bringt den Märkten Nachteile*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 9, 1995, at 21 (comments by Hans Büschgen, Professor for Banking at the University of Cologne, Germany).

<sup>18</sup> The London Stock Exchange has recently been criticized for its failure to modernize fast enough and for its lack of cooperation with other exchanges. The Chairman of the British subsidiary of the Swiss Bank Corporation went so far as to say that the London Stock Exchange had lost its chance to be the leader for trade in European stocks. See *Londoner Börse*, *supra* note 16, at 28. Turnover in European stocks has actually fallen in London, and a number of investment banks have reported that they no longer see any reason to issue stock in London as opposed to the national stock exchanges where the corporation is based. See *id.*

<sup>19</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. I(2), at 420.

<sup>20</sup> See *id.*

<sup>21</sup> See *id.*

only, from a regulatory standpoint, there must be a liberal tax and legal framework so as not to hinder financial transactions and investment and to promote efficient allocation of financial resources. The final factor shall be efficient markets in banking, the stock exchanges, and the insurance industry, with functioning market oversight.<sup>22</sup> While the federal government would be responsible for the framework conditions for internationally competitive financial markets, the Minister of Finance called upon the *Länder*,<sup>23</sup> stock exchanges, and market participants to lend their technical and organizational expertise.<sup>24</sup>

By the beginning of 1992, Germany had already taken steps in the right direction. The government had addressed the second factor and lowered investment costs by removing taxes on financial transactions.<sup>25</sup> The Stock Exchange Act had been amended to allow for trading in options and futures, and these markets had been opened up to investment companies.<sup>26</sup> In addition to these government actions, parallel steps had been taken by market participants. This included the establishment of the German Futures Exchange (*Deutsche Terminbörse*) in Frankfurt, the development of electronic securities trading systems, and improvements in information and settlement systems.<sup>27</sup>

Yet these were still only single steps. The next giant leap in realizing these reforms occurred in the form of a law called the “*Finanzplatz Deutschland Act*” or, as an alternative, the “Second Financial Market Promotion Act” (“*Zweites Finanzmarktförderungsgesetz*”).<sup>28</sup> Waigel proposed that this new Act would change the oversight structure of the German stock exchanges and establish a new federal oversight agency, enact laws regulating insider activities according to international standards, and implement varying EU directives regarding the financial services industry—the overall purposes of these directives include increased transparency of capital markets, strengthening the rights of investors, and regulating participation in stock exchange and securities

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<sup>22</sup> See *id.* art. II(1), at 421.

<sup>23</sup> A *Länd* is the German equivalent of a state or provincial level government (*Länder* = plural).

<sup>24</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. II(1), at 421.

<sup>25</sup> Between January 1, 1991 and January 1, 1992, the stock exchange turnover tax, capital contribution and transfer tax, and the stamp duty on bills of exchange were abolished. See *id.* art. III(2), at 421.

<sup>26</sup> See *id.*

<sup>27</sup> See *id.* art. III(3), at 421.

<sup>28</sup> See *id.* art. V(1), at 423.

transactions.<sup>29</sup> Waigel set the deadline for enactment by the second half of 1992.<sup>30</sup> The following Parts of this Article discuss the structures and key market participants in the main financial sectors in Germany upon which Waigel based his call for reform.

## B. *Banking*

In addition to the importance of a strong banking industry in and of itself, credit institutions play a fundamental role in the overall infrastructure of financial transactions within a country's economy, acting as intermediaries and agents of the country's payment system. The dominant actors in the German banking industry are the private "universal banks," which, as their name suggests, provide a wide range of financial services, including those that in the United States would be divided between investment and commercial banking. The broad range of banking services provided by the German universal banks compensates for internal risk, further contributing to the stability and overall services of the German financial sector.<sup>31</sup> Healthy banking and bank oversight in Germany have dampened shocks to the financial markets.<sup>32</sup>

The German banking industry is composed of multiple types of financial institutions, which, although they provide many similar services, differ substantially in form and structure from their counterparts in the United States. The most notable and oft-cited difference is the presence in Germany of "universal banks." These German financial institutions are not subject to an artificial delineation of credit versus securities functions such as that imposed in England and in the United States (under the Glass-Steagall Act).<sup>33</sup>

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<sup>29</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. V, at 423.

<sup>30</sup> See *id.* art. V(1), at 423.

<sup>31</sup> See *id.* art. I(2), at 420.

<sup>32</sup> See *id.*

<sup>33</sup> 12 U.S.C. § 24(Seventh) (1994). For the text of this provision, see *infra* note 564. Numerous attempts have been made to repeal or at least amend the Glass-Steagall Act to allow U.S. banks to engage in more securities activities. The most recent Congressional attempt in the summer and fall of 1995 almost succeeded. The House Banking Committee drafted a bill that would have repealed Glass-Steagall. There was general agreement in the Clinton Administration, among Republicans and Democrats from both Houses of Congress, among financial regulators, and throughout the three financial industries (banking, securities, and insurance), that the time was ripe for such legislation. In response to pressure from the insurance industry, however, the House leadership under the direction of Speaker Newt Gingrich inserted a rider to the bill that imposed a five year moratorium on banks entering the insurance industry. The banking lobbies opposed this provision, and, therefore, changed their position from favoring to opposing the legislation.

Although there are numerous universal banks in Germany, the field is dominated by the three largest banks based in Frankfurt am Main which operate throughout Germany as well as internationally: Deutsche Bank, Dresdner Bank, and Commerzbank. "The big banks play a dominant role in the [underwriting] business and all international fields of business. They handle approximately 60% of all payments within the framework of German foreign trade."<sup>34</sup> By the end of 1993, these three banks were ranked worldwide in the following positions based upon total tier one capital assets: Deutsche Bank, 14; Dresdner Bank, 37; and Commerzbank, 60.<sup>35</sup> By the end of 1993, the Deutsche Bank Group had over 73,000 employees, 2400 branches (including over 1700 outside Germany), and total assets of over DM 550 billion.<sup>36</sup>

The German banking industry has proven no easier than that of most other countries for foreign banks to enter on a retail level. In addition to the difficulty in establishing a deposit business without a branch network, the strong ties between German businesses and their primary banks make it difficult for foreign banks to establish commercial links with German industry.<sup>37</sup> The strength of foreign banks in Germany, however, lies in securities transactions.<sup>38</sup> Foreign banks have expanded traditional banking activities in Germany through the introduction of innovative products, including swap deals and trading in

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See Keith Bradsher, *No New Deal for Banking; Efforts to Drop Depression-Era Barriers Stall, Again*, N.Y. TIMES, Nov. 2, 1995, at D1. The presidential elections in 1996 and the partisan division over the 1996 budget debates make it unlikely that a serious attempt to overhaul the Glass-Steagall Act will be raised again in Congress before 1997.

Banks can already engage in limited securities activities in the United States through exceptions to the Glass-Steagall Act, such as by establishing a securities trading subsidiary under § 20 of the Bank Holding Company Act. See *infra* note 564 and accompanying text. The need to prevent insider trading within an institution that provides multiple investment services for its customers and trades on its own account requires the establishment of Chinese Walls. For a discussion of Chinese Walls, see *infra* note 384 and accompanying text. Because of concerns over the flow of material nonpublic information within a financial institution offering a variety of banking and financial services, the end result in the debate between the universal banking system and a system divided between commercial and investment banking functions ultimately leads to a compromise of the two systems.

<sup>34</sup> See FINANZPLATZ FRANKFURT, *infra* note 37, at 18.

<sup>35</sup> See *Top 1000 by Country: Germany*, THE BANKER, July 1994, at 180.

<sup>36</sup> DEUTSCHE BANK AG, 1993 ANNUAL REPORT, *Highlights* (1994).

<sup>37</sup> See INDUSTRIE-UND HANDELSKAMMER FRANKFURT AM MAIN [THE FRANKFURT CHAMBER OF INDUSTRY AND COMMERCE], FRANKFURT AM MAIN: INTERNATIONALER FINANZPLATZ [FRANKFURT AM MAIN: INTERNATIONAL FINANCIAL METROPOLIS] 38 (Aug. 1994) (text in German and English; cites to English version) [hereinafter FINANZPLATZ FRANKFURT].

<sup>38</sup> See *id.*

futures and derivatives.<sup>39</sup> American banks command the leading position in the derivatives business in Germany.<sup>40</sup>

The major financial center for foreign banks, as well as domestic banks, is Frankfurt am Main, discussed *infra* in Part II.E. in greater detail. Next to Frankfurt, and arguably Düsseldorf, Berlin has a claim of its own as a banking center. In the four years after unification, from the end of 1989 to the end of 1993, the number of financial institutions active in the city grew from 101 to 147.<sup>41</sup> Next to Frankfurt, Berlin also has one of the largest, and definitely the fastest growing international banking presence in Germany. In the four years after unification, the number of foreign banks with representative offices or branches in Berlin grew from sixteen to thirty-eight,<sup>42</sup> and had reached forty-five by September of 1995.<sup>43</sup> Although reasons may vary, the financing opportunities for the construction boom and emerging businesses in Berlin and eastern Germany, as well as throughout eastern Europe, have provided ample customers.

Although much foreign discussion of banking in Germany refers to the private universal banks, a very important, yet relatively low-keyed sector of the banking industry is that of the *Sparkassen* (savings banks). While the private universal banks are responsible for over eighty percent of all securities activities, the *Sparkassen* hold a majority of the retail deposits and often dominate the local municipality in which they are based. Through their semi-public, *Länd* based, central clearing banks, the *Sparkassen* can provide a universal range of credit functions with a stable, amalgamated deposit base. The last major sector of the market aside from specialized credit institutions are the *Genossenschaftsbanken* (credit cooperatives) which have a long tradition in small business and agricultural financing but play primarily a local role.

### C. Securities Markets

While German banks have strong international presences, the German stock markets have lagged behind. In large part, it could be argued that the weak securities markets are inversely related to the strength of the banks and credit institutions. German corporations

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<sup>39</sup> See *id.* at 38–39.

<sup>40</sup> See *id.* at 39.

<sup>41</sup> See INDUSTRIE-UND HANDELSKAMMER ZU BERLIN, BERICHT 1993/94 36 (1994).

<sup>42</sup> See *id.*

<sup>43</sup> Norbert Schwaldt, *Berlin wird Magnet für Auslandsbanken*, BERLINER MORGENPOST, Sept. 22, 1995, at 23.

have traditionally relied very heavily upon internal financing and debt (lending from their primary bank), in contrast to more prevalent reliance on equity financing in the United States.<sup>44</sup> From the other side, German shareholders are predominantly institutional; private investors play a much smaller role in the markets than in the United States.<sup>45</sup> In conjunction with the markets themselves, formal regulation of the German stock exchanges has lagged behind international standards. These factors are interrelated: both conducive regulatory structures and willing participants are necessary to establish vibrant securities markets. The government hopes that structural improvements will further market liquidity and ultimately the attractiveness of issuing stock as a vehicle for financing.<sup>46</sup>

In the process of modernization, not only must the rules governing the stock exchanges develop, but the actual structures of the exchanges, both literally and figuratively, must change. The need for multiple regional exchanges has been questioned. The development of computerized trading increases overall efficiency, but may lead to the demise of some of the smallest exchanges. The introduction of new financial products, such as futures, options, and other derivatives has gained early success in Germany and promises future growth.

## 1. The German Stock Exchanges

Germany has eight regional stock exchanges upon which traditional securities are traded in an auction format.<sup>47</sup> Of the eight stock exchanges in Germany, the *Frankfurter Wertpapierbörse* of Frankfurt am Main is by far the largest—currently the fourth largest in the world.<sup>48</sup>

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<sup>44</sup> See Mark J. Roe, *Some Difference in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1960–61 and n.96 (1993).

<sup>45</sup> See *id.* at 1936–38.

<sup>46</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. IV(3), at 423.

<sup>47</sup> The eight exchanges (and their locations), listed in order of size, are the following: *Frankfurter Wertpapierbörse* (Frankfurt am Main), *Rheinisch-Westfälische Börse zu Düsseldorf* (Düsseldorf), *Bayerische Börse* (Munich), *Hanseatische Wertpapierbörse Hamburg* (Hamburg), *Baden-Württembergische Wertpapierbörse zu Stuttgart* (Stuttgart), *Berliner Börse* (Berlin), *Niedersächsische Börse zu Hannover* (Hannover), *Bremer Wertpapierbörse* (Bremen). DEUTSCHE BÖRSE AG, 1993 DEUTSCHE BÖRSEN: JAHRESBERICHT 3 (1993). See also DEUTSCHE BÖRSE AG, DEUTSCHE BÖRSEN: 1993 ANNUAL REPORT 3 (1993) (English translation). Generally, this Article will refer to the exchanges only by their location, rather than by their full title (e.g., Düsseldorf stock exchange).

Despite the current overpopulation of exchanges, there has been a movement to reopen an exchange in the former East Germany that has been closed for over fifty years.

<sup>48</sup> See Deutsche Börse AG, *The Fourth Largest Stock Exchange in the World*, GALLERY: A BRIEF



The Frankfurt exchange handles over seventy percent of the trading in stocks and bonds for the entire country.<sup>49</sup> Aside from the stock exchange in Düsseldorf, the other regional exchanges are considerably smaller and less liquid.<sup>50</sup>

One must question why a relatively small country with still developing securities markets needs eight exchanges when the United States has only two primary and five regional stock exchanges to serve a much larger geographical area with significantly greater capitalization.<sup>51</sup> The theoretical comparison of the current system in Germany with multiple regional exchanges as opposed to a single central exchange in Frankfurt has been a central part of the discussion of the attractiveness of *Finanzplatz Deutschland*.<sup>52</sup> The notion that Germany needs a strong, internationally competitive primary exchange to compete with the large exchange locations of the world favors centralization.<sup>53</sup> A concentration of trading on one exchange would increase liquidity, drive down transaction costs, create better prices, and make that exchange more attractive. In the communications age, with the same dealers trading the same stocks on the different exchanges, there is a substantial redundancy and overlap of resources. On the other hand, the fact that the regional exchanges have played an important role in the development of the *Länder* and in bringing small and medium-sized companies to the organized capital market is beyond question.<sup>54</sup> The latter role will continue to be important in the future, but that reasoning does not justify the existence of each individual exchange.<sup>55</sup> At a minimum, however, the tendencies toward oligopoli-

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DESCRIPTION OF THE STOCK EXCHANGE SYSTEM 1, 1 (1994). The three largest are New York, Tokyo, and London, respectively. *See id.*

<sup>49</sup> *See* DEUTSCHE BÖRSE AG, DEUTSCHE BÖRSEN: 1993 ANNUAL REPORT 33 (1994).

<sup>50</sup> *See generally id.*

<sup>51</sup> The two primary exchanges are the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex"), upon which most of the exchange traded stocks in the United States are listed. The five U.S. regional stock exchanges are the Boston Stock Exchange ("BSE"), the Philadelphia Stock Exchange ("Phlx"), the Cincinnati Stock Exchange ("CSE"), the Chicago Stock Exchange ("CSE"), and the Pacific Stock Exchange ("PSE"). "These exchanges primarily trade securities that are also listed on the primary markets." DIVISION OF MARKET REGULATION, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, STUDY II: STRUCTURE OF THE U.S. EQUITY MARKETS, IN MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS II-1, II-6 to -7 (footnote omitted) (1994).

<sup>52</sup> *See* Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. IV(1), at 422.

<sup>53</sup> *See id.* art. IV(2)(a), at 422.

<sup>54</sup> *See id.*

<sup>55</sup> *See id.*

zation or even monopolization of securities trading must be mitigated.<sup>56</sup>

The federal government has taken a hands off approach to the question of the future of the regional exchanges. This issue is intimately tied to the growth of computer trading as an alternative to the auction exchanges, discussed *infra*.<sup>57</sup> Federal lawmakers seek to provide the most efficient regulatory system for the operations of both the auction stock exchanges and for computer stock trading, so that the individual markets shall compete for trading.<sup>58</sup>

The individual stock exchanges have worked together very closely in the past, and the establishment of the Deutsche Börse AG in Frankfurt am Main in 1993 has institutionalized this relationship. Before this period, the exchanges were controlled by the city Chamber of Commerce, which explains why the two entities may still be found at the same location. The Deutsche Börse AG is a private stock corporation that serves as the supporting authority for the Frankfurt Stock Exchange (owner of the premises and provider of the facilities and personnel), as well as the owner of all shares of the German Futures Exchange, and the *Deutsche Kassenverein AG*, which functions as a settlement system for securities transactions.<sup>59</sup> The concept of Deutsche Börse AG is a decisive breakthrough, because it allows stronger centralization of important duties while allowing the further development of the regional exchanges.<sup>60</sup> Germany's four most important stock exchanges, Frankfurt, Düsseldorf, Munich, and Berlin, are currently involved in negotiations to improve cooperation and extend the Deutsche Börse AG's support functions to all four in 1997.<sup>61</sup>

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<sup>56</sup> See Gesetzentwurf, *supra* note 7, at 61 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, creating § 2a of the Börsengesetz).

<sup>57</sup> See *infra* Part II.C.2 and accompanying notes.

<sup>58</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. IV(2) (a) (aa), at 422.

<sup>59</sup> See DEUTSCHE BÖRSE AG, DEUTSCHE BÖRSEN: 1993 ANNUAL REPORT 28 (1994). "Shareholders are those banks and [brokers] who are trading on the stock exchange. A stake of 10% is owned by the regional stock exchanges. Ownership is evidenced by registered shares which are transferable only with the company's consent." See DEUTSCHE BÖRSE AG, ORGANISATION AND FUNCTION 9 (Mar. 1994).

<sup>60</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. IV(2) (a) (bb), at 422.

<sup>61</sup> See *Düsseldorf stimmt für die Börsenkooperation*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 4, 1995, at 15. The advisory board of the Düsseldorf stock exchange has already approved the cooperation contract, and Munich and Frankfurt should make their decisions in December of 1995. In Düsseldorf, the fought over issue of the development of a computerized exchange was omitted, so that the debate could concentrate on the question of how the regional exchanges could ensure their continued existence without detracting from *Finanzplatz Deutschland*. The four exchanges here will establish a common order system. Of the stocks in the broader DAX-100

Although the future remains unclear, most analysts agree that a consolidation of the eight stock exchanges within Germany will be necessary. Despite the attempts at cooperation, there has also been some competition and politicking between the exchanges to retain or gain market share.<sup>62</sup> While the two largest exchanges, Frankfurt and Düsseldorf, will certainly survive, at least in the near term, the very smallest, in Bremen, will almost certainly close at some point. Aside from survival and closure, a third option is for the exchanges to specialize beyond the corporate shares and high grade debt traditionally traded. The two most oft-cited examples are Hamburg and Berlin. As the country's largest port and hence the landing point for many commodities, most Germans expect Hamburg to establish a commodities futures exchange relatively soon.<sup>63</sup> Hannover, Hamburg's neighbor in the agricultural area of Niedersachsen to the south, however, appears to have taken concrete steps toward establishing a commodity futures exchange by 1997.<sup>64</sup>

Berlin appears ready to reassert itself as a commercial financial center<sup>65</sup> by preparing its stock exchange for the next century. The area of greater Berlin is undergoing a period of intense growth.<sup>66</sup> The city's proximity to the emerging economies of eastern Europe and its historical ties in the area make the Berlin stock exchange a logical choice for eastern European countries interested in raising capital by selling equity on a Western exchange.<sup>67</sup> The city is already preparing the

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index, Frankfurt will process orders for the 30 stocks in the DAX index (comparable to the 30 American stocks in the Dow Jones Industrial Average) as well as 22 other stocks, Düsseldorf will be responsible for 31, Munich for 14, and Berlin for 3. *See id.*

<sup>62</sup> The chairman of the board of the Deutsche Börse AG in Frankfurt recently rebuked the Düsseldorf exchange, saying that the conditions there were less than desirable and that Düsseldorf is definitely second best among the German exchanges. The retort from Düsseldorf was a reminder that Frankfurt still trails London in trading volume and should be weary of Paris as well. *See Ein Frankfurter droht mit Düsseldorf*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 23, 1995, at 27.

<sup>63</sup> The amendments to the Stock Exchange Act in the Second Financial Market Promotion Act have removed the legal obstacles to creating such an exchange. *See infra* notes 326 to 330 and accompanying text.

<sup>64</sup> The Hannover stock exchange is currently preparing the infrastructure. The construction will take 15 months and will cost between 15 and 20 million DM. The prospects for the Hannover exchange are good, because currently there are only three commodity futures exchanges in Europe (London, Paris, and Amsterdam) as compared to ten in the United States. *See Warentermibörse in Hannover wahrscheinlich*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 9, 1995, at 21.

<sup>65</sup> *See* INDUSTRIE-UND HANDELSKAMMER ZU BERLIN, BERICHT 1993/94 28 (1994).

<sup>66</sup> The economic role of Berlin is expected to continue to grow not only with the rebuilding of the city, but also with the expected political integration with the surrounding *Länd* Brandenburg. *See id.*; *see also, Berlin and Brandenburg Sign Agreement to Merge*, N.Y. TIMES, Apr. 28, 1995, at A13.

<sup>67</sup> Additionally, an expected eastern expansion of the EU in the future would leave Berlin in a

infrastructure to meet this need. In April 1994, construction began upon the "Ludwig-Erhard-Haus," which will serve as a commercial center and source of information and support for businesses in the area.<sup>68</sup> Upon completion in 1997, this new building will hold the offices of the city Chamber of Commerce and the renovated Berlin Stock Exchange.<sup>69</sup> Although still relatively modest in size by international standards, the pace of growth at the Berlin stock exchange has been astounding—1993 saw not only records for turnover, but also the largest growth in turnover in the postwar period, moving Berlin into fifth place among the German exchanges.<sup>70</sup> Traders have named the recent connection of Berlin to the computerized trading systems and a lengthening of trading hours until 3:55 p.m. in order to let them see the opening tendencies at the New York Stock Exchange as grounds for the growing attractiveness.<sup>71</sup> In the first nine months of 1995, the number of firms admitted to trading on the exchange grew to fifty-seven from forty-eight at the end of 1994, reaching almost twice as many traders as in 1989.<sup>72</sup>

## 2. The Advent of Computerization

Computerized securities trading systems seek to employ modern technology to reduce costs.<sup>73</sup> The success of the NASDAQ system in the United States shows the potential for securities trading by computer systems to compete directly with regional stock exchanges. Although the German government seeks to promote optimal conditions for both systems to operate, the government will allow the market to decide the relative success of the systems.<sup>74</sup> Waigel set forth the goal of providing the same competitive conditions for securities trading on the auction exchange floor as computer trading in his statement describing amendments to the stock exchange laws necessary to promote the concept of *Finanzplatz Deutschland*.<sup>75</sup>

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more central position. See *INDUSTRIE—UND HANDELSKAMMER ZU BERLIN, BERICHT 1993/94 28* (1994).

<sup>68</sup> See *id.*

<sup>69</sup> See *id.* at 31. This building is located in a commercial district at a central point in the western part of the city.

<sup>70</sup> See *id.* at 37. Over this period, bond trading quadrupled while stock trading doubled. *Id.*

<sup>71</sup> See *Berliner Börse findet Interesse*, *FRANKFURTER ALLGEMEINE ZEITUNG*, Sept. 20, 1995, at 30.

<sup>72</sup> See *id.*

<sup>73</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. III(3), at 421–22.

<sup>74</sup> See *id.* art. IV(2)(a)(aa), at 422.

<sup>75</sup> See *id.* art. IV(3), at 423.

Although trading on the floor of an auction exchange has long been supported by computers, recent innovations have greatly improved floor trading. The “Stock-Exchange-Order-Service-System” (“BOSS”) was introduced in November 1992.<sup>76</sup> “BOSS assists the [broker] in finding a price by continuously calculating a price margin from the actual levels of all buy and sell orders . . . . Furthermore, with BOSS banks receive immediate confirmation of the execution of orders and can subsequently inform their clients without delay.”<sup>77</sup>

Recent years have also seen the development of an entirely electronic trading system. The first of these is the “Integrated Stock Exchange Trading and Information System” (“IBIS”), which has been in use since April 1991.<sup>78</sup>

It offers all market operators, i.e. banks, Kursmaklers and Free Maklers in Frankfurt and elsewhere the possibility of concluding trades in 36 heavily traded shares, 30 bonds of public issuers, 15 bonds of foreign issuers, and 21 warrants from [8:30 a.m. to 5:00 p.m.]. The minimum size of a trade is 500 shares, if they are actively traded, otherwise 100, and DM 1 million face value for bonds, so that IBIS is used above all by institutional investors like insurance companies, banks, or investment funds.<sup>79</sup>

Trading is entirely by quotation screens available to members, who can submit their own offer or accept one on the screen; the trade information is entered directly into the settlement system.<sup>80</sup> The early success of this system may be seen in the trading volume which it has captured. The percentage of turnover in the thirty shares listed in the country’s most widely watched DAX index (akin to the Dow Jones Industrial Average) “has risen from 17.8% in the first quarter of 1992”<sup>81</sup> to 29.02% in the fourth quarter of 1993 and to 36.71% in the fourth quarter of 1994, representing a total of 5.47% of trading in all instruments for the course of 1994.<sup>82</sup>

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<sup>76</sup> See DEUTSCHE BÖRSE AG, ORGANISATION AND FUNCTION 35 (Mar. 1994). BOSS is short for “*Börsen-Order-Service-Systems*.”

<sup>77</sup> *Id.*

<sup>78</sup> See DEUTSCHE BÖRSE AG, ORGANISATION AND FUNCTION 33 (Mar. 1994). IBIS is short for “*Integrierte Börsenhandels-und Informations-System*.”

<sup>79</sup> *Id.* at 33–34.

<sup>80</sup> *Id.* at 34.

<sup>81</sup> *Id.*

<sup>82</sup> See DEUTSCHE BÖRSE AG, FRANKFURTER MONATSTATISTIK FÜR DEZEMBER 1994 4 (Jan. 1995).

Another innovation has been the development of a real time computerized information system called pcKISS.<sup>83</sup> This system transmits prices on the eight stock exchanges, on IBIS, on the futures exchange, as well as prices from foreign markets, of foreign currencies, and of news.<sup>84</sup>

Beyond providing price information, pcKISS also allows participation in securities trading. The [German Futures Exchange] and IBIS screens can be integrated into pcKISS without problems and BOSS may also be assessed via the system. The participant also has with pcKISS a direct link to the settlement system . . . Thus pcKISS provides the possibility of combining the required services for information, trade and settlement into one unified system.<sup>85</sup>

### 3. Futures and Options

Germany entered the world of futures and options trading only recently, but the markets have already achieved considerable success, with liquidity surpassing that on the stock exchanges. Of the sixty-two futures and options exchanges around the world, one-third of them are located in the United States, followed by eight in the United Kingdom.<sup>86</sup> A dozen other European countries, such as Germany, have a single exchange.<sup>87</sup> This market is relatively concentrated, with the two largest U.S. exchanges accounting for thirty-eight percent of all trading.<sup>88</sup>

The German Futures Exchange is the Deutsche Terminbörse ("DTB"), located in Frankfurt, which opened for trading in 1990. Trading on the DTB has grown rapidly, to the point where it may be called more successful than the other German exchanges dealing primarily in underlying securities rather than in derivatives. While world growth in trading on derivatives exchanges grew twenty percent in 1993, trading on the DTB grew forty-four percent.<sup>89</sup> Trading was strongest in options,

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<sup>83</sup> See DEUTSCHE BÖRSE AG, ORGANISATION AND FUNCTION 36 (Mar. 1994).

<sup>84</sup> See *id.* at 36.

<sup>85</sup> *Id.* at 36–38.

<sup>86</sup> HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 829 (1995).

<sup>87</sup> See *id.* Outside of Europe, the other countries with futures and options exchanges include Japan (5), Canada (5), Brazil (3), Hong Kong, Singapore, Malaysia, and the Philippines. *Id.* at 829–30.

<sup>88</sup> See *id.* at 830.

<sup>89</sup> DTB DEUTSCHE TERMINBÖRSE GMBH, 1993 GESCHÄFTSBERICHT, ANNUAL REPORT 15 (1994).

with thirty-four million contracts traded in 1993, representing twenty-six percent of the European options markets. Total volume in financial futures reached over sixteen million contracts in 1993.<sup>90</sup> Products traded include options on the DAX Index, representing 42.7% of all trading in 1993, options on individual stocks at 24.4%, German government bond futures at 15.5%, other government bond futures at 9%, DAX Index Futures at 7.9%, and the remaining less than 1% in options on futures.<sup>91</sup>

One of the provisions in the Second Financial Market Promotion Act seeks to make trading in derivatives even more attractive in Germany, by adding a protection for traders in options and futures in cases of breach due to insolvency.<sup>92</sup> Another provision allows investment companies to invest in derivative products, which should increase demand in these markets.<sup>93</sup>

#### D. *Insurance*

Like the German banking industry, the insurance industry is much more mature than the securities markets. The main thrust of change in the insurance industry has come from increased competition throughout Europe as a result of harmonization measures and the removal of national barriers. Within the immediate past, however, there have been no German legislative reforms in the insurance industry to rival those affecting the banking and securities markets. In addition, the major participants in the latter two markets, the universal banks, are largely prohibited from offering insurance products, while the insurance industry also falls under the authority of different federal regulators. For these reasons, although a sound insurance industry is an essential part of the total concept of *Finanzplatz Deutschland*, this Article will focus largely on the recent reforms outside of the insurance industry.

#### E. *Finanzplatz Frankfurt*

Any discussion of *Finanzplatz Deutschland* will ultimately revolve around the financial capital, Frankfurt am Main.<sup>94</sup> Although Berlin was once

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> See *infra* notes 363–70 and accompanying text (discussing Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 15 (“*Finanztermingeschäfte im Insolvenzverfahren*”)).

<sup>93</sup> See *infra* notes 334–39 and accompanying text (discussing Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 3 (“*Änderung des Gesetzes über Kapitalanlagegesellschaften*”)).

<sup>94</sup> The correct reference to Frankfurt as the city on the Main River has become more important

and is now again the political capital and is reasserting some aspects of its place as an economic capital, the number one position of Frankfurt in terms of banking<sup>95</sup> and securities remains unquestioned. Only in the third aspect of the *Finanzplatz*—insurance—is the industry more evenly distributed throughout the country leaving Frankfurt as a smaller player.

Frankfurt's roots as a financial center stem from its location at the crossroads of major European trade routes, with its renowned trade fairs tracing back to the eleventh century.<sup>96</sup> Currency exchange business formed the basis for the establishment of the first recorded banking institution in Frankfurt, the "Wessil," founded in 1402.<sup>97</sup> The establishment of Berlin as the capital of Germany in the late nineteenth century and the World Wars and intervening turmoil of the first half of this century had devastated Frankfurt's role as an international financial center.<sup>98</sup> Its modern role as a financial center began with the establishment of a strong central bank, the German Bundesbank, in the postwar era.<sup>99</sup>

Within the EU, it appears that the importance of Frankfurt as a financial center will continue to grow:

Since the decision of the heads of state and government of the EC to award Frankfurt am Main the seat of the European Monetary Institute (EMI) and, with the completion of the Economic and Monetary Union (EMU), the seat of the European Central Bank (ECB), Frankfurt am Main is more than ever before in the limelight as a financial centre. With the European Central Bank not only the Deutsche Bundesbank but also the supreme monetary instance of the European Union will shape monetary policy from Frankfurt am Main at the end of this century.<sup>100</sup>

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since the German unification and the reawakening of Frankfurt *an der Oder* on the Polish border. All references in this Article to Frankfurt shall refer to Frankfurt am Main.

<sup>95</sup> About 70% of all foreign banks with a base in Germany have a presence in Frankfurt, and for half of all foreign banks, this is the only German presence. See *FINANZPLATZ FRANKFURT*, *supra* note 37, at 34. These banks represent 52 different countries from six continents. *Id.* at 35

<sup>96</sup> *FINANZPLATZ FRANKFURT*, *supra* note 37, at 6.

<sup>97</sup> *See id.*

<sup>98</sup> *See id.*

<sup>99</sup> To replace the Reichsbank after the war, the individual *Länder* had their own *Länd* central banks, loosely united under the Bank deutscher Länder, established in 1948. The Deutsche Bundesbank succeeded this system in a union of these entities on August 1, 1957. *See id.* at 12.

<sup>100</sup> *See id.* at 3. The decision to award Frankfurt the seat of the European Monetary Institute



A large part of this decision reflected deference to the German Bundesbank as an engineer of strong monetary policy and economic growth in Germany.<sup>101</sup> The recognition of the European leaders of the strength of the Deutsche Mark, however, was only one step toward *Finanzplatz Deutschland*. The more difficult tasks lay in convincing financial institutions of the benefits of operating in Germany and convincing investors from both within and outside the country of the strength of the public markets in Germany.

As far as banking institutions are concerned, Frankfurt am Main has truly emerged as an international financial center over the last few decades, with an increasing number of German and foreign banks operating there. As of June 1994, 422 domestic and foreign banks maintained a presence in Frankfurt.<sup>102</sup> Of the 143 German institutions, 67 had registered offices or central headquarters there.<sup>103</sup> In the post-war era, American banks established the first foreign bank branches in Frankfurt, leading the way for a tremendous international presence today.<sup>104</sup> "Of the 272 foreign banks in Frankfurt, 48 are autonomous banks, 108 are subsidiaries incorporated under German law and 116 are representative offices."<sup>105</sup> Foreign banks account for over eleven percent of all banking business in Frankfurt.<sup>106</sup> Few of the leading international banks can afford not to operate in Frankfurt.<sup>107</sup> In addition to the concentration of the credit institutions, "Six of the ten

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("EMI") was made by the twelve EC Member States at the Community Summit in Brussels on October 29, 1993. *See id.* at 16.

<sup>101</sup> Note that the two basic objectives of the European Central Bank as head organ of the European System of Central Banks ("ESCB") stem directly from the law establishing the German Bundesbank: (1) to protect the currency, and (2) to further the general economic policies of the federal government. *Compare* GESETZ ÜBER DIE DEUTSCHE BUNDESBANK, BGBl. I p. 1782, §§ 3, 12 (as amended as of Nov. 1, 1992) *with* TREATY ON EUROPEAN UNION art. 105(1) (1992) ("The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community . . .").

<sup>102</sup> *See* FINANZPLATZ FRANKFURT, *supra* note 37, at 11.

<sup>103</sup> *See id.* The remaining German institutions had a total of 23 registered branches and 53 places of business in Frankfurt. *Id.*

<sup>104</sup> Chase Manhattan Bank and Citibank established the first modern foreign bank branches in Frankfurt in 1947 and 1952 respectively. The United States still has the most bank branches in Frankfurt (10). *See id.* at 34.

<sup>105</sup> *Id.*

<sup>106</sup> *See id.* at 39.

<sup>107</sup> "Of the ten largest credit institutions in the world—in terms of balance sheet total at the end of 1992—nine are represented in Frankfurt; taking the 50 largest, 45 of them are represented here." FINANZPLATZ FRANKFURT, *supra* note 37, at 39.

largest (German) securities investment fund companies have their registered offices in Frankfurt."<sup>108</sup>

The earliest stock exchanges trace their roots in Frankfurt back to the sixteenth century, once again based upon the trading routes that intersected there.<sup>109</sup> Despite the early lead in fixed interest rate debt securities, the Frankfurt markets never developed a strong basis in corporate equity stock.<sup>110</sup> To some extent, the current reforms in this Article are aimed at this reticence that has been slow to change. In the modern postwar era, the international markets did not pick up again until 1956 with the trading of U.S. shares.<sup>111</sup> Only within the last decade, however, has the pace of reform in Frankfurt brought the German markets up to the speed of international standards.

Although the importance of the insurance industry in Frankfurt is dwarfed in comparison to the banking and securities sectors, once again Frankfurt am Main is favored as a German foothold by foreign companies. A total of 171 national and international insurance companies were registered in the greater Frankfurt area in June of 1994.<sup>112</sup> Nonetheless, only 11 of the 122 German companies had their headquarters there, while other larger German cities—Hamburg, Munich, and Cologne—surpassed Frankfurt in this category.<sup>113</sup> The international presence remains seated in Frankfurt, however, as shown by the fact that although Frankfurt ranks seventh in Germany in terms of total insurance contract premiums, it ranks first for premiums by foreign insurers in Germany.<sup>114</sup>

#### F. *Oversight of the Financial Markets in Germany*

Federal activity affecting the various financial institutions falls generally under the authority of the Federal Ministry of Finance. Below this ministry are three autonomous oversight agencies, the Federal Banking Supervisory Authority (*Bundesaufsichtsamt für das Kreditwesen*), the Federal Insurance Supervisory Authority (*Bundesaufsichtsamt für Versicherung*), and the newly established Federal Securities Trading Supervisory Authority (*Bundesaufsichtsamt für den Wertpapierhandel*).

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<sup>108</sup> *Id.* at 23.

<sup>109</sup> *See id.* at 42.

<sup>110</sup> *See id.* at 43–44.

<sup>111</sup> *See id.* at 45.

<sup>112</sup> *See* FINANZPLATZ FRANKFURT, *supra* note 37, at 61.

<sup>113</sup> *See id.* at 62–63.

<sup>114</sup> *See id.* at 63.

The creation of the latter agency filled a void in the triumvirate of the financial sectors in Germany. Finance Minister Waigel had openly recognized that the type of securities oversight necessary to carry out the laws and remedy grievances outside the organized capital markets did not yet exist in Germany.<sup>115</sup> Its creation was urgent because it was seen as an important component of an internationally reputable financial metropolis. As in the fields of banking and insurance, a federal agency meeting international standards would be needed to oversee the securities industry because the activities transcend the scope of the *Länder*. Germany faced outside pressure to establish a federal counterpart for international cooperation among securities oversight agencies.<sup>116</sup>

The changes discussed in this Article establish a three-tiered system of regulation within the securities industry and establish a second agency to oversee securities activities of credit institutions. The federal level of securities regulation and the establishment of the Securities Trading Supervisory Authority is discussed in part V.A.2. The regulation within the stock exchanges themselves has been supplemented with the establishment of the Trading Control Board mandated by the amendments to the Stock Exchange Act discussed in Part V.B. The following discussion addresses the intermediate role of the *Länder* in securities regulation which served as the primary form of oversight prior to the Second Financial Market Promotion Act. Part VI.E will discuss the interrelationship between the three levels of securities oversight as well as the interaction with the Federal Banking Supervisory Authority.

Although the role of the *Länder* has changed they will continue to serve an important role in securities regulation. First of all, the establishment of an exchange requires the approval of the Stock Exchange Supervisory Authority (*Börsenaufsichtsbehörde*) of the *Länd* in which the exchange will be located.<sup>117</sup> The *Länd* Stock Exchange Supervisory Authority shall have general oversight duties, in accordance with the Stock Exchange Act.<sup>118</sup> In order to implement this supervision, the Supervisory Authority may establish a State Commissioner's Office.<sup>119</sup> Although the Board of Directors of the exchange (*Börsenrat*)<sup>120</sup> shall

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<sup>115</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, art. I(2), at 420.

<sup>116</sup> See *id.*

<sup>117</sup> This provision comprises the first paragraph of the first section of the Stock Exchange Act. Börsengesetz, *supra* note 6, § 1(1).

<sup>118</sup> See Börsengesetz, *supra* note 6, § 1(2).

<sup>119</sup> "Staatskommissariat." See *id.* § 1(3).

<sup>120</sup> See *infra* notes 285–88 and accompanying text.

decree the rules and regulations of the stock exchange (*Börsenordnung*),<sup>121</sup> which govern, among other things, the lines of business of the exchange, its organization, and the publication of prices, exchange rates, and turnover;<sup>122</sup> the *Länd* Stock Exchange Supervisory Authority must approve these rules and regulations for them to have effect.<sup>123</sup>

The *Länd* Stock Exchange Supervisory Authority also has oversight responsibility for the official exchange brokers (*Kursmakler*) and the independent brokers (*freie Makler*), in their activities both on and off the exchange.<sup>124</sup> The Stock Exchange Act further empowers the individual *Länder* to establish a Sanctions Committee (*Sanktionsausschuss*), which can punish trading participants for actions that violate the regulations of the exchange, thereby disturbing trading, or whose actions damage commercial good faith or the honor of another trading participant.<sup>125</sup>

### III. OUTSIDE FORCES FOR REFORM IN GERMANY

As explained earlier in this Article, although economic pressures from within Germany certainly must have affected these reforms, the

<sup>121</sup> See Börsengesetz, *supra* note 6, § 3(2). The Board of Directors has attained this responsibility through the new amendments to the Stock Exchange Act. See *infra* note 287 and accompanying text.

<sup>122</sup> See Börsengesetz, *supra* note 6, § 4(2); see, e.g., DEUTSCHE BÖRSE AG, BÖRSENORDNUNG (July 1994); DEUTSCHE BÖRSE AG, RULES AND REGULATIONS OF THE FRANKFURT STOCK EXCHANGE (May 1994) (English translation).

<sup>123</sup> See Börsengesetz, *supra* note 6, § 4(4); see, e.g., DEUTSCHE BÖRSE AG, BÖRSENORDNUNG 3 (July 1994); DEUTSCHE BÖRSE AG, RULES AND REGULATIONS OF THE FRANKFURT STOCK EXCHANGE 3 (May 1994) (English translation) ("The Hessian Minister of Economics and Technology has approved the amendment of the Stock Exchange Rules and Regulations in accordance with § 4(4) of the Exchange Act by his letter dated August 24, 1993 (file no.: IIb 3-37 d 02.07.02).")

Normally, the *Länd* Supervisory Authority works very closely with the leadership of the exchange in drafting the rules and regulations; this process mitigates the risk to the exchange that the regulations would be rejected. As of January 1995, no new regulations had been approved to reflect the reforms of the Second Financial Market Promotion Act. In the case of Germany's largest stock exchange, the *Frankfurter Wertpapierbörse*, the responsible *Länd* Stock Exchange Supervisory Authority is the *Hessisches Ministerium für Wirtschaft, Verkehr, Technologie, und Europaangelegenheiten*, in Wiesbaden, the capital of the *Länd* Hessen, in which Frankfurt am Main is located. The regulations of Germany's second largest exchange, in Düsseldorf, closely mirror those in Frankfurt. Interview with Mr. Laun, *Hessisches Ministerium für Wirtschaft, Verkehr, Technologie, und Europaangelegenheiten*, Wiesbaden, Germany (Jan. 20, 1995).

<sup>124</sup> See Börsengesetz, *supra* note 6, § 8a. These powers regarding the *Kursmakler* have been expanded through the latest amendments by the Second Financial Market Promotion Act; see, e.g., Börsengesetz, *supra* note 6, § 30 (regarding the admission and dismissal of *Kursmakler*).

<sup>125</sup> See Börsengesetz, *supra* note 6, § 9. The *Länd* Authority shall determine its procedures and relationship to the Authority as well as provide advice and cover the costs of the committee.

pressures from outside Germany were much clearer. In a general sense, the growth of international competition in the financial markets provided pressure on Germany for reform. One event that served as a wakeup call for Germany that its securities markets in particular were falling farther behind world standards and that it could no longer rely on traditional practices of debt financing was the decision by one of Germany's oldest and most venerable corporations to list its shares directly on the New York Stock Exchange in 1993 in order to raise more capital.<sup>126</sup> As one of Germany's most liquid stocks,<sup>127</sup> this step truly suggested that the securities markets in Germany were a step below the top tier.<sup>128</sup> Meanwhile, the more specific directives of the EU have established concrete provisions which must be implemented into German law.

### A. *Directives of the European Union*

An ongoing series of directives have been issued by the Council of the EU in furtherance of the harmonization of the capital markets within the Member States. Each of these directives must be implemented by national legislation. The Second Financial Market Promotion Act, and in particular the Securities Trading Act of Article 1 of the former Act, implement a number of these directives. The most important and most obvious of these directives in terms of the scope of this Article is the directive on insider trading ("Insider Directive"), adopted by the EU Council in 1989.<sup>129</sup> Because of its central impor-

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<sup>126</sup> See generally, J. Michael Schell, *Daimler-Benz Leads Germany to New York Stock Exchange*, INT'L FIN. L. REV. 11 (Dec. 1993).

<sup>127</sup> In December of 1994, stock in Daimler-Benz had the second highest turnover in Germany of all German domestic stocks (close behind first) in terms of value, with a total of 26,625 trades representing 9,332,357 shares and a trading value of almost seven billion Deutsche Mark. DEUTSCHE BÖRSE AG, FRANKFURTER MONATSSSTATISTIK FÜR DEZEMBER 1994 5 (Jan. 1995) (*Inländische Aktien mit dem höchsten Umsatz*). This would be equal to a turnover of approximately \$4.67 billion per month, assuming a constant exchange rate of DM 1.5 to \$1. In comparison, for the single day of May 4, 1995, the second most active trading in terms of shares was for Ford Motor Co., with a total of 5,734,700 shares traded at prices around the closing value of \$26 for a total of approximately \$149 million dollars. See *Market Indicators*, N.Y. TIMES, May 5 1995, at D7 (New York Stock Exchange, Most Active). Assuming 22 trading days in the month, at this rate, trading in Ford stock would still only reach \$3.28 billion—two-thirds of the value for that in Daimler-Benz in December of 1994. On May 4, 1995, trading in direct shares of Daimler-Benz stock on the NYSE consisted of 90,500 shares at a closing price of \$47.25 for a total volume of approximately \$4.25 million, or a monthly rate of \$94 million (5% of the trading rate in Germany). See *New York Stock Exchange Issues*, N.Y. TIMES, May 5 1995, at D7.

<sup>128</sup> Although the figures for trading in Daimler-Benz show a high level of turnover, beyond the top thirty stocks, the liquidity of the German markets declines precipitously.

<sup>129</sup> Council Directive 89/592 of November 13, 1989 Coordinating Regulations on Insider Deal-

tance, the Insider Directive is discussed in detail in Part III.B of this Article.

The other directive specifically adopted in its entirety by the Securities Trading Act is the directive on disclosure of holdings in exchange-listed companies (“Holdings Disclosure Directive”).<sup>130</sup> The reporting requirements from the Holdings Disclosure Directive are similar to those required by the Securities and Exchange Commission (“SEC”) in the United States. One of the primary differences under the German system that makes this directive interesting is that German universal banks can perform both commercial and investment banking activities under one roof. Financial institutions in the United States, with limited exceptions, must perform one or the other activity according to the Glass-Steagall Act.<sup>131</sup> Even within the exceptions to this division within the United States, the requirements for firewalls are strict.<sup>132</sup>

The Rules of Conduct discussed *infra* in Part V.A.4 implement part of the Directive on Investment Services in the Securities Field.<sup>133</sup> These Rules are designed to minimize potential conflicts of interest in the provision of securities services and to promote the interests of the customer, thereby increasing the attractiveness of private investment in the financial markets.

Finally, the directive on the Coordination of Regulations for the Admission of Securities for Listing on a Securities Stock Exchange<sup>134</sup> promotes greater transparency in securities activities, in concert with the overall theme of the German reforms. The most important aspect of this directive as enacted into German law is the requirement for companies to disclose any facts that might materially affect the trading price of the security—“price-relevant circumstances.”<sup>135</sup>

ing, 1989 O.J. (L 334) [hereinafter Insider Directive]. The text of this Article shall use the American term “insider trading” rather than the British equivalent—“insider dealing.”

<sup>130</sup> Council Directive 88/627 of December 12, 1988 on the Information to be Published When a Major Holding in a Listed Company is Acquired or Disposed of, 1988 O.J. (L 334) [hereinafter Holdings Disclosure Directive].

<sup>131</sup> 12 U.S.C. § 24(Seventh) (1994). For the text of this provision, see *infra* note 564.

<sup>132</sup> Compare the regulation of § 20 subsidiaries of commercial banks in the United States. See *infra* note 564.

<sup>133</sup> Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field, 1988 O.J. (L 147).

<sup>134</sup> Directive 79/279 of March 5, 1979.

<sup>135</sup> See Gesetzentwurf, *supra* note 7, at 48 (explaining art. 1, § 15 of the Zweites Finanzmarktförderungsgesetz).

## B. *Regulation of Insider Trading*

Contrary to common misperceptions, Germany did not lack any form of oversight or regulation of insider activities and securities trading prior to the new Act. From the outside, however, one noted the peculiar absence of federal authority to mirror the SEC in the United States. Stemming from the federal nature of the German Republic, the competence to regulate securities trading was left to the individual *Länder*.<sup>136</sup> Existing provisions in federal laws address only a small portion of the possible misuses of nonpublic information.<sup>137</sup> While foreseeing the impending regulation, the Frankfurt stock exchange, in conjunction with market participants, had developed rules prohibiting insider trading in 1992.<sup>138</sup> These rules, however, were subject only to self-regulation by the market participants and exchanges. Because the German securities markets were relatively small by international standards, many feared that the costs of federal regulation and stricter insider trading prohibitions would outweigh the benefits. While theoretically possible, the small markets left little room for the manipulation of stock prices and arbitrage based on tacit information that has been the hallmark of insider traders elsewhere.

The notion that the markets were small and largely free from manipulation came into direct contrast with attempts to establish a financial metropolis with markets large enough to compete favorably on the world stage. Although not wishing to give up their universal banking system and self-regulation of the securities markets, most Germans in the financial markets have realized that Germany must adopt international standards in order to gain international recognition and trust. In just a few years, the financial industry moved from harsh criticism of the Insider Directive to strong support for reform.

The Insider Directive was adopted by the Council of the European Community under the authority of Article 100a of the EEC Treaty.<sup>139</sup> This provision directs the Council to "adopt the measures for the

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<sup>136</sup> Under the Basic Law of the Federal Republic of Germany, in economic matters including commerce, banking, stock exchanges, and private insurance, the *Länder* have legislative powers concurrent with those of the federal government. See GRUNDGESETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND, BGBl. p. 1, Art. 74(11) (1949, as amended through Dec. 21, 1993).

<sup>137</sup> See Gesetzentwurf, *supra* note 7, at 34–35 (citing Stock Act § 404, penal code §§ 203 ff., commercial code § 333, and the law against unfair competition § 17).

<sup>138</sup> Frankfurter Wertpapierbörse AG, INSIDER-REGELN (Sept. 1992). The Frankfurter Wertpapierbörse (not an "AG") is now under the control of the Deutsche Börse AG.

<sup>139</sup> See Insider Directive, *supra* note 129, at L 334.

approximation of the provisions of laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market."<sup>140</sup> The directive recognizes the important role of the secondary market in transferable securities within the Member States and seeks to promote investor confidence, which in turn should help ensure that the markets operate smoothly.<sup>141</sup> Because insider trading undermines investor confidence, such practices should be prohibited.<sup>142</sup>

The directive applies to all nonpublic information which would affect the price of a transferable security, whether it represents debt or equity, and whether sold as a spot, option, or futures contract.<sup>143</sup> The law prohibits trading by any person who has such nonpublic information by virtue of their position as an employee, shareholder, manager, director or fiduciary of the issuer.<sup>144</sup> These "insiders" are also prohibited from disclosing such information to third parties;<sup>145</sup> a person "who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than" an insider, will also be liable for trading upon that information.<sup>146</sup> Each Member State must designate the administrative authorities competent to uphold the resulting statute.<sup>147</sup> Employees of such agencies shall be bound by the same prohibitions on the use of privileged information.<sup>148</sup>

#### IV. THE LEGISLATIVE HISTORY OF THE SECOND FINANCIAL MARKET PROMOTION ACT

The legislative history of the Second Financial Market Promotion Act is instructive, in that it reflects the struggles between different German interests that have shaped the ultimate product. The delays in implementing the Act stemmed not from any misunderstanding of the goals of *Finanzplatz Deutschland* or by any means lack of competence. Rather, the period of time reflected a clash of interests among a large number of actors attempting to establish a very complex set of

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<sup>140</sup> EEC TREATY, *supra* note 2, art. 100a(1).

<sup>141</sup> See Insider Directive, *supra* note 129, at L 334.

<sup>142</sup> See *id.*

<sup>143</sup> See *id.* art. 1.

<sup>144</sup> See *id.* art. 2.

<sup>145</sup> See *id.* art. 3.

<sup>146</sup> See Insider Directive, *supra* note 129, art. 4.

<sup>147</sup> See *id.* art. 8.

<sup>148</sup> See *id.* art. 9.



rules which needed to be implemented in a relatively short time after enactment. Since many of the provisions of the Act reflect the outside pressures for reform, the German participants have basically been trying to adapt German standards to meet international norms, while at the same time working to preserve the strengths of the German system.

### A. *The German Legislative Process*

The following summary of the legislative process seeks to define the actors and provide a framework for understanding the development of the Act. The German federal legislative process is laid down in the Basic Law itself. The two houses of the legislature—the upper house which is composed of representatives of the individual *Länder* governments (“Bundesrat”)<sup>149</sup> and the lower house which is composed of members directly elected by the people (“Bundestag”)<sup>150</sup>—and the federal government itself<sup>151</sup> each play an integral role in this process. Unlike in the U.S. government system, the German Federal President plays a minor role in the domestic legislative process.<sup>152</sup>

Most regulatory laws are drafted by the responsible federal administrative agency, usually in conjunction with representatives of the affected industry. Bills that originate in the federal government must be submitted to the Bundesrat, which then has six weeks to issue an

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<sup>149</sup> See GRUNDGESETZ, BGBl. p. 1, art. 51. Unlike the U.S. Senate, the Bundesrat members are actual representatives of the *Länder* governments, rather than directly elected representatives of the citizens of each *Länder*. As such, the Bundesrat representative will be the head of the ministry under whose jurisdiction the matter under consideration falls, and representatives can be recalled at any time. See *id.* art. 51(1). Also, the multiple representatives from each *Länder* (the number of representatives being a factor of population size) must cast all votes for a *Länder* together as a bloc. See *id.* art. 51(3).

<sup>150</sup> The deputies to the German Bundestag are elected in general, direct, free, equal, and secret elections. See GRUNDGESETZ, BGBl. p. 1, art. 38. They represent the entire people; separate federal election regulations prescribe a system whereby only parties that meet a fringe requirement of 5% of total votes shall be represented, and parties are allotted seats according to their percentage of the total national vote as well as through direct regional elections.

<sup>151</sup> The Federal Government consists of the Federal Chancellor and the Federal Ministers. See GRUNDGESETZ, BGBl. p. 1, art. 61. The Federal Chancellor is elected by the Bundestag upon the proposal of the Federal President. See *id.* art. 63(1). The Federal Ministers are appointed and dismissed by the Federal President upon the proposal of the Federal Chancellor. See *id.* art. 64(1).

<sup>152</sup> The primary role of the President is to represent Germany in international affairs. See *id.* art. 59(1). Even those executive powers given the President, such as the power to execute orders and decrees, require the countersignature of the Federal Chancellor or the appropriate Federal Minister, see *id.* art. 58, while in the international realm, treaties may also require approval by another government entity. See *id.* art. 59(2).

opinion on the bill,<sup>153</sup> but not a binding vote. After this period, the bill must also be introduced into the Bundestag, which must adopt the bill for it to become federal law.<sup>154</sup> Following adoption by the Bundestag, the Bundesrat reviews the bill once again and may demand the convening of a joint committee of both houses to iron out differences in the bill.<sup>155</sup> The Bundestag shall then have final say on any resulting amendments.<sup>156</sup>

In summary, draft bills begin with the administrative experts and debate occurs in the directly elected parliament, the Bundestag. Its leader and Bundestag member, the Federal Chancellor, can introduce a bill, the representatives of the *Länder* shall offer their opinions, and the Bundestag shall make the final decision.

The Second Financial Market Promotion Act followed such a process: the federal government introduced a bill, which had been drafted by the Ministry of Finance in consultation with representatives of the banking and financial industries. After Bundesrat comment, a further draft was then introduced into the Bundestag for debate. Because of the general consensus of the need for the reforms and the care that had been taken in drafting the Act, there was no need for the bill to go into joint committee before final enactment by the Bundestag.

#### B. *The Legislative History of the Second Financial Market Promotion Act*

The German Federal Government introduced the first draft bill of what would become the Second Financial Market Promotion Act to the Bundesrat on November 5, 1993.<sup>157</sup> The federal government derives concurrent competence with the *Länder* to initiate a bill dealing with the supervision of securities trading and the scope of stock exchange activity from the German Basic Law itself.<sup>158</sup> In the more specific regu-

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<sup>153</sup> See GRUNDGESETZ, BGBl. p. 1, art. 76(2).

<sup>154</sup> See *id.* art. 77(1).

<sup>155</sup> See *id.* art. 77(2). The joint committee shall be composed of two-thirds of its members from the Bundestag and one-third from the Bundesrat. In this capacity, the Bundesrat members shall not be bound by the respective *Länd* governments they represent. See *id.* art. 53a(1).

<sup>156</sup> See *id.* art. 77(2).

<sup>157</sup> Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat Drucksache 793/93 (Nov. 5, 1993). This draft is identical to that later submitted to the Bundestag. Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundestag Drucksache 12/6679 (Jan. 27, 1994). See *infra* note 161. All references to the draft bill in this Article shall cite the Bundestag printing of the draft.

<sup>158</sup> See *supra* note 136 and accompanying text.

lation of the actual structure of the exchanges, the federal government preempts the competence of the *Länder*.<sup>159</sup> The latter distinction reflects the inability of the individual *Länder* to effectively regulate and to maintain national uniformity.<sup>160</sup>

In comparing the differences between the draft of the Second Financial Market Promotion Act with the adopted version, the most striking point is how similar the two actually are. This suggests that an early consensus had emerged on the need for such changes, and perhaps also indicates the diligence of the Ministry of Finance in preparing the draft. The final adopted version contains a total of twenty articles (seven more than the draft), but most of the seven articles added later contain relatively minor amendments to existing laws. Perhaps more significantly, no substantial provisions in the draft have been stricken from the final bill. Of the most groundbreaking changes in the first two articles of the Act, the greatest difference between the draft and the enacted version is that the draft contains no reference to the Rules of Conduct, discussed *infra* in Part V.A.4.

Although a comparison of the draft with the enacted version illustrates the evolution of the Act, the value of the draft stems not so much from the text itself, but rather from the additional information that accompanies it. Following the text of the draft bill, one finds twice as many pages devoted to the official explanation (*Begründung*) of the provisions of the bill by the German federal government.<sup>161</sup> This explanation provides a general overview of the Act in terms of its goals, followed by a discussion of the individual provisions of the bill.

A month after the submission of the draft bill by the government to the Bundesrat, the responsible committee of the Bundesrat issued a set of recommendations (including explanations thereof) to the Bundesrat in preparation for discussion of the bill.<sup>162</sup> Additionally, the *Länd*

<sup>159</sup> The draft bill cites the above reasons as its basis. See Gesetzentwurf, *supra* note 7, at 38.

<sup>160</sup> The federal preemption right also stems from the Grundgesetz. See GRUNDGESETZ FÜR DIE BUNDESREPUBLIK DEUTSCHLAND, BGBl. p. 1, art. 72(2)(1, 3) (1949, as amended through Dec. 21, 1993).

<sup>161</sup> Begründung to the Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat Drucksache 793/93, 100–284 (Nov. 5, 1993) (99 page draft and 185 page explanation); Bundestag Drucksache 12/6679 (Jan. 27, 1994) 33–93 (29 page draft and 61 page explanation). The texts are identical; the pagination differs only due to the printing format.

<sup>162</sup> Empfehlungen der Ausschüsse zu Punkt der 664. Sitzung des Bundesrates am 17. Dezember 1993 [Recommendations of the Committees for the 664th Session of the Bundesrat on Dec. 17, 1993], Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat

Nordrhein-Westfalen submitted two amendments to the bill,<sup>163</sup> reflecting some of the conflicting interests between the federal government in creating more of an internationally competitive marketplace for Germany as a whole and the desire of the *Länder* to protect the regional exchanges.<sup>164</sup> The Bundesrat addressed the bill on December 17, 1993, and issued a favorable opinion, recommending few changes to the bill.<sup>165</sup>

After receiving the Bundesrat opinion, the federal government introduced an identical copy of the draft bill including the identical explanation into the Bundestag on January 27, 1994, with the opinion of the Bundesrat and the government's answer to that opinion appended.<sup>166</sup> The core debate over the draft bill occurred during the following four and a half months. Most of the significant changes to the original draft were made during this phase. The finance committee of the Bundestag issued its final recommendations and report on June 15, 1994.<sup>167</sup> Two days later, on June 17, 1994, the full session of the Bundestag enacted the draft bill as the Act on Securities Trading and

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Drucksache 793/1/93, (Dec. 6, 1993). The four committees responsible for the recommendations were the finance committee as coordinator, the committee for internal affairs, the legal committee, and the economic committee. *Id.* at 1.

<sup>163</sup> Antrag des Landes Nordrhein-Westfalen zum Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat Drucksache 793/2/93, (Dec. 15, 1993); Bundesrat Drucksache 793/3/93, (Dec. 15, 1993).

<sup>164</sup> See *infra* note 309.

<sup>165</sup> Stellungnahme des Bundesrates, Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat Drucksache 793/93 (Beschluss) (Dec. 17, 1993), *reprinted in* Gesetzentwurf, *supra* note 7, at 94–100 (Anlage 2) [hereinafter Stellungnahme des Bundesrates]. For a discussion of Bundesrat opinion in the German legislative process, see *supra* note 153 and accompanying text.

<sup>166</sup> Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundestag Drucksache 12/6679 (Jan. 27, 1994). A copy of the opinion of the Bundesrat (see *supra* note 162) and the government answer to this opinion (*Gegenäußerung der Bundesregierung*) may be found at pages 94–100, and 101–04, respectively. All citation in this Article to the draft bill shall refer to this version published in the Bundestag documents, since this version essentially became the working draft. Recall that the Bundestag must adopt the bill for it to become federal law. See *supra* note 154 and accompanying text.

<sup>167</sup> Beschlußempfehlungen und Bericht des Finanzausschusses, Bundestag Drucksache 12/7918 (June 15, 1994). In addition to addressing the draft bill of the federal government this report also addresses a petition from members of the Bundestag from the German Social Democrat Party regarding the struggle against insider trading on the German exchanges (Antrag der Abgeordneten Dr. Hans de With, Hermann Bachmaier, Angelika Barbe u.a. under der Fraktion der SPD, "Bekämpfung des Insider-Handels an deutschen Börsen," Bundestag Drucksache 12/5437). See Bundestag Drucksache 12/7918, at 1.

for the Modification of Stock Exchange and Securities Regulation (Second Financial Market Promotion Act) and sent it to the Bundesrat for final review.<sup>168</sup> Although the Bundesrat has the authority to demand the convening of a joint committee of both houses to iron out differences in the bill, a broad consensus made such a committee unnecessary.<sup>169</sup> The Act as codified was entered into the German Federal Law Gazette on July 26, 1994.<sup>170</sup> Certain provisions went into effect on August 1, 1994, with the remainder of the Act coming into force on January 1, 1995.<sup>171</sup>

This summary oversimplifies the actual forces involved in the evolution of this Act, because it only discusses the official aspects of the legislative process. While this discussion began with the draft bill introduced into the German parliament by the federal government, the history of the Second Financial Market Promotion Act reaches back much further, to the background for the statement of Finance Minister Waigel on *Finanzplatz Deutschland*, discussed *supra* in Part II.A. A public discussion of an actual draft began as early as July of 1993, when the Federal Ministry of Finance submitted a proposal.<sup>172</sup> "In August 1993 Germany's exchanges presented in detail their common view on the proposal."<sup>173</sup> Some of these were adopted into the draft bill.<sup>174</sup>

This glimpse into the pre-parliamentary stages of the legislative process reveals a very important point: when enacting new regulations, the government works very closely with the industries affected. This is extremely important in such complicated areas as the securities markets, compounded by the fact that the previous competence to regulate

<sup>168</sup> Gesetzesbeschluß des Deutschen Bundestages, Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), Bundesrat Drucksache 585/94 (June 17, 1994). The draft bill states that the Act requires the approval of the Bundesrat, referring to the Grundgesetz provision regarding the execution of federal laws by the *Länder*. See Gesetzentwurf, *supra* note 7, at 38 (citing GRUNDGESETZ art. 84(1)).

<sup>169</sup> For a discussion of the joint committee, see *supra* note 155 and accompanying text.

<sup>170</sup> Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), BUNDESGESETZBLATT Teil I [BGBl. I] 1749-85 (July 26, 1994). Although the law was entered on July 26th, 1994, the publication date of the addition of the Federal Law Gazette (the German equivalent to the United States Code for federal law) was July 30, 1994. The Act bears the signatures of the Federal President, Roman Herzog; the Federal Chancellor, Helmut Kohl; the Federal Finance Minister, Theo Waigel; and the Federal Justice Minister, Sabine Leutheusser-Schnarrenberger. *Id.* at 1785.

<sup>171</sup> See Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 20.

<sup>172</sup> See DEUTSCHE BÖRSE AG, DEUTSCHE BÖRSEN: 1993 ANNUAL REPORT 74 (1994).

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

these markets was held by the *Länder*, rather than by any federal authority. The best example of the ongoing effort to involve the market participants is the codification of this relationship in the Rules of Conduct under the Securities Trading Act, discussed *infra* in Part V.A.4, which gives the central associations of the concerned industry the right to review the guidelines promulgated by the new Federal Securities Trading Supervisory Authority according to the Securities Trading Act.<sup>175</sup> Two of the associations most actively involved in the legislative and lobbying processes were the Federal Association of German Banks (*Bundesverband deutscher Banken*) and the Association of German Savings and Loan Institutions (*Deutscher Sparkassen-und Giroverband*).

### C. *The Government Explanation of the Act (Begründung)*

While the official government explanation accompanying the draft bill submitted into the two houses of parliament details each and every provision of the Act, this Part of this Article contains a brief overview that focuses on the goals of the Act. The rest of this Article seeks to incorporate this detailed explanation. Part V delineates the provisions of the final Act, while Part VI analyzes its effects.

The draft states as its overall goal an improvement in the attractiveness and international competitiveness of *Finanzplatz Deutschland* through broadening investor protections, safeguarding the ability of the German securities stock exchanges to function, international cooperation in securities supervision, broadening the capabilities of investment companies, and removing limitations in the Securities Deposit Act and Stock Corporation Act.<sup>176</sup> Aside from this, the draft law served to implement the EU Insider Directive and Transparency Directive.<sup>177</sup> The means of implementation are the amendment of existing laws and the enactment of the new Securities Trading Act.<sup>178</sup>

The government's explanation of the purpose of the Act echos the speech by Minister Waigel, whose own Finance Ministry drafted the bill.<sup>179</sup> The federal government has set a high priority on the maintenance

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<sup>175</sup> See *infra* note 266 and accompanying text.

<sup>176</sup> See Gesetzentwurf, *supra* note 7, at 1.

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at 1–2.

<sup>179</sup> See *supra* Part II.A. The government explanation actually states that the draft substantially follows the concept of *Finanzplatz Deutschland* laid down by Waigel. See Gesetzentwurf, *supra* note 7, at 1.

and improvement of the attractiveness of *Finanzplatz Deutschland*; this Act serves to continue past initiatives with a renewed offensive for the further positive development of the financial markets.<sup>180</sup> The German government believes that the financial markets must be able to optimally serve the financial needs of market participants and to allow room for creative innovation.<sup>181</sup> National markets can no longer be considered in isolation; worldwide competition has intensified in Germany through European integration.<sup>182</sup> The state's role shall be to establish the framework of rules for the markets to fulfill their functions; in particular, the state must care for the protection of investors.<sup>183</sup>

The German government wishes to pursue the following general goals with the Act: trust building measures, adaptation of the regulatory framework for the stock exchanges, and deregulatory measures.<sup>184</sup> In terms of the first concept, the government refers to the trust of investors, which is of decisive importance for the financial markets to function.<sup>185</sup> One aspect of this trust stems from the assurance of equal treatment and protection against improper usage of information.<sup>186</sup> Since insider trading runs directly counter to this trust, the Act shall bring international standards prohibiting insider trading to Germany.<sup>187</sup> The Act also seeks to raise investor protection both by requiring greater disclosure and making public information more available to investors.<sup>188</sup> Greater transparency in both understanding the market processes and the ownership structure of exchange listed companies also aids in investment calculations.<sup>189</sup> From the regulatory perspective, the *Länder* have agreed with the Federal Ministry of Finance that the previous decentralized system of stock exchange regulation must evolve into a cooperative arrangement between the federal and *Länder* governments.<sup>190</sup>

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<sup>180</sup> See Gesetzentwurf, *supra* note 7, at 33-34.

<sup>181</sup> See *id.*

<sup>182</sup> See *id.*

<sup>183</sup> See *id.*

<sup>184</sup> See *id.*

<sup>185</sup> See Gesetzentwurf, *supra* note 7, at 33.

<sup>186</sup> See *id.*

<sup>187</sup> See *id.*

<sup>188</sup> See *id.*

<sup>189</sup> See *id.*

<sup>190</sup> See Gesetzentwurf, *supra* note 7, at 33-34.

The reform of the regulatory framework reflects the dynamic changes in the German stock exchanges due to the internationalization of securities activities as well as pressure from electronic information and trading systems which opens the possibility for superregional concentration of securities activities.<sup>191</sup> This Act seeks to secure the international competitiveness of the German exchanges and trading systems.<sup>192</sup> After the successful steps to allow a financial futures exchange in 1989, the next step for furthering trading possibilities shall be to establish a commodities futures exchange.<sup>193</sup> Provisions throughout the Act further deregulatory measures, often through amendments that liberalize existing laws.<sup>194</sup> Other such measures put into effect the Insider Directive and Holdings Disclosure Directive of the European Union.<sup>195</sup>

Although the Insider Directive called for enactment by the Member States by June 1, 1992,<sup>196</sup> Germany was far behind the trend. This could be attributed in part to the differences between the traditional and required regimes. As stated above, however, the need for change was generally accepted. The more difficult problems stemmed from the forms in which these changes should materialize. A primary concern was the maintenance of the federal structure and the struggle of the *Länder* to maintain both the regional exchanges and their direct supervision.

## V. THE PROVISIONS OF THE SECOND FINANCIAL MARKET PROMOTION ACT

The Second Financial Market Promotion Act consists of twenty articles covering thirty-seven pages in the German Federal Law Gazette (*Bundesgesetzblatt*). The vast majority of these articles consists of amendments to a broad range of financial laws, designed to harmonize the provisions of this Act. The bulk of the reform, however, is contained in the first two articles of the Act. Article One contains the entirely new Securities Trading Act. Article Two implements broad changes to the Stock Exchange Act. The remaining articles promote broad reform throughout existing German financial regulations.

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<sup>191</sup> See *id.* at 34.

<sup>192</sup> See *id.*

<sup>193</sup> See *id.*; see also discussion *infra* notes 328–30 and accompanying text.

<sup>194</sup> See *Gesetzentwurf*, *supra* note 7, at 34.

<sup>195</sup> See *id.*

<sup>196</sup> Insider Directive, *supra* note 129, art. 14.



### A. *The Securities Trading Act (Wertpapierhandelsgesetz)*

The most important new provisions of the Second Financial Market Promotions Act can be found in its first Article, the Securities Trading Act.<sup>197</sup> The Securities Trading Act applies to trading both on and off of the exchanges<sup>198</sup> in instruments including<sup>199</sup> securities<sup>200</sup> and derivatives.<sup>201</sup> This article directly implements the directive on Insider Dealing<sup>202</sup> and the Holdings Disclosure Directive<sup>203</sup> as well as limited aspects of the Directive on Investment Services in the Securities Field<sup>204</sup> and the directive on the Coordination of Regulations for the Admission of Securities for Listing on a Securities Stock Exchange.<sup>205</sup> The Securities Trading Act makes insider trading criminally punishable for the first time in Germany and establishes the Federal Securities Trading Supervisory Authority<sup>206</sup> to enforce its provisions. In addition, this Act furthers the goal of market transparency by requiring both institutions engaged in securities activities and large shareholders to report certain information to the new Supervisory Authority and the public.

The prohibition of insider trading became effective as of August 1, 1994, with the majority of the rest of the Act, including the duties

<sup>197</sup> See *Wertpapierhandelsgesetz*, *supra* note 5.

<sup>198</sup> See *id.* § 1.

<sup>199</sup> Although the following two footnotes detail financial instruments to which this Act shall apply, the list is not meant to be exclusive; the term securities represents instruments which can be traded on an organized market such as a stock exchange. See *Gesetzentwurf*, *supra* note 7, at 39 (explaining art. 1, § 2(1) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>200</sup> The securities (*Wertpapiere*) covered include: stock shares (*Aktien*), certificates which represent shares, debt instruments (*Schuldverschreibungen*), participation certificates (*Genußscheine*), warrants (*Optionsscheine*), and other comparable securities. See *id.* § 2(1).

<sup>201</sup> The Act defines derivatives (*Derivate*) to include rights traded on a domestic or foreign market, whose exchange or market price depends directly or indirectly upon changes in the exchange or market price of securities or foreign currencies or upon changes in interest rates. See *id.* § 2(2). This includes options and futures contracts. See *Gesetzentwurf*, *supra* note 7, at 39 (explaining art. 1, § 2(2) of the *Zweites Finanzmarktförderungsgesetz*). In addition, the Act applies to changes in voting right participations of shareholders of exchange listed companies (*Veränderungen der Stimmrechtsanteile von Aktionären an börsennotierten Gesellschaften*). See *id.* § 1.

<sup>202</sup> Provisions implementing this directive may be found in §§ 12–14, 19, and 20 of the Securities Trading Act.

<sup>203</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, note \* (This footnote is located at the title of the Act and states that the Act shall implement these two directives.). Provisions implementing the Holdings Disclosure Directive may be found in §§ 21–26, 28–30, and 41 of the Securities Trading Act.

<sup>204</sup> Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field, 1988 O.J. (L 147).

<sup>205</sup> Provisions implementing this directive may be found in § 15 of the Securities Trading Act.

<sup>206</sup> *Bundesaufsichtsamt für den Wertpapierhandel*. See *Wertpapierhandelsgesetz*, *supra* note 5, § 3.

of the Securities Trading Supervisory Authority, effective January 1, 1995.<sup>207</sup> Disclosure of holdings of exchange-listed companies shall be made no later than the first shareholders' meeting after April 1, 1995, and the first reporting of trading in securities to the Authority shall be required no later than January 1, 1996.<sup>208</sup>

### 1. The Prohibition of Insider Trading

The Securities Trading Act embodied the recognition that the earlier private prohibitions against insider trading were inadequate and that existing provisions in federal laws address only a small portion of the possible misuses of nonpublic information.<sup>209</sup> The insider trading prohibitions closely follow the format laid down in the directive, especially in terms of the securities covered and persons falling under the definition of insider.<sup>210</sup> Insider securities shall include securities, options, and futures contracts traded over the counter at a German exchange or listed for trading on an exchange within the EU or European Free Trade Area.<sup>211</sup> The definition of insiders includes persons having nonpublic information by virtue of their status as manager, director, or employee of the corporation or a controlling company; as shareholder; or by virtue of a professional relationship with the corporation.<sup>212</sup> Insiders cannot buy or sell securities based on nonpublic information, cannot convey this information to another person, and cannot recommend that others trade in securities based upon such information.<sup>213</sup> A third person who becomes aware of inside information is also prohibited from such actions.<sup>214</sup> Violators of these provisions are subject either to a fine or to imprisonment for up to five years,<sup>215</sup> reflecting the severity of the offense and in recognition of the negative effects of insider trading on *Finanzplatz Deutschland*.<sup>216</sup>

<sup>207</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 20.

<sup>208</sup> See *Wertpapierhandelsgesetz*, *supra* note 5, § 41(1), (2).

<sup>209</sup> See *Gesetzentwurf*, *supra* note 7, at 34–35; see also *supra* note 137 and accompanying text.

<sup>210</sup> See *Wertpapierhandelsgesetz*, *supra* note 5, §§ 12, 13.

<sup>211</sup> See *id.* § 12(1), (2).

<sup>212</sup> See *id.* § 13. Among those belonging to the latter group are the following: accountants, tax advisors, business consultants, notaries, attorneys, and their coworkers as well as employees of the corporation and others who have access to nonpublic information because of a contractual relationship with the corporation. See *Gesetzentwurf*, *supra* note 7, at 46 (explaining art. 1, § 13(1) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>213</sup> See *Gesetzentwurf*, *supra* note 7, § 14(1).

<sup>214</sup> See *id.* § 14(2).

<sup>215</sup> See *id.* § 38.

<sup>216</sup> See *id.* § 35.

## 2. The Federal Securities Trading Oversight Authority

The duty to carry out these provisions rests upon the Federal Securities Trading Supervisory Authority. This entity is an independent federal superior agency within the competence of the Federal Ministry of Finance.<sup>217</sup> The President of the Authority shall be appointed by the German President upon the nomination of the federal government.<sup>218</sup> The duties of the Authority stem from the Securities Trading Act and are to be exercised exclusively in the public interest; the Authority shall work to mitigate and counteract circumstances that would adversely affect the accomplishment of securities trading or have significant adverse effects upon the securities markets.<sup>219</sup> At the start of business after January 1, 1995, the Authority had forty-one employees and should grow to ninety-seven by the end of 1995.<sup>220</sup> Although the Authority is an entirely new federal entity, its employees have collectively a large amount of experience in the field of securities oversight; their previous experience includes positions in the Federal Ministry of Finance, the Federal Banking Supervisory Authority, the *Länder* authorities responsible for oversight of securities, and from within the stock exchanges and securities firms themselves.<sup>221</sup> Additionally, a Securities Council (*Wertpapierrat*), composed of representatives of the *Länder* and other federal agencies, shall assist the Securities Trading Supervisory Authority in its supervision.<sup>222</sup>

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<sup>217</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 3(1). This Authority is established under the authority of the Grundgesetz, which provides for the establishment of federal superior agencies (*Bundesoberbehörde*) by federal legislation for areas within the competence of the federal government. See Gesetzentwurf, *supra* note 7, at 39 (citing GRUNDGESETZ art. 87(3)).

<sup>218</sup> See *id.* § 3(2).

<sup>219</sup> See *id.* § 4.

<sup>220</sup> See *Deutschland: Wittich—Lebhafte Ad-Hoc-Publizität im Januar*, REUTER GERMAN NEWS SERVICE, Feb. 23, 1995, available in LEXIS, Nexis Library, Zeitung File [hereinafter *Wittich*] (citing an interview with George Wittich, President of the Supervisory Authority). The draft bill foresaw the creation of a total of 97 new positions. Gesetzentwurf, *supra* note 7, at page 3 of the executive summary.

<sup>221</sup> See *Wittich*, *supra* note 220. President George Wittich had formerly served in the department of the Federal Ministry of Finance that helped draft the Securities Trading Act. Interview with Dr. Andreas Möller, Attorney, Division of Money and Credit, German Federal Ministry of Finance, Bonn, Germany (Jan. 25, 1995).

<sup>222</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 5. This Securities Council shall assist the new federal agency with the collective experience of the *Länder* in regulating the exchanges. Although only eight *Länder* have exchanges, each *Länd* is represented, since the federal Authority's area of competence includes all of Germany in trading both *on and off* the exchanges. See Gesetzentwurf, *supra* note 7, at 40 (explaining art. 1, § 5(1) of the Zweites Finanzmarktförderungsgesetz).

The Authority shall work together with other German regulatory agencies responsible for banking and insurance regulation, the German Bundesbank, and the stock exchange supervisory authorities of the *Länder*.<sup>223</sup> The new Authority shall also represent Germany in dealing with agencies of other countries responsible for the oversight of securities trading and stock exchanges.<sup>224</sup> It shall cooperate with its foreign counterparts in exchanging information<sup>225</sup> and in overseeing the prohibition on insider trading and the disclosure of ownership of exchange-listed companies.<sup>226</sup>

The costs of the Authority shall be recovered through levies imposed upon the credit institutions and brokers based upon their transaction volume, and upon issuers, according to the turnover in their securities.<sup>227</sup> The market participants shall bear the costs since they directly benefit from the changes; the activities of the Authority should make *Finanzplatz Deutschland* more attractive for both German and foreign investors.<sup>228</sup> For 1995, the projected budget is just under DM 20 million.<sup>229</sup>

In order to carry out its mandate to deter insider trading, the Federal Securities Trading Supervisory Authority will need to receive and digest a great deal of information. This will include a knowledge of the traders in the market and their actual turnover of securities. From the companies themselves, the Authority will need to know who the insid-

Aside from the *Länder*, representatives of the following agencies may participate: the German Federal Ministries of Finance, of Justice, and of Economics; the German Bundesbank; and the Federal Banking Supervisory Authority. *Id.* § 5(1). Although the Securities Council must be summoned by the President of the Federal Securities Trading Supervisory Authority at least once a year, *see id.* § 5(3), the first meeting shall not occur until at least September of 1995. Interview with George Dreyling, Vice President, Federal Securities Trading Supervisory Authority, Frankfurt am Main, Germany (Jan. 13, 1995) [hereinafter Dreyling Interview].

<sup>223</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 6.

<sup>224</sup> *See id.* § 7(1); *see also* Gesetzentwurf, *supra* note 7, at 35, 42. In recognition of the need to represent all of Germany in such discussions, the Federal Ministry of Finance had assumed the German position in the International Organization of Securities Commissions ("IOSCO") in 1990. *See id.* at 42.

<sup>225</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 7. Such cooperation shall implement the Memoranda of Understanding of IOSCO. *See* Gesetzentwurf, *supra* note 7, at 42 (explaining art. 1, § 7(1) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>226</sup> *See* Gesetzentwurf, *supra* note 7, at 35.

<sup>227</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 11(1). The credit institutions shall be assessed 75% of the costs; the *Kursmakler, Freimakler*, and other traders, a total of 5%; with another 10% to be borne by the issuers. *Id.* The government burden reaches beyond the remaining 10%; the federal government will be assessed additional costs as the largest issuer.

<sup>228</sup> *See* Gesetzentwurf, *supra* note 7, at 44 (explaining art. 1, § 11(1) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>229</sup> Dreyling Interview, *supra* note 222.

ers are. And perhaps most importantly, the Authority will need to know of material facts, i.e., those which insiders could use to their advantage.

### 3. Reporting Requirements

In theory, insider trading can be minimized by limiting the amount of information available for exploitation. The insider trading prohibition only applies to nonpublic information. Therefore, a mitigation of the time period before material information is made public will serve to limit insider trading opportunities. The Act pursues this approach to preventing insider trading by imposing reporting requirements upon public corporations. The disclosure will improve transparency, which should improve the ability of the financial markets to function.<sup>230</sup> The new provision replaces a prior public disclosure obligation imposed by the Stock Exchange Act.<sup>231</sup>

Under section fifteen of the Securities Trading Act, all issuers of securities that are traded on a German stock exchange must disclose any facts that might materially affect the trading price of the security—“price-relevant circumstances” (“*kursbeeinflussende Tatsachen*”).<sup>232</sup> In addition to disclosure to the Supervisory Authority and to the heads of the stock exchanges where traded,<sup>233</sup> the information must be disclosed to the public by means of a national official exchange newspaper<sup>234</sup> or an electronic information dissemination service.<sup>235</sup> Violations of these provisions shall be subject to a fine.<sup>236</sup>

<sup>230</sup> See Gesetzentwurf, *supra* note 7, at 48 (explaining art. 1, § 15 of the Zweites Finanzmarktförderungsgesetz).

<sup>231</sup> See Gesetzentwurf, *supra* note 7, at 48 (explaining art. 1, § 15(1) of the Zweites Finanzmarktförderungsgesetz). With the enactment of the Securities Trading Act, this other provision has been repealed. See Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 2, § 23 (repealing § 44a of the Börsengesetz).

<sup>232</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15 (“*Veröffentlichung und Mitteilung kursbeeinflussender Tatsachen*”).

<sup>233</sup> See *id.* § 15(2).

<sup>234</sup> See *id.* § 15(3)(1) (*Börsenpflichtblatt*). This category includes not only the stock exchange specific newspaper, BÖRSEN-ZEITUNG, but also large national newspapers like the FRANKFURTER ALLGEMEINE ZEITUNG and SÜDDEUTSCHE ZEITUNG.

<sup>235</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15(3)(2).

<sup>236</sup> See *id.* § 39. The following examples illustrate the range of maximum fines for selected violations: from maximums of DM 100,000 for not providing information requested by the Supervisory Authority as requested according to § 15(5), sentence 1; to DM 500,000 for not providing the information to the oversight agencies prior to public dissemination according to § 15(2), sentence 1; or for providing incorrect information or not publishing within the proper time periods; and up to DM 3,000,000 for simply not publishing or publishing first by a means other than that prescribed. See *id.*

Once the material information has been disclosed to the public, the Supervisory Authority must be able to compare this information with actual turnover in the markets to evaluate suspicious trading. By the end of 1995, all institutions engaged in the business of securities and derivatives trading must report their trades and identifying information in electronic form by the following business day.<sup>237</sup> This reporting obligation applies to domestic credit institutions, domestic branches of foreign institutions, other approved foreign institutions, and domestic businesses admitted to trading on a domestic stock exchange for every transaction in securities or derivatives admitted for trading on an exchange of a Member State of the EU or the European Free Trade Area or traded in the German over-the-counter markets.<sup>238</sup> The obligation applies both to orders for customers and trading for the credit institution's own account.<sup>239</sup> Violations are subject to a fine.<sup>240</sup>

The final form of disclosure required by the Act implements the Holdings Disclosure Directive.<sup>241</sup> These requirements further the goal of promoting transparency in the securities markets which facilitates investment decisions and serves the company itself by providing information about its ownership structure.<sup>242</sup> Any person controlling voting rights above five percent<sup>243</sup> and at intervals of ten, twenty-five, fifty, and

<sup>237</sup> See *id.* §§ 9, 41(1). Information subject to disclosure includes the name of the security or derivative and its code number; date and time of the transaction; the price, number, and nominal amount traded; the institutions involved in the trade; the relevant exchange or electronic trading system; and information to identify the trade. See *id.* § 9. The sheer volume of information necessitates electronic reporting. See Gesetzentwurf, *supra* note 7, at 43 (explaining art. 1, § 9(2) of the Zweites Finanzmarktförderungsgesetz).

<sup>238</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 9(1).

<sup>239</sup> See *id.* § 9(2); see also Gesetzentwurf, *supra* note 7, at 43 (explaining art. 1, § 9(1) of the Zweites Finanzmarktförderungsgesetz).

<sup>240</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 39.

<sup>241</sup> See Gesetzentwurf, *supra* note 7, at 52 (explaining art. 1, § 21(1) of the Zweites Finanzmarktförderungsgesetz); see also Holdings Disclosure Directive, *supra* note 130.

<sup>242</sup> See Gesetzentwurf, *supra* note 7, at 35, 52–53 (explaining art. 1, § 21 of the Zweites Finanzmarktförderungsgesetz).

<sup>243</sup> The 5% limit is lower than the 10% first step required by the EU directive, but has been adopted by other countries, including the United States, Japan, France, the Netherlands, Austria, Belgium, and Switzerland, while the United Kingdom requires reporting at 3% and Italy at 2%. (The United States requires reporting for holdings greater than 10% of any class of equity security under section 16(a) of the Securities Exchange Act of 1934, (15 U.S.C. § 78p(a) (1994)) and 5% under § 13(d)(1) (15 U.S.C. § 78m(d)(1)(1994)). Beyond the international standards are more practical reasons for the 5% reporting requirement: 10% of the voting rights of the large corporation is a high marginal value; 5% can have a significant influence especially in terms of block trading; certain domestic stock corporations have voting rights restrictions at 5%; the smaller the free trading stock volume of a company is, the more important that information is for the markets, if the amount of freely traded shares will be lessened by more block trading; and the lower reporting margin will aid in the battle against the misuse of insider information. See

seventy-five percent, of the outstanding stock of an exchange-listed company must report that information to the company and the Supervisory Authority within seven calendar days of any change in threshold holdings.<sup>244</sup> The company must then within nine calendar days further disclose that information to the public.<sup>245</sup> The Act contains additional provisions for specific issues of indirect holdings, including those of holding companies or affiliated companies.<sup>246</sup> Violations are subject to a fine.<sup>247</sup> These transparency measures support the other reforms of the Act that prohibit insider transactions.<sup>248</sup>

#### 4. The “Rules of Conduct”<sup>249</sup>

The final major area of the Securities Trading Act encompasses those provisions relating to “Rules of Conduct” (“*Verhaltensregeln*”) for businesses providing investment services in securities (*Wertpapierdienstleistungsunternehmen*).<sup>250</sup> The activities covered include the purchase

Gesetzentwurf, *supra* note 7, at 52 (explaining art. 1, § 21(1) of the Zweites Finanzmarktförderungsgesetz). Although a matter of debate, the lower limit prevailed in the name of increased transparency in the German markets. See *Gegenäußerung der Bundesregierung*, *supra* note 166, reprinted in, Gesetzentwurf, *supra* note 7, at 101 (response to Bundesrat Comment no. 5, art. 1, § 23 of the Zweites Finanzmarktförderungsgesetz).

<sup>244</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 21. Stockholders must make their first reports pursuant to these provisions by the date of the first stockholders meeting after April 1, 1995. *Id.* § 41(2). The Federal Securities Trading Supervisory Authority is empowered to obtain information from exchange-listed companies and their shareholders in the pursuance of these provisions. *Id.* § 29.

<sup>245</sup> See *id.* § 25. This disclosure duty extends to foreign firms whose shares are admitted to trading on a German exchange. See *id.* § 26.

<sup>246</sup> See *id.* §§ 22–24.

<sup>247</sup> See *id.* § 39.

<sup>248</sup> See Gesetzentwurf, *supra* note 7, at 52 (explaining art. 1, § 21(1) of the Zweites Finanzmarktförderungsgesetz).

<sup>249</sup> The Rules of Conduct for firms providing investment services in securities may be found in Part Five of the Securities Trading Act. Wertpapierhandelsgesetz, *supra* note 5, §§ 31–37. These rules have been implemented into German law according to the EU Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field, 1988 O.J. (L 147) (*Wertpapierdienstleistungsrichtlinie*). The draft bill of the Second Financial Market Promotion Act contained no provisions implementing the directive; in explaining the functions of the new Federal Securities Trading Supervisory Authority under the draft bill, however, the federal government did mention that it foresaw a broadening of the duties of the new authority through the implementation of the directive. The English term “Rules of Conduct” has been widely adopted into German usage, as shown by the use of the English term in this explanation in the draft bill. See Gesetzentwurf, *supra* note 7, at 34.

The exact provisions implementing this directive and codified in the Second Financial Market Promotion Act were added by the finance committee of the Bundestag. Beschlüßempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 49–56 (adding art. 1, §§ 30a–30g to the draft bill, codified at art. 1, §§ 31–37 of the Zweites Finanzmarktförderungsgesetz).

<sup>250</sup> See Wertpapierhandelsgesetz, *supra* note 5, §§ 31–37. Note that these requirements stem

and sale of securities or derivatives for others, including through the institution's own account, as well as brokerage activities involved in such transactions.<sup>251</sup> In order for businesses to serve the best interests of their customers and provide all necessary and useful information to the customers, the investment services companies must inquire about the customers' experience in investing, their goals, and their financial circumstances.<sup>252</sup> The companies are specifically forbidden from recommending transactions in securities or derivatives that are not in the customers' interest,<sup>253</sup> or from entering into transactions for its own account<sup>254</sup> or for third parties which the company knows would be detrimental to a customer.<sup>255</sup>

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from yet another EU Council Directive. The Securities Trading Act defines these businesses to include domestic credit institutions (*Kreditinstitute*), domestic branches of foreign institutions, other approved foreign institutions, and domestic businesses admitted to trading on a domestic stock exchange. See Wertpapierhandelsgesetz, *supra* note 5, § 2(4).

The definition of these institutions was inserted by the finance committee of the Bundestag when the Rules of Conduct were added to the draft bill. See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 14 (adding art. 1, § 2(4) to the draft bill of the *Zweites Finanzmarktförderungsgesetz*). The significance of the definition is that although it encompasses credit institutions and brokers, it does not include investment companies, since the investment *in the name of the company* of money entrusted to them is not considered an investment service in securities. See *id.* at 190 (explanation).

<sup>251</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 2(3). The Securities Trading Act provides for exceptions to these Rules for transactions between parent companies and subsidiaries, public entities administering their debt obligations, or the actions of central banks. See *id.* § 37(1). Aside from the organization obligations and recordkeeping for transactions on an exchange, the provisions of these Rules shall also not apply to transactions between investment service companies. See *id.* § 37(1).

<sup>252</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 31(2). If these rules are followed, a customer of the investment services company should be in a position to assess the implications and risks of the investment decision. Therefore, a customer must not merely be informed of the risks of an individual derivative instrument, but also of how this investment fits into the customer's overall portfolio. Nonetheless, the company should take the sophistication of the investor into account in determining the proper information to provide. See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 204–05 (explaining art. 1, § 30a(2) of the draft bill, codified at art. 1, § 31(2) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>253</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 32(1). This includes transactions which would tend to move the prices of securities held by the company in a direction desirable for the company. See *id.* § 32(1)(2). This prohibits the practice known as "scalping." *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 206 (explaining art. 1, § 30b(1)(2) of the draft bill, codified at art. 1, § 32(1)(2) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>254</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 32(1)(3). This prohibits the practice known as "front running." *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 206–07 (explaining art. 1, § 30b(1)(3) of the draft bill, codified at art. 1, § 32(1)(3) of the *Zweites Finanzmarktförderungsgesetz*). The prohibition against front-running applies equally to a company acting in its own interest or on behalf of another. *Id.* at 208 (explaining art. 1, § 30b(2) of the draft bill).

<sup>255</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 32(2)(2).



Investment services companies shall also attempt to avoid conflicts of interest with customers.<sup>256</sup> This shall include an organizational structure that minimizes conflicts of interest between the investment service company and its customers, as well as among customers.<sup>257</sup> The companies must also implement internal control measures to monitor and prevent violations of these provisions.<sup>258</sup> For oversight purposes, the investment service companies must keep records of client orders.<sup>259</sup> The companies shall be subject to a yearly audit that will also examine compliance with other reporting obligations under the Securities Trading Act.<sup>260</sup>

The Federal Securities Trading Supervisory Authority may require investment service companies to provide information or documentation for the purpose of furthering oversight of these companies.<sup>261</sup> More importantly, the Authority may draft guidelines for the fulfillment of the obligations imposed by these provisions.<sup>262</sup> These guidelines are meant not so much to provide administrative orders tied to punishments for violations; rather, the guidelines should give the providers of investment services some information as to how the Supervisory Authority expects the Rules of Conduct to be followed in practice.<sup>263</sup> The guidelines will incorporate the experiences of the administrative practice built up over a period of time, and may be changed when necessary.<sup>264</sup> Nonetheless, a breach of these guidelines shall be

<sup>256</sup> See *id.* §§ 31(1)(2), 33(2).

<sup>257</sup> See *id.* § 33(2). Although such conflicts cannot be entirely removed, they can be minimized. In order to do this, the company must take certain organizational measures in terms of both the structure and operations of the business. See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 209 (explaining art. 1, § 30c of the draft bill, codified at art. 1, § 33 of the *Zweites Finanzmarktförderungsgesetz*).

<sup>258</sup> See *Wertpapierhandelsgesetz*, *supra* note 5, § 33(3).

<sup>259</sup> See *id.* § 34(1). Additionally, the Federal Ministry of Finance may draft additional record-keeping requirements or may delegate this authority to the Federal Securities Trading Supervisory Authority. See *id.* § 34(2). The records must be kept for six years. See *id.* § 34(3). German credit institutions already keep these type of records pursuant to announcements of the Federal Banking Supervisory Authority. See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 210 (explaining art. 1, § 30d of the draft bill, codified at art. 1, § 34 of the *Zweites Finanzmarktförderungsgesetz*).

<sup>260</sup> See *Wertpapierhandelsgesetz*, *supra* note 5, § 36 (including reports on turnover in securities pursuant to § 9). This audit would most probably be conducted in conjunction with the existing audit of safe deposit holdings under the Federal Banking Supervisory Authority. *Id.*

<sup>261</sup> See *id.* § 35(1).

<sup>262</sup> See *id.* § 35(2).

<sup>263</sup> See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 212 (explaining art. 1, § 30e(2) of the draft bill, codified at art. 1, § 35(2) of the *Zweites Finanzmarktförderungsgesetz*).

<sup>264</sup> See *id.*

considered a violation of the underlying Rules of Conduct.<sup>265</sup> The German Bundesbank, the Federal Banking Supervisory Authority, and the central associations of the concerned industry may comment on these guidelines before their adoption.<sup>266</sup> In the case of the organizational structure, which affects both investor protection and the internal operations of the business, the Federal Securities Trading Supervisory Authority shall promulgate these guidelines in conjunction with the Federal Banking Supervisory Authority,<sup>267</sup> which among other things, is responsible for the chartering and soundness of credit institutions.

Although these requirements clearly impose burdens on securities companies, the actual standards are rather vague. The impact of the guidelines to be established by the Federal Securities Trading Supervisory Authority for compliance with these standards remains to be seen.

### B. *The Stock Exchange Act (Börsengesetz)*

The amendments to the Stock Exchange Act enact a number of reforms,<sup>268</sup> addressing the internal and external oversight of the exchanges, the institutional leadership structure of the exchanges themselves, the roles of market participants, and more general reforms to promote the German securities markets. The new provisions expand the powers of the *Länd* level Stock Exchange Supervisory Authority in the course of its supervision to collect information and require the submission of documentation from the exchanges themselves as well as dealers, brokers, and traders.<sup>269</sup> The Supervisory Authority can also now establish regulations to prevent the breach of exchange rules or regulations, that would impair the orderly implementation of exchange activities or their oversight.<sup>270</sup> Persons working for a *Länd* Stock Exchange Supervisory Authority or other agencies, as well as for the exchanges themselves, may not make public or use any nonpublic information gained in the course of their professional capacities, or after their employment.<sup>271</sup>

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<sup>265</sup> See *id.*

<sup>266</sup> See *id.*

<sup>267</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 35(2); Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 212 (explaining art. 1, § 30e(2) of the draft bill, codified at art. 1, § 35(2) of the Zweites Finanzmarktförderungsgesetz).

<sup>268</sup> Börsengesetz of June 22, 1896, as amended by the Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 2. All references to the Stock Exchange Act include the most recent amendments and cite simply to "Börsengesetz." See Börsengesetz, *supra* note 6, § 1.

<sup>269</sup> See Börsengesetz, *supra* note 6, § 1a(1).

<sup>270</sup> See *id.* § 1a(2).

<sup>271</sup> See *id.* § 2b(1).

The most significant changes in the supervisory structure involve the creation of an entirely new, independent entity within the exchange itself. This "Trading Control Board" ("*Handelsüberwachungsstelle*") ("TCB") shall be established according to standards of the *Länd* Stock Exchange Supervisory Authority and shall be responsible for overseeing the trading on the exchange and the settlement of exchange transactions; the Control Board shall collect data and conduct investigations to these ends.<sup>272</sup> The TCB shall concern itself with the daily business of the exchange, such as actual trading floor practices.<sup>273</sup> The *Länd* Stock Exchange Supervisory Authority can give instructions to the TCB and take over investigations begun by the latter.<sup>274</sup> The management of the exchange itself can also commission the TCB with inquiries.<sup>275</sup>

The head of the TCB shall be selected upon nomination by the management of the exchange board of directors with the consent of the *Länd* Stock Exchange Supervisory Authority.<sup>276</sup> In order to ensure their independence, those persons employed by the TCB and entrusted with oversight duties may only be discharged of their duties against their will with the consent of the *Länd* Stock Exchange Supervisory Authority.<sup>277</sup> The TCB shall have competences similar to those of the Supervisory Authority in the collection of information and the ability to require submission of documentation by market participants.<sup>278</sup> If the TCB finds evidence of a violation of the stock exchange rules or regulations, that could impair the orderly implementation of exchange activities, it must instruct the management of the exchange and the *Länd* Supervisory Authority.<sup>279</sup>

The amendments also alter the control structure of the stock exchanges, making the management independent from the representatives of market participants, and the exchanges, in general, more responsible for stock exchange business.<sup>280</sup> In conformity with the other re-

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<sup>272</sup> See *id.* § 1b(1).

<sup>273</sup> For a more detailed discussion of the duties of the TCB, see *infra* notes 550–60 and accompanying text.

<sup>274</sup> See Börsengesetz, *supra* note 6, § 1b(1).

<sup>275</sup> See *id.*

<sup>276</sup> See *id.* § 1b(2). This measure serves to ensure the Board's status as an independent organ within the stock exchange, i.e., absent undue influence from the management of the exchange or exchange participants. See Gesetzentwurf, *supra* note 7, at 60 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, creating § 1b(2) of the Börsengesetz).

<sup>277</sup> See Börsengesetz, *supra* note 6, § 1b(2).

<sup>278</sup> See *id.* § 1b(3) (referring to § 1a(1)); see *supra* notes 272–75 and accompanying text.

<sup>279</sup> See Börsengesetz, *supra* note 6, § 1b(5).

<sup>280</sup> See Gesetzentwurf, *supra* note 7, at 36.

forms, these changes are driven by international standards, which require a standing professional exchange management to meet the ever more complex needs of running the exchange.<sup>281</sup> Prior to the Second Financial Market Promotion Act, the exchanges were controlled by a Board of Governors (*Börsenvorstand*), comprised of representatives of the market participants.<sup>282</sup> The Board of Governors was responsible for the management of the exchange, and appointed a management committee.<sup>283</sup>

The new provisions establish a model for control of the exchange based upon the modern stock corporation.<sup>284</sup> The highest exchange authority is the Board of Directors (*Börsenrat*), which consists of up to twenty-four persons, who represent the different interests involved in securities trading, including, issuers, investors, and credit institutions.<sup>285</sup> A more independent management shall care for the daily operation of the exchange.<sup>286</sup> The responsibilities of the newly created Board of

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<sup>281</sup> See *id.* at 62 (explaining art. 2, no. 2 of the Zweites Finanzmarktförderungsgesetz, amending § 3 of the Börsengesetz).

<sup>282</sup> See Börsengesetz, *supra* note 6, § 3, BGBl. III, Gliederungsnummer 4110-11 (revised version prior to amendment by the Zweites Finanzmarktförderungsgesetz).

<sup>283</sup> See *id.* § 3(1).

<sup>284</sup> See Gesetzentwurf, *supra* note 7, at 62 (explaining art. 2, no. 2 of the Zweites Finanzmarktförderungsgesetz, amending § 3 of the Börsengesetz).

<sup>285</sup> See Börsengesetz, *supra* note 6, § 3(1). The following groups must be represented: financial institutions admitted to trade on the exchange, including the investment companies; independent brokers (*freie Makler*) and other admitted businesses; official exchange brokers (*Kursmakler*); the insurance companies that have issued securities traded on the exchange; other issuers of traded securities; and investors. *Id.* No more than half the members of the board may represent the financial institutions, investment companies, and companies under common control with these. *Id.* Within itself, the Board of Directors must elect its own chairman and deputies. *Id.* § 3(3). Under the prior system, the Board of Governors had been most often dominated by the credit institutions; these reforms should strengthen the interests of issuers, private investors, and institutional investors. See Gesetzentwurf, *supra* note 7, at 62 (explaining art. 2, no. 2 of the Zweites Finanzmarktförderungsgesetz, amending § 3 of the Börsengesetz).

The specific inclusion of investment companies within the concept of credit institutions was added by the Bundestag according to the recommendations of its finance committee. See Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 69 (amending art. 2, no. 2 of the draft bill of the Zweites Finanzmarktförderungsgesetz, amending § 3 of the Börsengesetz). The reason for this is that while the amendments purport to strengthen the representation of issuers, private investors, and institutional investors economically speaking, investment companies fall within the same general realm as the banks. Therefore, the credit institutions and investment companies, as a whole, should not represent more than half of the Board of Directors. See *id.* at 222-23 (explanation).

The final amendment to the Stock Exchange Act provides that upon the effective date of the Second Financial Market Promotion Act, the Board of Governors shall assume the duties of the Board of Directors. Their duties shall last until the elections of a new Board of Directors, not later than twelve months after the effectiveness of the Act. See Börsengesetz, *supra* note 6, § 97(1).

<sup>286</sup> Under the old regime, the management of the exchange had an insufficiently defined

Directors include the decree of exchange regulations and fee regulations; the appointment of the management of the exchange upon nomination by the *Länd* Stock Exchange Supervisory Authority; oversight of the management and decree of management regulations; and the decree of stipulations for exchange activities.<sup>287</sup> Important decisions, including the introduction of technical systems for trading or the settlement of exchange trades, require Board approval.<sup>288</sup> In general, however, under the new laws, the management shall be responsible for the leadership of the exchange.<sup>289</sup>

This has important consequences for the stock exchanges. For instance, one of the activities formerly controlled by the Board of Governors and now within the competences of the management of the exchange is the admission of parties to trading on the exchange.<sup>290</sup> Under the prior regime in which the trading parties controlled the admissions process, current members could have denied admission to potential competitors. The independence of the management might be even more important in the opposite situation of ousting a participant from the exchange; close working relationships might have made the market participants reticent to chastise a fellow exchange member. Under the amended law, however, the management is obligated to remove those who disturb the order or business of the exchange.<sup>291</sup> The effect of granting admission to the exchange has been broadened in recognition of the increase in computerized trading. An entirely new section of the Stock Exchange Act addresses the requirements for participation in electronic trading at a securities exchange; the admission of a business to trading on the auction floor shall suffice, so long as the business observes the regulations of the electronic trading system.<sup>292</sup>

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support function to the Board of Governors. See Gesetzentwurf, *supra* note 7, at 62 (explaining art. 2, no. 2 of the Zweites Finanzmarktförderungsgesetz, amending § 3 of the Börsengesetz).

<sup>287</sup> See Börsengesetz, *supra* note 6, § 3(2).

<sup>288</sup> See *id.* § 3(2).

<sup>289</sup> See *id.* § 3c(1).

<sup>290</sup> See *id.* § 7(1). Similarly, transactions in futures contracts on the exchanges must be admitted by the management, whereas previously this required the approval of the Board of Governors. See *id.* § 50(1) (as amended by the Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 2, § 25).

<sup>291</sup> See *id.* § 8(2).

<sup>292</sup> See *id.* § 7a. The reason for this is that the requirements for admission for trading are the same on all German stock exchanges. Therefore, no additional admissions procedures should be necessary for participation in an electronic trading system. See Gesetzentwurf, *supra* note 7, at 67 (explaining art. 2, no. 7 of the Zweites Finanzmarktförderungsgesetz, creating § 7a of the Börsengesetz).

The amendments also expand the regulation of brokers. While previously the management of the exchange had been responsible for overseeing the continual solvency of brokers,<sup>293</sup> the new TCB shall now be responsible for ensuring that brokers provide security to meet their outstanding obligations.<sup>294</sup> If the TCB is convinced that the broker has exceeded these limits, the management of the exchange shall see that more security is provided or open positions are resolved; otherwise, the broker may be excluded from trading.<sup>295</sup> In addition, the amendments to the Stock Exchange Act have increased the punishment for actions by trading participants that violate the regulations of the exchange or that damage commercial good faith or the honor of another trading participant. The maximum sanctions imposable by the *Länd* Sanctions Committee (*Sanktionsausschuss*)<sup>296</sup> have been increased from a fine of DM 2000 to DM 50,000 and an exclusion from the exchange of ten to now thirty trading days.<sup>297</sup>

Other amendments to the Stock Exchange Act address the issues of competition among exchanges and trading systems within Germany. The Bundesrat characterized the changes as a balanced compromise solution between regional and national interests; without guaranteeing the positions of the regional exchanges, the new regulations nonetheless provide economic opportunity for further development.<sup>298</sup> An individual *Länd* Stock Exchange Supervisory Authority may assign some of its duties to a counterpart in another *Länd*;<sup>299</sup> this is designed to help the smaller regional exchanges.<sup>300</sup> These *Länder* authorities are

<sup>293</sup> See Gesetzentwurf, *supra* note 7, at 68 (explaining art. 2, no. 10 of the Zweites Finanzmarktförderungsgesetz, creating § 8c of the Börsengesetz).

<sup>294</sup> See Börsengesetz, *supra* note 6, § 8c(2). The security can be in the form of a bank guarantee, guarantee insurance, or a deposit with the exchange, not to exceed DM 500,000. See *id.* § 7(4a).

<sup>295</sup> See Börsengesetz, *supra* note 6, § 8c(3).

<sup>296</sup> See *supra* note 125 and accompanying text.

<sup>297</sup> See Börsengesetz, *supra* note 6, § 9(2). Prior to these changes, the Sanctions Committee was known as the Committee of Honor (*Ehrenausschuss*). The changes in both the level of sanctions and the name reflect the fact that the focus of the former system was too narrow. With an increase in the number of persons admitted to trading on the exchange (due to amendments to § 7 of the Börsengesetz), violations of stock exchange regulations threaten not only the honor of another trader, but may also injure a business admitted to trading on the exchange. See Gesetzentwurf, *supra* note 7, at 68 (explaining art. 2, no. 11 of the Zweites Finanzmarktförderungsgesetz, amending § 9 of the Börsengesetz).

<sup>298</sup> Stellungnahme des Bundesrates, *supra* note 165, (general comments on the draft bill), reprinted in Gesetzentwurf, *supra* note 7, at 100.

<sup>299</sup> See Börsengesetz, *supra* note 6, § 2(1).

<sup>300</sup> See Gesetzentwurf, *supra* note 7, at 61 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, amending § 2 of the Börsengesetz).

also empowered to prevent anticompetitive limitations in trading, information, settlement, and securities services.<sup>301</sup>

The amendments implement Finance Minister Waigel's wish to provide the same competitive conditions for securities trading on the auction exchange floor as for computerized trading, while letting the markets decide the relative success of the systems.<sup>302</sup> Beyond the mere issue of admission to trading,<sup>303</sup> the Act foresees a role for the stock exchange supervisory authorities in removing obstacles to competition between trading forms and systems through the opening of the markets and to the establishment of more trading, information, and settlement systems.<sup>304</sup> The Act purports to place electronic trading systems on an equal footing with their predecessors.<sup>305</sup> The statement that the state shall not provide a guarantee that all stock exchanges and trading systems will survive, evidences further proof of the government's sincerity in its attempts to establish fair competition.<sup>306</sup>

In order to put this policy into practice, the amendments to the Stock Exchange Act empower investors to make decisions over the venue for their orders.<sup>307</sup> The customer for a purchase or sales order for securities on an exchange must designate the place of execution, including whether the transaction should be concluded on the auction exchange or through electronic trading.<sup>308</sup> In the absence of such a

<sup>301</sup> See Börsengesetz, *supra* note 6, § 2a; see also Gesetzentwurf, *supra* note 7, at 61 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, creating § 2a of the Börsengesetz) (A weakening of the market position of the stock exchange brokers, the regional exchanges and smaller companies in the securities markets would not be in the interests of preserving competition and, therefore, the attractiveness of *Finanzplatz Deutschland* as a whole.).

<sup>302</sup> See Waigel, *Finanzplatz Deutschland*, *supra* note 10, at 422.

<sup>303</sup> See *supra* note 292 and accompanying text.

<sup>304</sup> See Gesetzentwurf, *supra* note 7, at 36.

<sup>305</sup> See *id.*

<sup>306</sup> See Gesetzentwurf, *supra* note 7, at 36.

<sup>307</sup> See *id.* at 36–37.

<sup>308</sup> See Börsengesetz, *supra* note 6, § 10(1). An earlier version of §§ 10–27 had been repealed sometime prior to the passage of the Second Financial Market Promotion Act, so that at the time of the amendment, the section 10 provisions regarding the determination of placement of the trade were entirely new.

The only exception to this designation rule applies to fixed-interest bonds with a total face value of under DM 2,000,000. *Id.* § 10(3); see *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 224–25. Whether or not to have an exception at all was a subject of intense debate throughout the history of the Act. The draft bill had proposed excepting all fixed-interest bonds. See Gesetzentwurf, *supra* note 7, at 20 (art. 2, no. 10 of the draft bill of the Zweites Finanzmarktförderungsgesetz, creating § 10(3) of the Börsengesetz). The reason for this was that most trading in the bond market was between institutional investors, while other such instruments had little turnover on the markets. See *id.* at 69 (explaining the draft of § 10(3)).

designation by the customer, the order shall be presumed to be for trading on an auction exchange,<sup>309</sup> the party with whom the order has been placed shall determine the place of execution, taking into con-

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Upon the first review, the Bundesrat committees recommended that this exception be struck in its entirety from the bill. Empfehlungen der Ausschüsse, *supra* note 162, no. 18, at 17. The entire committee was concerned that the exception was contrary to the Act's goals of transparency and controlled price determination; the protection of investors and improvement of the acceptance of *Finanzplatz Deutschland* would in this case contradict the interests of the banking industry. The exception would shield a great deal of trading in securities from supervision. Instead of accepting the government's explanation that the markets would be too illiquid to require bond trading at the exchanges, the committee believed the illiquid situation could be improved by requiring more trading on the exchange. *See id.* (explanation). When meeting as a whole, the Bundesrat did not address the concerns of its committees at all.

The exception was limited to the DM 2,000,000 exclusion by the finance committee of the Bundestag during the next stage of the review process. Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, Bundestag Drucksache 12/7918, at 85 (amending art. 2, no. 10 of the draft bill of the Zweites Finanzmarktförderungsgesetz). The change was based upon the belief that encouraging trading in these instruments and settlement of customer orders over the exchanges would help to build liquidity. This figure represents the minimum issue volume for fixed-interest bonds admitted for trading on the Frankfurt Stock Exchange and through the IBIS trading system. The finance committee believed that this compromise would both promote investor protection and strengthen the stock exchange as an institution. *See* Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 224–25 (explanation).

<sup>309</sup> *Id.* § 10(2). The reason for this presumption is that trading on the auction exchange offers the private investor a guarantee of a fair price determination. If this were not the case, such as if a particular instrument were trading almost entirely through electronic trading, then the broker could execute the order elsewhere, in the interest of the customer. *See* Gesetzentwurf, *supra* note 7, at 69 (explaining art. 2, no. 10 of the Zweites Finanzmarktförderungsgesetz, creating § 10(2) of the Börsengesetz).

The legislative history of this provision reveals the concern of the individual *Länder* to preserve their regional exchanges. After the federal government had presented the draft bill to the Bundesrat, the *Länd* Nordrhein-Westfalen recommended the following change to this provision: In the absence of a designation of place of exchange by the customer, the order shall be presumed to be for trading on an auction exchange; *the place of execution shall be the stock exchange in the federal Länd in which the party with whom the order has been placed received the order.* If that would be contrary to the interests of the customer, or if the person receiving the order is in a *Länd* without an exchange, then the receiver shall choose the place of execution. Antrag des Landes Nordrhein-Westfalen, *supra* note 163, Bundesrat Drucksache 793/2/93, at 1. Apparently, the credit institutions had argued against this "home exchange principle" ("*Heimatbörsenprinzips*"), stating that this would raise their costs by DM 15 to DM 25 per order. But Nordrhein-Westfalen responds that the implementation of the BOSS-Cube system has made additional costs insignificant. Moreover, this amendment would strengthen the regional exchanges, a movement necessary to further the overall interests of fair competition between electronic trading systems and the auction exchanges. *See id.* at 2–3 (explanation). Nordrhein-Westfalen had a vested interest in such a clause, because the Rheinisch-Westfälische Börse located in the *Länd* capital, Düsseldorf, is the second largest stock exchange in the country, next to Frankfurt, but lies only a little over 200 km to the northeast. Unfortunately for Nordrhein-Westfalen, the Bundesrat as a whole declined to include this suggestion in its comments on the draft, and the home exchange principle has not been codified into the final Act.



sideration the interests of the customer.<sup>310</sup> A given security may be traded over electronic systems, so long as an exchange in which that security is admitted for trading has consented and the electronic systems are regulated by that exchange.<sup>311</sup> Electronic systems nonetheless have one advantage in that they may trade securities assigned to the over-the-counter market.<sup>312</sup>

The government realized that the central obligations of stock exchange supervision include a guarantee of the establishment of exchange prices free from manipulation—investors must be able to trust in this.<sup>313</sup> A supervised, orderly price determination is an essential measure of quality for any stock exchange wishing to compete on an international level.<sup>314</sup> The marketing of financial instruments based on German stock indexes, as well as the ability to establish German computer trading screens abroad, depend entirely upon the trust in market prices.<sup>315</sup> In furtherance of the general goal of increased transparency, the amendments to the Stock Exchange Act strengthen the independence of the market in determining prices.<sup>316</sup> The trading participants must promptly make known the exchange prices and the underlying turnover.<sup>317</sup> While under the previous regulations the Board of

<sup>310</sup> See *Börsengesetz*, *supra* note 6, § 10(2).

<sup>311</sup> See *id.* § 12(1).

<sup>312</sup> See *id.* § 12(2).

<sup>313</sup> See *Gesetzentwurf*, *supra* note 7, at 69 (explaining art. 2, no. 11 of the *Zweites Finanzmarktförderungsgesetz*, creating § 11 of the *Börsengesetz*).

<sup>314</sup> See *id.*

<sup>315</sup> See *id.* at 69–70.

<sup>316</sup> One amended provision states that before they can establish an exchange price, the trading participants must be aware of the price differential due to supply and demand. See *Börsengesetz*, *supra* note 6, § 11(2). The Bundesrat recommended a requirement that the price differential should be disclosed upon its review of the draft bill. See *Stellungnahme des Bundesrates*, *supra* note 165, (comment no. 15, art. 2, no. 12 of the *Zweites Finanzmarktförderungsgesetz*, amending § 11(2) of the *Börsengesetz*), *reprinted in* *Gesetzentwurf*, *supra* note 7, at 98. If traders from outside the exchange must place an order without knowing the market price of the opposite position, then their sale or purchase order is less likely to be fulfilled. See *id.* (explanation). The federal government responded that it would consider the issue. See *Gegenäußerung der Bundesregierung*, *supra* note 166, *reprinted in* *Gesetzentwurf*, *supra* note 7, at 103 (response to Bundesrat comment no. 15). The finance committee of the Bundestag implemented this recommendation in its own words. See *Gesetzesbeschluß*, *supra* note 168, at 86 (art. 2, no. 12, amending § 11(2) of the *Börsengesetz*). The change should serve the goal of limiting the possibility of selling brokers to use their information edge to manipulate the determination of the stock exchange price of a security. See *id.* at 225 (explanation).

<sup>317</sup> See *Gesetzentwurf*, *supra* note 7, at 69. Stock exchange prices (*Börsenpreise*) are defined as prices for securities which are traded during operating hours on a securities stock exchange in official trading or in the regulated market; or prices established on a commodities exchange; as well as prices established through an approved, regulated electronic trading system. See *id.*

Governors of the exchange had a say in the official determination of the exchange price,<sup>318</sup> under the new amendments, the official exchange brokers (*Kursmakler*) shall officially determine exchange prices.<sup>319</sup>

Although some of the amendments expand the regulation of the *Kursmakler*, in general, the amendments to the Stock Exchange Act expand their range of allowable activities for the purpose of increasing market liquidity.<sup>320</sup> In order to meet growing capital demands for managing risk and to compete with other European brokers newly allowed to operate in Germany,<sup>321</sup> the law shall allow *Kursmakler* to organize their business in limited liability form.<sup>322</sup> In the same way electronic trading allows dealers to pass along orders, the amendments now allow inter-locking trading between brokers who deal in the same stock on different exchanges.<sup>323</sup> Brokers, who during the trading day in official trading or in the regulated market cannot carry out a trading order within a reasonable time period, may transfer the order to another broker on another exchange during the same trading day.<sup>324</sup> This will serve the interests of investors in having their orders placed, and will raise the liquidity of the German trading systems as a whole.<sup>325</sup>

Most of these provisions seek to improve upon the existing securities markets in Germany. But a series of more subtle amendments to the Stock Exchange Act open up the possibility of introducing an entirely new range of securities trading in Germany—the removal of the obstacle to establishing a commodity futures exchange (*Warenterminbörse*). German agriculture has pushed for such steps as the agriculture policy of the EU retreats from price supports and farmers could increasingly

§ 11(1). Prices for securities traded on an exchange in the unofficial over-the-counter market (*Freiverkehr*) are also considered exchange prices. *See id.* § 78(2).

<sup>318</sup> *See* Börsengesetz, *supra* note 6, § 29(1), BGBl. III, Gliederungsnummer 4110-11 (revised version prior to amendment by the Zweites Finanzmarktförderungsgesetz).

<sup>319</sup> *See* Börsengesetz, *supra* note 6, § 29(1). By the official determination of the exchange price for securities, only representatives of the *Länd* Stock Exchange Supervisory Authority and of the exchange's TCB may be present. *See id.* § 29(2).

<sup>320</sup> *See* Gesetzentwurf, *supra* note 7, at 37.

<sup>321</sup> *See id.* at 73 (explaining art. 2, no. 18 of the Zweites Finanzmarktförderungsgesetz, creating § 34a of the Börsengesetz).

<sup>322</sup> Previously, *Kursmakler* could only operate under the business form of the sole trader (*Einzelkaufmann*). *Id.* Under the new law, if certain conditions are met, the *Kursmakler* may organize in the form of a private limited liability company (*Gesellschaft mit beschränkter Haftung* ("GmbH")) or a public stock corporation (*Aktiengesellschaft* ("AG")). *See* Börsengesetz, *supra* note 6, § 34a(1).

<sup>323</sup> *See* Gesetzentwurf, *supra* note 7, at 37.

<sup>324</sup> *See id.* § 13.

<sup>325</sup> *See id.* at 71 (explaining art. 2, no. 12 of the Zweites Finanzmarktförderungsgesetz, creating § 12 of the Börsengesetz).

benefit from other means of safeguarding their expected income.<sup>326</sup> To this end, existing sections in the Stock Exchange Act prohibiting futures contracts in grain and mill products have been repealed.<sup>327</sup> Based upon the successful example of the new German Futures Exchange in Frankfurt, an essential element for the commodity futures exchange shall be the ability of private investors to participate in the trading.<sup>328</sup> In order to protect private investors against more sophisticated counterparties,<sup>329</sup> the amended statute requires the seller of a commodity futures contract to inform the other side in writing before the conclusion of the contract of the special risks in commodity futures activities.<sup>330</sup> The amendments also expand the punishments for the manipulation of market or exchange prices of securities to include fraudulent actions regarding derivatives.<sup>331</sup>

### C. *Other Provisions of the Second Financial Market Promotion Act*

The other articles of the Second Financial Market Promotion Act address a range of issues designed to promote the concept of *Finanzplatz Deutschland*. Many of the provisions amend preexisting financial laws to further German market reform. Other provisions harmonize regulations to account for the new Securities Trading Act and the duties of the Federal Securities Trading Supervisory Authority. The final category includes independent reforms to promote the German markets. This Part mentions some of the more important articles.

Beyond the abovementioned amendments to the Stock Exchange Act, the next most significant changes appear in Article Three, which amends the German Investment Company Act to broaden the range

<sup>326</sup> See *id.* at 37.

<sup>327</sup> Börsengesetz, *supra* note 6, §§ 65–68 (repealed by the Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 2, § 28).

<sup>328</sup> See Gesetzentwurf, *supra* note 7, at 74 (referring to art. 2, no. 26 of the draft bill, codified at art. 2, no. 27 of the Zweites Finanzmarktförderungsgesetz, repealing § 53(3) of the Börsengesetz which previously prohibited private participation).

<sup>329</sup> See *id.* at 74 (explaining art. 2, no. 26 of the draft bill, codified at art. 2, no. 27 of the Zweites Finanzmarktförderungsgesetz, amending § 53(2) of the Börsengesetz).

<sup>330</sup> See Börsengesetz, *supra* note 6, § 53(2). This requirement goes beyond the disclosure for other financial futures contracts due to the special risks involved. Many factors influence future price developments of commodities, including natural catastrophes, which make it difficult to predict future supply. See Gesetzentwurf, *supra* note 7, at 74 (explaining art. 2, no. 26 of the draft bill, codified at art. 2, no. 27 of the Zweites Finanzmarktförderungsgesetz, amending § 53(2) of the Börsengesetz). Additionally, the statute requires the contract writer to repeat the information about the risks one year later and at certain time intervals. See Börsengesetz, *supra* note 6, § 53(2).

<sup>331</sup> See Börsengesetz, *supra* note 6, § 88.

of investment opportunities available to certain money market or mutual funds.<sup>332</sup> These changes should lead to improved portfolios and yields, and improved risk management operations.<sup>333</sup> The changes also repeal prior restrictions on investment company activities in the derivative markets.<sup>334</sup> For the first time, investment companies may invest up to ten percent of the value of assets in stock purchase warrants.<sup>335</sup> Other derivative products now available for investment include options on foreign exchanges and options on securities indexes.<sup>336</sup> Among the restrictions on investment on the latter two types of options are, in some cases, the condition that these foreign exchange options and securities index options be traded on a German domestic or a foreign exchange.<sup>337</sup> Another liberalization allows investment companies for the first time to assign securities to third parties in return for remuneration for a short time period.<sup>338</sup> In order to protect investors, investment companies can only transfer the securities against a pledge or assignment of a Deutsche Mark account, bonds, or other securities held at a securities depository bank.<sup>339</sup>

The significance of these reforms reaches beyond merely increasing the scope of investment company activity and the opportunities for investors. These reforms specifically serve to support the German markets for derivative products. This holds true especially due to the fact that institutional investors play such a large role in Germany. The

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<sup>332</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 3 (“*Änderung des Gesetzes über Kapitalanlagegesellschaften*”). The Investment Company Act may be found as follows: *Gesetz über Kapitalanlagegesellschaften*, BGBl. I, 127 (Jan. 14, 1970), last amended in BGBl. I, 2378 (Dec. 27, 1993).

<sup>333</sup> See *Gesetzentwurf*, *supra* note 7, at 37.

<sup>334</sup> See *id.*

<sup>335</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 3(5)(c) (amending § 8a of the *Gesetz über Kapitalanlagegesellschaften* to add subparagraph 4).

<sup>336</sup> See *id.* art. 3, no. 5(c) (amending § 8a of the *Gesetz über Kapitalanlagegesellschaften* to add paragraph (5)). Investment companies will also be allowed to sell foreign exchange futures contracts and options contracts if they hold certain offsetting contracts. See *id.* art. 3, no. 8 (creating § 8e).

<sup>337</sup> See *id.* art. 3(8) (amending § 8e(2) of the *Gesetz über Kapitalanlagegesellschaften* regarding foreign exchange options and futures), art. 3(9)(b) (amending § 8f(2)(2) regarding securities index options (“*Wertpapierindex-Optionen*”).

<sup>338</sup> See *id.* art. 3(12) (amending the *Gesetz über Kapitalanlagegesellschaften* to add subparagraph § 9a(1)). The contract stipulations for the fund must provide for such activity; the person borrowing the securities must reimburse the investment company with securities of the same type, grade, and amount at the end of the contract term. See *id.*

<sup>339</sup> See *id.* art. 3(12) (amending the *Gesetz über Kapitalanlagegesellschaften* to add subparagraph § 9b(1)).

increased activity in these markets, specifically on the *Deutsche Terminbörse*, should increase their liquidity and overall attractiveness.

Article Five addresses the attractiveness of stock ownership for individual investors. In comparison with other countries, the nominal prices for German stocks are relatively high, with trading values of DM 500 or even DM 1000 not out of the ordinary.<sup>340</sup> This article amends the Stock Law to lower the minimum par value of shares offered by stock corporations from fifty Deutsche Mark to five.<sup>341</sup> Decreasing the denomination of shares allows individuals to invest smaller amounts of money, and promotes trading of small holdings, thereby enhancing liquidity.<sup>342</sup> The small investor would also benefit from the ability to

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<sup>340</sup> See Gesetzentwurf, *supra* note 7, at 37. Because of this, German stocks could appear very expensive to foreign investors. The government explanation of the draft bill stated that the trading price of a weighted average of common shares was nine times the nominal value, leading to the 500–1000 figures. Industry had been calling for a long time for a lowering of the nominal value, and the *Länder*, led by *Hessen* (in which Frankfurt am Main is located) have also spoken out in favor of such a change. The amendments will bring the German nominal share value into line with international standards. See *id.* at 82–83 (explaining art. 4, no. 1 of the draft bill, codified at art. 5, no. 1 of the *Zweites Finanzmarktförderungsgesetz*, amending § 8 of the *Aktiengesetz*).

<sup>341</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 5(1)(a) (“*Änderung des Aktiengesetzes*”). The Stock Act may be found as follows: *Aktiengesetz*, BGBl. I, 1089 (Sept. 6, 1965), last amended in BGBl. I, 1377 (June 24, 1994).

<sup>342</sup> It is unclear why companies themselves would not have already addressed this problem through a “stock split,” in which each stockholder would receive a multiple of the number of shares each one had previously, without changing either the gross or relative value of the holdings of the individual stockholder. For example, if shares in Daimler-Benz were trading at around DM 700 each, as they were in early 1995, the corporation could declare its intention to “split” each existing share into five new shares. The immediate trading value of these “new” shares would be DM 140 each (approximately \$100 in early 1995), since the company has created no new wealth, just a different representation of the existing ownership shares. (Note that this assumes away any other price changes such as a rise in the value of the stock if traders thought this would make Daimler-Benz trading more liquid.)

Under United States law, the stock split serves as a common form for lowering the trading price of a stock.

The motivation for a split would typically be a desire to make trading in the stock easier; since shares are most cheaply and easily traded in multiples of 100, the price per share may reach such a point that the price per 100 shares and accordingly of the typical trade may be out of reach for the small investor. A split can remedy such a situation, also making it easier for holders to realize part of their gains by selling off some of their investments.

DETLEV F. VAGTS, *BASIC CORPORATION LAW: MATERIALS—CASES—TEXT* 673 (3rd ed. 1989).

According to the government explanation of the draft of this amendment, § 8(3) of the German Stock Corporation Act would allow a stock split. See Gesetzentwurf, *supra* note 7, at 83 (explaining art. 4, no. 1 of the draft bill, codified at art. 5, no. 1 of the *Zweites Finanzmarktförderungsgesetz*, amending § 8(1) of the *Aktiengesetz*). But it remains unclear what effect the amendment would have on trading in existing stock, since a stock split in the above example

diversify the same monetary investment across a broader, and, therefore, less risky, portfolio of shares. Although some new issuers have already taken advantage of this lower par value, other factors limit the effectiveness of this legal change. The most formidable obstacle stems from the fees charged by the credit institutions for securities trades—these are most often charged on a per piece basis,<sup>343</sup> effectively raising transactions costs for stocks with lower par values.

Article Seven alters the Securities Deposit Act.<sup>344</sup> This Act provides for the central holding of securities, promoting securities trading and settlement by eliminating the need to transfer the actual paper certificates representing the securities from the buyer to the seller. Instead, the certificates are entrusted to a bank known as a securities collection bank<sup>345</sup> that holds the certificates in safekeeping, while an account represents the customer's (or broker's) interest. In the case of a sale of the securities, the certificates remain in place, but the account of the seller is debited and that of the buyer is credited. Through these changes, the amendments simplify the clearing system for settling transactions in securities and derivatives.<sup>346</sup>

The second type of changes addressed by the latter articles in the Second Financial Market Promotion Act work to implement and to harmonize other regulations with the Securities Trading Act.<sup>347</sup> For example, in addition to the changes in Article Three that expand allowable investment company activity,<sup>348</sup> a further provision serves the more mundane task of harmonizing existing rules. Taking the new Securities Trading Act literally, the investors in a mutual fund would have voting rights in a company imputed to them indirectly—as “owners” of the fund that holds stock in the company.<sup>349</sup> Such an interpre-

would have been allowed under the prior regime as well, since even after the split, the nominal value of the stock was greater than DM 50.

<sup>343</sup> See “*Publizitätspflicht ist ungenügend*”, SÜDDEUTSCHE ZEITUNG, Oct. 31–Nov. 1, 1995, at 26. Due to these concerns, the German Association for the Protection of Security Holders has proposed allowing the issuance of stock with no par value. See *id.* The head of the Association also criticized the disclosure requirements under the Act as favoring sophisticated investors with access to computerized data services over private investors who relied upon the printed media with its subsequent delay in publication. See *id.*

<sup>344</sup> See Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 7 (“*Änderung des Depotgesetzes*”). The Securities Deposit Act may be found as follows: Depotgesetz, BGBl. III, Gliederungsnummer 4130–31, last amended in BGBl. I, 1507 (July 17, 1985).

<sup>345</sup> Wertpapiersammelbank.

<sup>346</sup> See Gesetzentwurf, *supra* note 7, at 37–38.

<sup>347</sup> See *supra* Part V.A. for discussion of the Securities Trading Act.

<sup>348</sup> See *supra* notes 332–39 and accompanying text.

<sup>349</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 22(1)(2).

tation would subject the investors to all the reporting requirements for those holding certain threshold percentages of stock in exchange-listed corporations.<sup>350</sup> In order to avoid this result, the amendment clarifies that, for the purposes of those provisions, all voting rights accompanying stocks held by the fund shall be treated as belonging to the investment company itself.<sup>351</sup>

Other articles amend existing statutes to account for the new Federal Authority. Article Eight amends the Sales Prospectus Act to require that, prior to public dissemination, a copy of any prospectus for the sale of securities must be provided to the Securities Trading Supervisory Authority.<sup>352</sup> Previously, an issuer would have to send this to the proper authority in every *Länd* in which the securities were to be traded.<sup>353</sup> Article Eleven contains the more mundane purpose of merely amending the list of federal superior agencies to include the new Federal Authority.<sup>354</sup>

A few provisions contain other minor changes to existing law. Article Four amends provisions of the Foreign Investment Act regarding securities.<sup>355</sup> Article Fourteen amends the Income Tax law regarding the sale of securities.<sup>356</sup> Article Sixteen changes not a law, but the regulations regarding listing on a stock exchange.<sup>357</sup> The changes expand the category of underlying instruments upon which conversion and subscription rights may be based from the previous standard of instruments traded in OECD countries to the new standard of all instru-

<sup>350</sup> See *supra* note 243 and accompanying text.

<sup>351</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 3(13) (amending § 10(1a) of the *Gesetz über Kapitalanlagegesellschaften*).

<sup>352</sup> See *id.* art. 8(2) ("*Änderung des Verkaufsprospektgesetzes*"). The Sales Prospectus Act may be found as follows: *Verkaufsprospektgesetz*, BGBl. I, 2749 (Dec. 13, 1990), last amended in BGBl. I, 512, 2436 (Apr. 27, 1993). The Authority will collect a fee for the deposit of the prospectus. See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 8, no. 6.

<sup>353</sup> See *Gesetzentwurf*, *supra* note 7, at 89–90 (explaining art. 7, no. 2 of the draft bill, codified at art. 8, no. 2 of the *Zweites Finanzmarktförderungsgesetz*, amending § 8 of the *Verkaufsprospektgesetz*).

<sup>354</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 11.

<sup>355</sup> See *id.* art. 4 ("*Änderung des Auslandsinvestment-Gesetzes*"). The Foreign Investment Act may be found as follows: *Auslandsinvestment-Gesetz*, BGBl. I, 986 (July 29, 1969), last amended in BGBl. I, 2310 (Dec. 21, 1993).

<sup>356</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 14 ("*Änderung des Einkommensteuergesetzes*"). The Income Tax Act may be found as follows: *Einkommensteuergesetz*, BGBl. I, 1898 (Sept. 7, 1990), amended in BGBl. I, 1630 (July 24, 1994).

<sup>357</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 16 ("*Änderung des Börsenzulassungs-Verordnung*"). The Stock Exchange Admission Regulation may be found as follows: *Börsenzulassungs-Verordnung*, BGBl. I, 1234 (Apr. 15, 1987), amended in BGBl. I, 512, 2346 (Apr. 27, 1993).

ments about which the German public can regularly obtain information.<sup>358</sup>

The final type of changes in the Second Financial Market Promotion Act establishes new law, as in the Securities Trading Act of the first article. Article Fifteen attempts to remove some of the uncertainty regarding financial futures contracts in insolvency proceedings by establishing netting regulations.<sup>359</sup> This article applies to the following types of financial futures obligations whose prices are determined on a market or a stock exchange: the delivery of precious metals or securities; monetary obligations determined in a foreign currency; obligations dependent on an exchange rate, interest rate, or price of other goods or services; or options on any of the above.<sup>360</sup> The article addresses the status of claims regarding any of these financial obligations that come due after the opening of bankruptcy proceedings and, therefore, cannot be fulfilled.<sup>361</sup> Under the new rules, the non-breaching party may only pursue the underlying claim as a general creditor in bankruptcy.<sup>362</sup> The nature of these obligations, however, suggests that the non-breaching party will often receive less than full compensation for the unfulfilled contract, even if the consideration paid were reimbursed, if damages for lost profits were not recoverable.

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<sup>358</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 16, no. 1 (amending § 11(2) of the *Börsenzulassungs-Verordnung*). The changes increase the number of securities available, including those from the rapidly expanding markets of South Korea, Taiwan, and Singapore, which are not OECD members. See *Gesetzentwurf*, *supra* note 7, at 91 (explaining art. 9, no. 1 of the draft bill, codified at art. 16, no. 1 of the *Zweites Finanzmarktförderungsgesetz*, amending § 11(2) of the *Börsenzulassungs-Verordnung*).

<sup>359</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 15 (“*Finanztermingeschäfte im Insolvenzverfahren*”). Actually, this article duplicates a provision of another Act under consideration at the same time as the Second Financial Market Promotion Act, Article 105 of the Introductory Act for Insolvency Proceedings (*Einführungsgesetz zur Insolvenzordnung*). In that other law, this provision would go into effect the day after promulgation. The finance committee of the Bundestag, however, feared a delay in the other act, and so added this provision to the Second Financial Market Promotion Act. See *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 273–74 (explanation of art. 8d of the draft bill, codified at art. 15 of the *Zweites Finanzmarktförderungsgesetz*).

<sup>360</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 15(1).

<sup>361</sup> See *id.*

<sup>362</sup> See *id.* art. 15(2). The article recognizes, however, that individual contracts of this type may constitute individual provisions of a larger agreement or ongoing transaction. If a contract for multiple transactions contains a provision that contract damages can only be resolved jointly, then the entirety of the transactions shall be treated as if they were a single reciprocal contract. See *id.* art. 15(1). These provisions shall also apply in the case of consolidated proceedings. See *id.* art. 15(3).



Article Fifteen accounts for this discrepancy in lost profits derived from futures contracts.<sup>363</sup> In addition to the underlying contract claim, the non-breaching party may file an additional claim for the lost profits resulting from the breach, which shall be calculated as the difference between the agreed upon price and that of the respective market or exchange, available on the second workday after the opening of the bankruptcy proceedings.<sup>364</sup> This type of protection for expected profits clearly makes the German markets more attractive for those transacting and trading in futures and options.<sup>365</sup>

Finally, Article Twenty lists the effective dates.<sup>366</sup> Most of the provisions of the Second Financial Market Promotion Act discussed in this Part of this Article became effective on August 1, 1994.<sup>367</sup> The other provisions became effective on January 1, 1995, including the provisions of Article Eight, requiring that a securities sales prospectus must be submitted to the Federal Securities Trading Supervisory Authority.<sup>368</sup> Recall that the Authority opened for business on January 1, 1995.

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<sup>363</sup> The following example illustrates this point. Assume that Broker had entered into a futures contract to sell to Investor 1000 shares of stock in Daimler-Benz at DM 700 each, deliverable on Monday, July 3, 1995 in Frankfurt. The parties signed the contract and Investor paid the DM 700,000 on May 8, 1995. This is a contract for future delivery of securities. On July 3, Investor sees that Daimler-Benz is trading at DM 750 and calls his broker to see that the securities have been transferred only to learn that the Broker had filed for bankruptcy the previous Friday, June 30. As a general creditor in bankruptcy, Investor could only file a claim to have the payment returned. Investor would receive his pro rata share of the Broker's estate at the end of the proceeding; if the Broker's assets only equalled half his liabilities, then Investor would receive only 50 Pfennig per Mark, or a total of DM 350,000. But Investor is worse off as a result of the failure, because this was a futures contract. Investor had contracted not for DM 700,000 worth of Daimler-Benz stock, but for 1000 share at that price. In order to buy the equivalent shares now, Investor would have to pay DM 750,000. Although an investor might also suffer a loss, such as if the Daimler-Benz stock in this case had fallen to DM 650 per share, that scenario does not affect this analysis, since the non-breaching party would only bring a claim for lost profits otherwise due under the contract.

<sup>364</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 15(2). In the above example, if the price of the stock were to climb to DM 752 on Tuesday, July 4, 1995, two days after the bankruptcy filing (Friday to Tuesday, since the U.S. independence day is not a holiday in Frankfurt), Investor could file an additional claim for his lost profit of DM 52,000. This figure is calculated as the difference in the stock's trading price on the second day after the advent of bankruptcy proceedings (DM 752) minus the contract price (DM 700), times the number of shares (1000):

$$(752-700) \times 1000 = \text{DM } 52,000.$$

<sup>365</sup> Although the above example dealt with a single transaction in a reciprocal contract, no provisions of Article 15 suggest that if such a contract were traded on the exchange that it would be treated any differently in the case of a bankruptcy-related default.

<sup>366</sup> See *Zweites Finanzmarktförderungsgesetz*, *supra* note 3, art. 20 ("*Inkrafttreten*").

<sup>367</sup> *Id.*

<sup>368</sup> See *id.*

Similarly, Article Sixteen followed the later date.<sup>369</sup> Finance Minister Waigel may have underestimated the scope of the reforms which took two years longer than he proposed for enactment.<sup>370</sup>

## VI. ANALYSIS

As discussed throughout this Article, the series of reforms in Germany aim to increase efficiency in the financial markets, lowering overall costs, increasing allocative efficiency, and increasing investor information, opportunity, and protections. The purported overall goal is the increased attractiveness of *Finanzplatz Deutschland*.

Although broad consensus supported the need for change—exemplified in areas like the regulation of insider trading where Germany had fallen behind the worldwide trend—this consensus has not spread across all areas of reform, nor across the scope of individual reforms. In this context, the title of this Article, *An Outsider's Look Into the Regulation of Insider Trading in Germany . . .* takes on a meaning beyond the notion that the Article has been written by an American regarding German reforms. Beyond this is the vital understanding that although many of the reforms delineated in this Article represent an evolution of the German financial sectors and the inevitable march of progress, a significant number of these reforms have responded to pressures from *outside* Germany.<sup>371</sup> Some pressures have been identified as directives of the EU designed to promote common practices in the process of harmonization of the Common Market. Other pressures stem from the recognition of the development of worldwide standards among the leading industrialized countries resulting from the globalization and internationalization of international finance, often mirroring developments pioneered in the United States. This Article details some difficult steps Germans have already taken towards the implementation of these reforms. The next most important step shall be to convince the world, and the Americans in particular, that the changes have been embraced.<sup>372</sup>

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<sup>369</sup> *Id.*

<sup>370</sup> See *supra* note 29 and accompanying text.

<sup>371</sup> Although the fact that some of the German reforms stem from outside pressures is apparent from a cursory examination of the subject, for an understanding of the breadth and significance of these pressures, the author of this Article is indebted to Dr. Kotz. Interview with Dr. Hans-Helmut Kotz, Chief Economist, Deutsche Girozentrale—Deutsche Kommunalbank, Frankfurt am Main, Germany (Jan. 19, 1995).

<sup>372</sup> Although the concept that pressure for reform has come from outside Germany is not particularly novel, it is essential that the American reader grasp this point. Germany can only draw a greater share of foreign investment if it convinces investors that these reforms are in place.

Arguments for the apparent benevolence of such pressures are that they indeed represent world standards, stemming from open economies where market forces have led to the survival of only the most efficient financial structures, markets, and instruments. They have stood the test of time and proven their superiority. To attain a “global” standard or even one acceptable by the twelve, and now fifteen, Member States of the EU, the standard cannot be too radical or represent any gross deviation from the current practices of the more advanced countries. In the United States in particular, the New York Stock Exchange is generally considered the most efficient capital market in the world.<sup>373</sup> So why shouldn’t other countries want to follow this lead?

Put simply, other countries are not the United States. This Article meticulously details the structure of the German financial system in Part II, showing that the German financial markets are different from their U.S. counterparts—in the most basic sense. The traditional German reliance on debt and internal financing rather than equity, with a correspondingly larger role played by more powerful universal banking institutions at the expense of the stock markets,<sup>374</sup> highlights these differences. Surely, most Germans have realized that *Finanzplatz Deutschland* cannot develop as one of the world’s leading financial metropolises, while continuing to rely primarily upon its banking sector, without further developing its securities markets. Even with this recognition, the Germans remain adamant in not sacrificing their universal banking system to this end.

A more thorough theoretical discussion of the comparative merits of the universal banking system and other factors characteristic of the German financial system is beyond the scope of this Article. Beyond a cursory level, this Article does not wish to call into question the fundamentals of the worldwide accepted standards, such as the policy that insider trading in a developed marketplace should be prohibited. The question posed by this Article is much more difficult and fact specific. In light of the differences between the underlying financial system in Germany and other countries, including the United States in particu-

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<sup>373</sup> “The success of the functioning of possibly the most efficient market known, the New York Stock Exchange, has been in part due to the careful formalization of the rules of the game by its board of governors and the Securities and Exchange Commission.” Allen D. Boyer, *Free Speech, Free Markets, and Foolish Consistency: Corporate First Amendment Rights and the SEC*, 92 COLUM. L. REV. 474, 496 (1992) (book review) (citing Martin Shubik, *Corporate Control, Efficient Markets, and the Public Good*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 31, 33 (John C. Coffee, Jr. et al. eds., 1988)).

<sup>374</sup> See Roe, *supra* note 44, at 1936-38.

lar, this Article poses the question of whether the market reforms that have been so successful in other countries can and should be imposed upon Germany. The German economy has developed as one of the world's strongest and most stable, with its own model of universal banking in particular. Can the extremely detailed securities regulations of the United States simply be translated into the German language and enacted by the German Bundestag, and should one then expect immediately to see as dynamic and deep a securities market as in the United States?

Clearly, the answer to the latter question is no. But this Article purports to prove that the reasons for this result stem from more than a mere transition period to digest the changes and for the capitalization of the markets to grow. This Article has repeatedly addressed the issue of reform from three different viewpoints: that of the governmental agents and regulators, the market participants and private infrastructure, and the investors and customers. The period of time required to implement the reforms varies widely across these major groupings.

From the regulatory viewpoint, the government is doing its part in enacting the reforms, but this process takes time, as exemplified by the fact that the Second Financial Market Promotion Act was enacted two years beyond the deadline in the EU directive. Although the Federal Securities Trading Oversight Authority is already up and running, it is still in the process of digesting its duties and implementing its mandate, as discussed *infra* in Part VI.B. This last point is the best example of the inability merely to translate and to impose a regulatory framework upon Germany. Even accounting for the benefit of an example, should we expect the new German counterpart to the SEC within a matter of months or even years to establish the type of impact that the SEC has cultivated through over sixty years of rules, regulations, investigations, and no-action letter experience?

On the second level are the market participants themselves who will need to adapt to the new regulations and structures. Surely they will benefit from the increased attractiveness of Germany as a place for investment. But this progress does not come without costs. In particular, the market participants (i.e., predominantly the large universal banks) will bear both the direct costs of increased fees to pay for the infrastructure reforms and the indirect costs of adapting their own practices to comply with the new rules.

Sophisticated investors cannot fully benefit from the reforms until the government has established the regulatory framework and the market participants have adapted and expanded their services accord-

ing to the new regulations. Investors evaluate the bottom line in the form of the return on their investment, which comes only from the workings of the financial markets in practice, not in theory. All investment is at some point a gamble, dependent upon individual expectations which meet at the market, determining everything from interest rates to stock prices to foreign exchange spot prices, and all the derivatives thereof. The government and market participants can help to lower the transactions costs and increase the information available to investors. Ultimately, however, the investors must place their trust, and their money, in the German markets to consider these reforms a success. In essence, the success of these reform measures will parallel a change in the financial culture of Germany.

#### A. *Adaptation to the New Rules by the Market Participants*

The United States is critical of the universal banking system in Germany because the traditional regulatory structure had no deterrent to prevent the intermingling of information between the bank's own securities accounts and those of its customers—hence, creating the potential for insider trading. The primary argument in favor of universal banking is that it is a much more stable structure to hedge against risks and market fluctuations. The classic retort to U.S.-based criticism on the German banking system in recent years is that Germany has never had a savings and loan crisis as in the United States, which required billions of dollars in taxpayer money for a bailout.

Of significant concern for credit institutions and other securities market participants are the costs of the new requirements of the Second Financial Market Promotion Act. The new laws designed to prohibit insider trading, and the Rules of Conduct for dealing with customers, impose additional disclosure and compliance burdens. It remains to be seen if and how the credit institutions and even the stock exchanges themselves can pass on these costs to investors.<sup>375</sup>

The most visible direct costs will come in the form of an account payable to the new Federal Securities Trading Supervisory Authority pursuant to its power to recoup its costs from companies involved in securities activities.<sup>376</sup> The vast majority of securities investment services are performed by credit institutions.<sup>377</sup> These institutions are sub-

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<sup>375</sup> See Gesetzentwurf, *supra* note 7, at 38.

<sup>376</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 11(1)(1).

<sup>377</sup> See Gesetzentwurf, *supra* note 7, at 40 (explaining art. 1, § 5(1) of the Zweites Finanzmarktförderungsgesetz which includes the German Bundesbank and the Federal Banking Su-

sequently assessed seventy-five percent of the Supervisory Authority's costs.<sup>378</sup>

Other less readily quantifiable costs stem from the requirement of section 15 of the Securities Trading Act for the reporting of information that will substantially influence the trading price of a security.<sup>379</sup> Although the scope of exactly what must be disclosed remains unclear, as discussed *infra* Part VI.D, the requirement does not intend to place an undue burden on corporations. Upon application by an issuer of securities, the Federal Securities Trading Supervisory Authority can release that corporation from the disclosure obligation for specific facts if such disclosure would be contrary to legitimate interests of the issuer.<sup>380</sup> In addition, while the draft bill required publication in a national newspaper,<sup>381</sup> a subsequent amendment allows the issuer the option of choosing disclosure by means of an electronic information dissemination system.<sup>382</sup> Not only will electronic disclosure further transparency by increasing the speed of public dissemination of the information, but competition among the new providers of this service should keep costs down.<sup>383</sup>

The most important and least quantifiable changes will stem from the efforts of the credit institutions to comply with the Rules of Conduct. This Article will not address the issue of compliance in great detail, because the issue remains one of speculation while the Federal Securities Trading Supervisory Authority is drafting the guidelines to implement these Rules. At a minimum, however, the traditional credit institutions of Germany will have to take one step further away from a pure notion of a universal banking system. As in the United States, credit institutions will have to establish "Chinese Walls"<sup>384</sup> to divide

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pervisory Authority on the Securities Council to the new Federal Securities Trading Supervisory Authority because of potential issues of banking oversight).

<sup>378</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 11(1)(1); see also Gesetzentwurf, *supra* note 7, at 44 (explaining art. 1, § 11(1)).

<sup>379</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15.

<sup>380</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15(1); see also Gesetzentwurf, *supra* note 7, at 49 (explaining art. 1, § 15(2) of the draft bill of the Zweites Finanzmarktförderungsgesetz, codified within § 15(1)). This provision stems directly from the EU directive. See Insider Directive, *supra* note 129, art. 1; see also *supra* note 141 and accompanying text.

<sup>381</sup> See Gesetzentwurf, *supra* note 7, at 9 (draft bill art. 1, § 15(3) of the Zweites Finanzmarktförderungsgesetz).

<sup>382</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15(3).

<sup>383</sup> By January of 1995, before the reporting requirement had even gone into effect, the Reuters electronic information dissemination service was already advertising its new services to meet these disclosure requirements.

<sup>384</sup> The internal policies and procedures developed by investment service businesses, such as investment banks and retail brokerage houses, for the purpose of restricting the flow of material

their personnel dealing directly with the trading of securities for their own accounts and those providing direct services to customers. The lack of such divisions in the past has led to widespread suspicion outside Germany of insider trading, since there were no formal legal barriers to the dissemination of otherwise nonpublic information within an institution. The new control structures for both the organization and functioning of the credit institutions will both serve to enforce the prohibition of insider trading in Germany and increase the protection of the investors by helping to ensure that the investment service companies are acting in the interests of their customers.

While the prohibition on insider trading based on nonpublic information seeks to prevent individuals from using information about a corporation for personal gain in the markets, a corporation might be concerned about additional abuses of information disclosed publicly as well as that required solely by supervisory authorities. Additionally, individuals may have concerns about their own privacy. The Securities Trading Act has implemented safeguards to prevent these other forms of informational abuse. Due to the nature of its work, the Act extends an obligation over all persons employed by the Authority to maintain confidentially, in particular with business secrets and personal information.<sup>385</sup> Information shared between the German and foreign supervisory authorities may only be used in the oversight of insider prohibitions or in administrative or judicial proceedings.<sup>386</sup> Another provision of the Act limits the storage and use of personal information to investigations of potential insider violations and provides for the deletion of such information once no longer needed.<sup>387</sup>

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nonpublic information from the division of the business in which it originates are colloquially referred to as "Chinese Walls." See HAZEN, *THE LAW OF SECURITIES REGULATION* 407 (2nd ed., 1990). For a discussion of the development of Chinese Walls in the United States and an acceptance of the use of such procedures reflected in caselaw and SEC rules, see *id.* at 406–12.

<sup>385</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 8. The exceptions include passing this information to prosecutors in criminal proceedings. See *id.* Section 18(1) allows the Authority to provide personal information regarding defendants and witnesses to the public prosecutor's office for the purpose of criminal prosecutions and to other regulatory authorities. See *id.* §§ 6, 7, § 8(1) (cooperation with other domestic and foreign authorities). *Id.*

<sup>386</sup> See *id.* § 19(2) (usage by foreign authorities), (3) (usage by the German Federal Securities Trading Supervisory Authority). This provision implements article 10 of the Insider Directive. See Gesetzentwurf, *supra* note 7, at 51 (explaining art. 1, § 19 of the Zweites Finanzmarktförderungsgesetz).

<sup>387</sup> See *id.* § 17.

## B. *Scope of Activity of the Securities Trading Supervisory Authority*

Although the Securities Trading Act appears to have addressed the major concerns of the Insider Directive and the Holdings Disclosure Directive, the adaption of such regulations can prove more difficult in practice. Many concerns remain about the implementation of these rules and of the abilities of the Federal Securities Trading Supervisory Authority to carry out its mandate.

The very establishment of the Authority evidences progress, however, in terms of a strong signal on both national and international levels.<sup>388</sup> The Supervisory Authority has quickly made progress in world recognition. It has already concluded an agreement with its French counterpart to cooperate in the oversight of the futures exchange markets.<sup>389</sup> The greatest sign that the German oversight system has reached international standards was the decision by the United States Commodity Futures Trading Commission ("CFTC") to issue a no-action letter, effectively allowing futures contracts from the German Futures Exchange based upon the DAX market index to be offered and sold in the United States.<sup>390</sup> The following pages will examine the jurisdiction of the new German regulatory authority in contrast to its American counterparts.

### 1. Jurisdiction and Defining "Security"

The Securities Trading Act applies to trading both on and off of the exchanges of securities and derivatives.<sup>391</sup> The Act mandates authority over these transactions to the German Federal Securities Trading Authority. A comparison with the United States reveals the breadth of

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<sup>388</sup> See Gesetzentwurf, *supra* note 7, at 36.

<sup>389</sup> See *Deutschland: Deutsche und Pariser Börsenaufsicht Kooperieren*, REUTER GERMAN NEWS SERVICE, Mar. 28, 1995, available in LEXIS, Nexis Library, Zeitung File. This movement by the regulators parallels the cooperation of the *Deutsche Terminbörse* ("DTB") with the French futures exchange, *Marche a Terme International de France* ("MATIF"), which have been working to link their trading using DTB screens. See Tracy Corrigan, *Quirky Offshoots Gain Respect*, FIN. TIMES, Oct. 20, 1993.

<sup>390</sup> See *Deutsche Terminbörse futures contract based on the Deutscher Aktienindex*, CFTC No-Action Letter, 1994 CFTC Ltr. LEXIS 107 (Dec. 20, 1994). The no-action letter conditioned its approval on the Second Financial Markets Promotion Law taking effect, the establishment of the Federal Securities Trading Supervisory Authority, and confirmation that the Authority would share information with the CFTC; all such conditions have since been met. See *DAX Index Futures Available for U.S. Sale*, 27 Sec. Reg. L. Rep. No. 2, (BNA) 139 (Jan. 20, 1995).

<sup>391</sup> Recall that this Act applies to securities, options, futures, and a range of other financial instruments. See *supra* notes 198–201 and accompanying text.



this mandate in terms of the types of transactions covered. In the United States, securities transactions fall under the jurisdiction of the SEC.<sup>392</sup> Options on securities also fall under SEC oversight.<sup>393</sup> On the other hand, the regulation of other derivatives, including futures transactions, falls under the guise of the CFTC.<sup>394</sup> This division of oversight responsibility was a subject of bitter debate shortly after the establishment of the CFTC in 1974.<sup>395</sup> The division of competence was

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<sup>392</sup>The Securities and Exchange Commission is composed of five Commissioners, appointed by the President upon the advice and consent of the Senate. Securities Exchange Act of 1934, 15 U.S.C. § 78d (1994). Various divisions of the SEC have responsibility for the securities laws' disclosure requirements; oversight of secondary trading markets, including the activities of exchanges and broker-dealers; and for enforcement actions for violations of the securities laws. See JAMES D. COX ET AL., *SECURITIES REGULATIONS: CASES AND MATERIALS* 21 (1991) [hereinafter COX, *SECURITIES REGULATION*].

<sup>393</sup>See COX, *SECURITIES REGULATION*, *supra* note 392, at 1294 (“[O]ptions trading is now (and arguably has always been) the province of the securities markets and hence the securities regulators . . .”). “At least since 1982, the authority of the SEC to regulate options trading and the options markets has been clear: The option contract itself is deemed a separate security.” *Id.* at 1293.

The German law reflects a similar reasoning in the Securities Trading Act by classifying warrants (*Optionsscheine*) under securities. See *supra* note 200. Stock warrants are defined under U.S. law as follows:

Certificates entitling the owner to buy a specified amount of stock at a specified time(s) for a specified price. Such differ from stock options only in that options are generally granted to employees and warrants are sold to the public. Warrants are typically long period options, are freely transferable, and if the underlying shares are listed on a securities exchange, are also publicly traded.

BLACK'S LAW DICTIONARY 1585 (6th ed. 1990).

<sup>394</sup>See COX, *SECURITIES REGULATION*, *supra* note 392, at 1294 (“[T]rading in any form of future is exclusively within the regulatory jurisdiction of the Commodity Futures Trading Commission.”). The CFTC is an independent agency of the United States Government, composed of five Commissioners, appointed by the President upon the advice and consent of the Senate. Commodity Exchange Act, 7 U.S.C. § 2(a)(2)(A) (1994). The jurisdiction of the Commission extends to “contracts of sale of a commodity for future delivery . . .” 7 U.S.C. § 2(a)(1)(A)(i) (1994). In the case of a sale for *future* delivery, the Commission also has jurisdiction over transactions on a board of trade “in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments . . .” *Id.* § 2(a)(1)(A)(ii). The Commission also has authority over futures and options on futures on an index of securities. See *id.* § 2(a)(1)(B)(ii). A futures contract may be defined as follows: “[A] present right to receive at a future date a specific quantity of a given commodity for a fixed price.” BLACK'S LAW DICTIONARY 676 (6th ed. 1990).

<sup>395</sup>See Don L. Horwitz & Jerry W. Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67, 72 (1983) [hereinafter Horwitz, *Sunset*]. The CFTC was established by the 1974 amendments to the Commodities Exchange Act: the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974). See Horwitz, *Sunset*, *supra* at 72 n.36.

resolved in the Shad-Johnson accords,<sup>396</sup> later adopted by Congress,<sup>397</sup> which established the following resolution: SEC jurisdiction would include *options* on securities, "*options* on groups or indexes of securities and *options* on foreign currency traded on securities exchanges . . .";<sup>398</sup> the CFTC would have "jurisdiction over *futures* contracts on exempted securities (other than municipal securities) and on groups of securities or indexes as well as *options on futures* contracts for such indexes."<sup>399</sup> "It was further agreed that futures contracts (or options on futures) for individual corporations and municipal securities would not be permitted, but that the CFTC would have jurisdiction over options on foreign currency traded on commodity exchanges."<sup>400</sup> Unlike the American system, the new German Authority will be responsible for trading in all of the aforementioned contracts.<sup>401</sup>

To some extent, the division in the American system may reflect different priorities of the two U.S. agencies. In large part, the SEC has generally considered its primary mission as one of investor protection, with the assumption that a strong, healthy securities marketplace would follow therefrom. Conversely, the mission of the CFTC has often been seen in terms of maintaining a strong, liquid marketplace, with investor protection largely a means (albeit an important one) to that end.<sup>402</sup>

The German law has approached the question of priorities in a different fashion. Under the German Securities Trading Act, the duties of the German Securities Trading Supervisory Authority are to be exercised exclusively in the public interest.<sup>403</sup> The Authority shall work

<sup>396</sup> At the time, John Shad and Philip Johnson were the chairmen of the SEC and CFTC, respectively. See Horwitz, *Sunset*, *supra* note 395, at 70.

<sup>397</sup> See *id.* at 76.

<sup>398</sup> *Id.* at 73 (emphasis added). SEC jurisdiction also included securities generally exempted from the securities laws, such as Government National Mortgage Association certificates and certificates of deposit. *Id.*

<sup>399</sup> *Id.*

<sup>400</sup> *Id.*

<sup>401</sup> In the context of defining transactions subject to the prohibition on insider trading, the Securities Trading Act describes contracts equivalent to securities (§ 12(1)(1, 2)), options (§ 12(2)(1, 2)), futures contracts including those based on market indices (§ 12(2)(3)), and options on futures (§ 12(2)(4)).

<sup>402</sup> COX, SECURITIES REGULATION, *supra* note 392, at 1294.

<sup>403</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 4. This provision was missing from the draft bill. See Gesetzentwurf, *supra* note 7, at 5 (art. 1, § 4 of the draft bill of the Zweites Finanzmarktförderungsgesetz). The provision was suggested upon review by the finance committee of the Bundestag. *Beschlußempfehlungen und Bericht des Finanzausschusses*, *supra* note 167, at 15 (adding art. 1, § 4(2) to the Zweites Finanzmarktförderungsgesetz). Their reasoning was that the

to mitigate and counteract circumstances that would adversely affect the accomplishment of securities trading or have significant adverse effects upon the securities markets.<sup>404</sup>

This broad jurisdiction would appear to place an impossible burden on the new German Authority, but the amount of oversight necessary is proportional to the size of the markets. Recall that, although growing, the German securities markets are currently less developed than their U.S. counterparts.<sup>405</sup> More importantly, however, the actual financial instruments which are considered "securities" for the purposes of the respective German and U.S. agencies differ dramatically.<sup>406</sup> The German Securities Trading Act defines "securities" to include stock shares, certificates which represent shares, debt instruments, participation certificates, warrants, and other comparable securities and, in general, is meant to include all instruments which can be traded on an organized market such as a stock exchange.<sup>407</sup> In general, this list appears to cover the major financial instruments in the general public conception of securities and the financial markets. The authority of the German Securities Trading Authority and the obligations of market participants under the Act all relate to this definition of security. For instance, the insider trading prohibitions apply to all such defined securities that are listed on a stock exchange or traded in the over-the-counter markets.<sup>408</sup> The various disclosure requirements imposed by the Act likewise revolve around publicly traded securities of these types.<sup>409</sup>

The U.S. securities acts contain a much broader definition of "security."<sup>410</sup>

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collat-

trust of the public investor is necessary for the functional ability of the securities markets, and that this amendment would promote this trust. *See id.* at 190-91 (explanation of amendment).

<sup>404</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 4; *see also supra* note 219 and accompanying text.

<sup>405</sup> *See supra* Part II.C and accompanying notes.

<sup>406</sup> Since "derivatives" merely reflect the values and expectations of their underlying securities, the differences in definitional form between the two countries is much more important for the term "securities."

<sup>407</sup> *See supra* Part V.A. and accompanying notes.

<sup>408</sup> This provision covers not only German markets, but those throughout the EU and the European Free Trade Association, and applies equally to instruments bearing a broad range of rights to the abovementioned securities. *See Wertpapierhandelsgesetz, supra* note 5, § 12.

<sup>409</sup> *See supra* Part V.A.3. and accompanying notes.

<sup>410</sup> The definition of "security" in the Securities Act of 1933 (12 U.S.C. § 77b(1) (1994)) differs

eral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.<sup>411</sup>

Note that this definition includes options, but not futures. Common law has further expanded this definition, most importantly in broadly interpreting the term "investment contract."<sup>412</sup> This contrast reveals that the same statutory reporting obligations for dealing in "German securities" encompass a great deal fewer transactions than those in "U.S. securities." The burdens on the German Authority are thus proportionately lighter than those on their American counterparts.

One might try to explain part of the difference between the scope of instruments covered in that the German Securities Trading Act is drawn more narrowly than its U.S. counterparts. The German Act deals only with the creation of the new Authority, insider trading prohibitions, various reporting requirements and the Rules of Conduct.<sup>413</sup> The broader U.S. securities acts, for example, also contain requirements for registration statements and prospectuses<sup>414</sup> as well as regulations for brokers and dealers,<sup>415</sup> which in Germany are regulated under separate acts.<sup>416</sup> A closer examination, however, reveals the opposite to be the

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slightly from that in the Securities and Exchange Act of 1934 (12 U.S.C. § 78c(a)(10) (1994)). The Supreme Court has held these differences to be immaterial—the two provisions should be treated as virtually identical. *Tcherepnin v. Knight*, 389 U.S. 332, 335 (1967).

<sup>411</sup> 12 U.S.C. § 77(b)(1) (1994).

<sup>412</sup> "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person: (1) invests his money; (2) in a common enterprise; and (3) is led to expect profits; (4) solely from the efforts of the promoter or a third party." *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

<sup>413</sup> See *supra* Part V.A.4 and accompanying notes.

<sup>414</sup> See 15 U.S.C. §§ 77f-77h, 77j-77l (1994).

<sup>415</sup> See, e.g., 15 U.S.C. § 78o (1994).

<sup>416</sup> These functions are regulated respectively under the German Sales Prospectus Act and the Stock Exchange Act. See *supra* Part V.B and accompanying notes.

case: the U.S. definition of “security” is broader in the areas of prevention of deceptive trading practices than in the more specialized areas of registration requirements.<sup>417</sup>

The fact that the German Securities Trading Oversight Authority shall address a smaller range of securities instruments than the SEC need not be construed as a sign of weakness. For the newly created German agency, the tasks ahead are already somewhat daunting—the activities to be supervised include the entire range of registered and over-the-counter securities and derivatives. The ability to accomplish its goals in these areas is much more important at this early stage than an attempt to address trading at the fringes of the markets, particularly in the context of the German desire to raise its capital markets to the highest world standards.<sup>418</sup>

## 2. Mandate: Protecting Investors or the Marketplace?

Now that the scope of activity of the new German Authority has been analyzed, the more important questions of the ability to act within this scope remain. A comparison between the German Authority and its U.S. counterparts in terms of their respective mandates sheds light upon the prospects for enforcement.

Outside of the reference to acting in the public interest,<sup>419</sup> the German Act contains no general reference to the goal of investor protection aside from the provisions regarding the Rules of Conduct, which address the more narrow issue of relations between institutions engaged in securities activities and their customers.<sup>420</sup> This absence is particularly peculiar in that the first draft of the law cited the broadening of investor protection first among its goals.<sup>421</sup> Although increased liquidity and market transparency will strengthen the trust of investors in the German markets, the furthering of these goals are an indirect rather

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<sup>417</sup> Compare 15 U.S.C. §§ 77c, 77d (1994) (securities and transactions exempted from registration) with § 77q(3) (prohibiting fraudulent transactions in securities, including those otherwise exempted from registration under § 77c) and § 78j(b) (prohibiting use of deceptive devices in the purchase or sale of registered or unregistered securities).

<sup>418</sup> See *supra* Part II.A and accompanying notes.

<sup>419</sup> See *supra* note 403 and accompanying text.

<sup>420</sup> For a discussion of the Rules of Conduct, see *supra* Part V.A.4. These sections of the Act apply only to services provided by securities service business—the services must be in the interest of their customers (*im Interesse seiner Kunden*). See Wertpapierhandelsgesetz, *supra* note 5, § 31(1)(1).

<sup>421</sup> See *supra* notes 176 (citing investor protection first in a list of the goals of the Act) and 183 (referring to investor protection as an important part of the state’s duties in establishing a favorable framework for the financial markets) and accompanying texts.

than direct means of protecting the investor. A comparison of the following new changes resulting from the Second Financial Market Promotion Act illustrates this point. One amendment to the German Stock Exchange Act has as its exclusive purpose the *direct* protection of less sophisticated investors: the seller of a commodity futures contract must inform the other side in writing of the special risks in commodity futures activities.<sup>422</sup> A second change promotes transparency, which *indirectly* protects investors. An amendment to the Stock Exchange Admission Regulation requires that information about the underlying securities must be readily available to the German public for securities bearing subscription rights to these underlying instruments to be admitted for trading on an exchange.<sup>423</sup> In other words, if the German public cannot determine the price of the underlying security, then no trading based on this non-transparent instrument shall be allowed. Nonetheless, an unsophisticated investor might still be harmed by buying allowable subscription rights if the investor did not know the risks involved in buying subscription rights in the first place.

The mandate of the German Authority as adopted in the Act sounds more like the marketplace promotion goal of the CFTC<sup>424</sup> than the investor protection goal of the SEC.<sup>425</sup> In light of the circumstances

<sup>422</sup> See *supra* note 330 and accompanying text.

<sup>423</sup> See *supra* note 358 and accompanying text.

<sup>424</sup> References to both the public interest and investor protection are absent from the Commodity Exchange Act. As suggested above, this Act refers largely to the protection of the markets. *E.g.*,

Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an *undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the Commission shall . . .*

7 U.S.C. § 4a(a) (1994) (emphasis added).

<sup>425</sup> Compare the following references in the Securities Exchange Act of 1934: “[The trading of securities on unregistered exchanges shall be unlawful unless] in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate *in the public interest or for the protection of investors* to require such registration.” 15 U.S.C. § 78e (1994) (emphasis added). “[A]n exchange may be registered as a national securities exchange under the terms and conditions. . . [which the Commission] may prescribe as necessary or appropriate *in the public interest or for the protection of investors.*” 15 U.S.C. § 78f(a) (1994) (emphasis added). “[T]he Commission, by rule, *consistent with the public interest, the protection of investors,* and the other purposes of this title, may relieve any self-regulatory organization of any responsibility under this title to enforce compliance. . . .” 15 U.S.C. § 78s(g)(2) (1994) (emphasis added). “[T]he appropriate regulatory agency for a self-regulatory organization is authorized, by order, if in its opinion *such action is necessary or appropriate in the*

surrounding the establishment of the German Federal Securities Trading Supervisory Authority—outside pressure for change and a desire to create a *Finanzplatz Deutschland*, the mission of promoting a strong marketplace appears to more accurately describe the mandate of the new German authority. For example, in the context of the prohibition of insider trading, the government explanation of the draft bill justifies the extension of competence beyond the stock exchanges to include the over-the-counter markets, because the public would not distinguish where the offense occurs.<sup>426</sup> But rather than protecting investors or their expectations, the explanation states that this insider trading prohibition shall help the ability of the securities markets to function.<sup>427</sup> This in turn reflects the purposes of the EU Insider Trading Directive, “promoting investor confidence to the end of smoothly functioning markets.”<sup>428</sup>

The SEC was established in 1934 in response to, and was greatly affected by, the stock market crash of 1929 and the Great Depression.<sup>429</sup> The German reforms, on the other hand, have grown not out of failure, but out of national economic success and a subsequent desire to move further onto the world economic stage. Similarly, the CFTC was established in 1974 in recognition of the growing importance and value of trading in commodity futures contracts. Whether or not the background of the German agency will be reflected in its interpretation of its mandate remains to be seen, but this could have repercussions in the agency’s activities designed for investor protection. One type of fringe question that would balance the two missions would be the proper balance that the Supervisory Authority should insist upon between allowing the introduction of innovative market instruments and providing the proper disclosure for other than the most sophisticated investors to adequately evaluate the new instruments. A further

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*public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title, to suspend. . . or revoke the registration of such [SRO]. . .*” 15 U.S.C. § 78s(h)(1) (1994) (emphasis added); or to expel a member of an SRO, any person associated with a member, or any officer or director of an SRO if “*necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title . . .*” 15 U.S.C. § 78s(h)(2), (3), (4) (1994) (emphasis added) (same provision for each situation).

<sup>426</sup> See Gesetzentwurf, *supra* note 7, at 45 (explaining art. 1, § 12(1) of the Zweites Finanzmarktförderungsgesetz).

<sup>427</sup> See *id.*

<sup>428</sup> See Insider Directive, *supra* note 129, at L 334.

<sup>429</sup> See generally Securities Exchange Act of 1934, 15 U.S.C. § 78b (1994) (“Necessity for Regulation”).

balancing would be required in determining when to prosecute otherwise innovative market participants for violating the Rules of Conduct.

### 3. Rights of Action and Theories of Liability

Intimately tied to this issue of the relative mandates of the different agencies are the rights of action proscribed by the authorizing legislation. The German Federal Securities Trading Supervisory Authority is the competent administrative authority to bring civil actions for violations of the disclosure, reporting, or recordkeeping obligations imposed by the Securities Trading Act.<sup>430</sup> Criminal proceedings for insider trading violations shall be brought by a public prosecutor upon information presented by the Authority.<sup>431</sup> Missing from the trio of litigation possibilities is the right of an independent third party to bring a private claim for Securities Trading Act violations. In fact, the only mention of private rights of action in the Act specifically excludes them for any violation of the duties of disclosure and reporting of price-relevant circumstances.<sup>432</sup> This example reflects a general absence of private rights of action under German law. The U.S. securities laws provide injured parties with multiple individual rights of action, such as for violation of requirements for proper filing and disclosure of information in a sales prospectus.<sup>433</sup> The German Sales Prospectus Act<sup>434</sup> con-

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<sup>430</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 40 (referring to the penalties imposed under § 39).

<sup>431</sup> See *id.* § 18 (referring to the penalties imposed under § 38 for violations of § 14); see also *infra* Part VI.C. for a more detailed discussion of the criminal enforcement procedure.

<sup>432</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 15(6). For a discussion of these requirements, see *supra* Part VI.A.3.

Interestingly, the provision excluding private rights of action was not included in the draft bill. See Gesetzentwurf, *supra* note 7, at 9 (art. 1, § 15 of the draft bill of the Zweites Finanzmarktförderungsgesetz). This provision was added by the finance committee of the Bundestag during the review process. Beschlüßempfehlungen und Bericht des Finanzausschusses, *supra* note 167, Bundestag Drucksache 12/7918, at 32 (adding art. 1, § 15(6) to the draft bill of the Zweites Finanzmarktförderungsgesetz). The final version makes clear that this exclusion does not preclude or limit any rights of action based upon existing legal grounds. See Wertpapierhandelsgesetz, *supra* note 5, § 15(6). The finance committee's explanation for the amendment makes clear that other legal bases for liability of the company remain undisturbed; the alternative would lead to the undesirable effect of singling out companies issuing securities for protection of liability. See Beschlüßempfehlungen und Bericht des Finanzausschusses, *supra* at 199. This leaves unclear what, if any, cause of action might be available for a private party for violation of any of the provisions of the Securities Trading Act.

<sup>433</sup> See section 12 of the Securities Act of 1933. 15 U.S.C. § 771 (1994).

<sup>434</sup> Verkaufprospektgesetz, BGBl. I, 2749 (Dec. 13, 1990), last amended in BGBl. I, 512, 2436 (Apr. 27, 1993). For a discussion of the amendments to this Act in the Second Financial Market



tains no analogous provisions. Likewise, the German Stock Exchange Act<sup>435</sup> provides no private means of redress for investors injured through illegal conduct.

Nonetheless, since the insider trading prohibitions are an entirely new addition to German law, one would expect any private rights of action under these laws to be delineated in the German Securities Trading Act. A comparison with United States law illustrates this point. Under section 16(b) of the Securities Exchange Act of 1934, officers, directors, or large shareholders of a corporation shall be liable to return to the corporation any "short-swing" profits from trading in its securities in a suit brought by the corporation itself or derivatively by its shareholders.<sup>436</sup> Additionally under section 21A, the SEC may bring a civil suit against any person trading in a security based upon non-public information.<sup>437</sup> Section 14(e) makes trading on the basis of nonpublic information illegal in the context of a tender offer.<sup>438</sup> The SEC may refer violations of the securities acts to the Justice Department for criminal prosecution.<sup>439</sup> Under these provisions, the corporation may recover from insiders who traded illegally, the SEC may pursue civil actions, and the Justice Department may bring a criminal action against the insider.

Despite these possible actions, most insider trading suits in the United States arise under a less clear standard. U.S. courts have read an implied private right of action for insider trading into Rule 10b-5,<sup>440</sup> implemented under section 10(b) of the Securities Exchange Act of 1934.<sup>441</sup> In a civil law country such as Germany, a court would not allow a private right of action absent an express statutory provision. Absent

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Promotion Act, see *supra* note 352 and accompanying text. A discussion of the liability of issuers for violation of the provisions of the Sales Prospectus Act is beyond the scope of this Article.

<sup>435</sup> See *supra* Part V.B.

<sup>436</sup> See 15 U.S.C. § 78p(b) (1994) (the time period is defined as "less than six months"). Violation of this provision is subject to strict liability; no abuse of nonpublic information need be shown. See HAZEN, *supra* note 384, at 627 ("in light of its broad remedial purpose, section 16(b) will require disgorgement of insider short-swing profits even in the absence of any wrongdoing.")

<sup>437</sup> See 15 U.S.C. § 78u-1(a)(1) (§ 21A(a)(1) of the Securities Exchange Act of 1934 (1994); § 21A is entitled "Civil Penalties for Insider Trading"). "The amount of the penalty which may be imposed on the person who committed such violation shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purpose, sale, or communication." 15 U.S.C. § 78u-1(a)(2) (1994).

<sup>438</sup> See 15 U.S.C. 78n(e) (1994); see also Rule 14e-3, codified at 17 C.F.R. § 240.14e-3 (1994).

<sup>439</sup> See COX, SECURITIES REGULATION, *supra* note 392, at 858.

<sup>440</sup> See Rule 10b-5, codified at 17 C.F.R. § 240.10b-5 (1994).

<sup>441</sup> 15 U.S.C. § 78j(b) (1994); see VAGTS, BASIC CORPORATION LAW, *supra* note 342, at 563.

this implied right, a U.S. investor might still have a private right of action under section 20A of the Securities Exchange Act of 1934, which provides:

Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.<sup>442</sup>

Over the past six decades since the passage of the Securities Act of 1933<sup>443</sup> and the Securities Exchange Act of 1934,<sup>444</sup> the U.S. common law system has expanded the prohibitions against insider trading in other areas beyond the implied right of action. The most important has been the development of different “theories”<sup>445</sup> of liability when the potential violation does not fit clearly under a category proscribed by statute. A current example of common law evolution and the potential breadth of judge-made law can be seen in recent decisions involving the “misappropriation theory” of liability.<sup>446</sup> This theory has been adopted by the Second,<sup>447</sup> Seventh,<sup>448</sup> and Ninth<sup>449</sup> Circuit Courts of Appeals and defined as follows: “Under this theory, a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction.”<sup>450</sup>

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<sup>442</sup> 15 U.S.C. § 78t-1(a) (1994) (“Private Rights of Action Based on Contemporaneous Trading”).

<sup>443</sup> 15 U.S.C. §§ 77a-77z (1994).

<sup>444</sup> 15 U.S.C. §§ 78a-78ll (1994).

<sup>445</sup> In addition to the misappropriation theory, discussed *infra*, consider the “fraud on the market theory” which imposes liability on persons who attempt to influence market prices through disclosures of misleading information and benefit from the price changes by concurrently trading. See HAZEN, *supra* note 384, at 733-35.

<sup>446</sup> Background on the common law development of insider trading provisions and a discussion of the misappropriation theory may be found in HAZEN, *supra* note 384, at 735-48.

<sup>447</sup> *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

<sup>448</sup> *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992).

<sup>449</sup> *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

<sup>450</sup> *United States v. Chestman*, 947 F.2d 551, 556, *cited in United States v. Rebrook*, 58 F.3d 961, 965 (1995), *cert. denied*, 1995 U.S. LEXIS 7525 (1995).

The new German insider trading prohibitions appear to encompass the misappropriation theory of liability. Persons in “a fiduciary duty or similar relationship of trust and confidence” would fall under the German definition of “insider.”<sup>451</sup> The new German Securities Trading Act then places a blanket prohibition on trading by insiders based upon nonpublic information.<sup>452</sup> In the United States, however, this notion of misappropriation establishes a crucial link for the enforcement of insider trading prohibitions. U.S. legislation has not defined the terms “insider”<sup>453</sup> or “insider trading”<sup>454</sup> and common law has not completely filled the gap—the U.S. Supreme Court has not decided the issue of who is an insider.<sup>455</sup> Therefore, the misappropriation theory acts as a functional definition of who shall be subject to insider trading prohibitions, based upon common law fiduciary notions rather than a more narrow delineation of categories of persons.<sup>456</sup>

Nonetheless, the misappropriation theory has still only been accepted by some of the Circuit Courts. Although the Supreme Court has skirted the issue, it has not decided the validity of this theory;<sup>457</sup> as such, the misappropriation theory remains good law in those Circuits which have adopted it.<sup>458</sup> The lack of Supreme Court guidance, however, also leaves other Circuit Courts free to reject the misappropriation theory. This is exactly what happened in the last major disposition of this issue. The Fourth Circuit Court of Appeals rejected in its entirety the misappropriation theory adopted by its sister circuits.<sup>459</sup>

<sup>451</sup> See *supra* note 212 and accompanying text.

<sup>452</sup> See *supra* Part V.A.1.

<sup>453</sup> Consider § 16 of the '34 Act: rather than defining the term insider to be applicable throughout the Securities Exchange Act, this section prohibits certain persons, “beneficial owner, director, or officer” from retaining short swing profits. 15 U.S.C. § 78p(b) (1994). Even this group is much smaller than that defined as insiders under the German Act.

<sup>454</sup> Congress has considered the possibility of defining improper trading on inside information as trading while in possession of material, nonpublic information. See HAZEN, *supra* note 384, at 748. This would have been very close to the current German definition. See *supra* Part V.A.1. Congress apparently decided not to narrow the definition legislatively in favor of leaving the guidelines to the courts; the legislative history of this discussion also suggests an endorsement of the misappropriation theory. See HAZEN, *supra*, at 748.

<sup>455</sup> See HAZEN, *supra* note 384, at 744. Case law has established, however, that insider status shall extend to persons with fiduciary duties, such as attorneys, accountants, and financial advisors. *Id.*

<sup>456</sup> Once again, compare the categories of persons delineated under § 16. See *supra* note 453.

<sup>457</sup> *United States v. Rebrook*, 58 F.3d 961, 965 n.3 (1995), *cert. denied*, 1995 U.S. LEXIS 7525 (1995); HAZEN, *supra* note 384, at 742.

<sup>458</sup> See HAZEN, *supra* note 384, at 742.

<sup>459</sup> *United States v. Rebrook*, 58 F.3d 961, 966 (1995), *cert. denied*, 1995 U.S. LEXIS 7525 (1995) (reiterating its decision in a recent prior slip opinion).

The court interpreted section 10(b) of the Securities and Exchange Act<sup>460</sup> to require an essential element of deception beyond the breach of fiduciary duty punishable under the misappropriation theory.<sup>461</sup> The Fourth Circuit could find no authority for the misappropriation theory and concluded that the theory was irreconcilable with Supreme Court precedent.<sup>462</sup> The Supreme Court denied certiorari.<sup>463</sup>

Since there is a clear division among the Circuit Courts on this issue, it is likely that the Supreme Court will decide whether or not to adopt the misappropriation theory in a future case. If it were to reject the theory, this would weaken the ability of the SEC to prosecute persons for trading based upon nonpublic information, since this theory does serve as an expansion of liability based on fiduciary or confidential relationships. Nonetheless, this is only one small aspect of the many enforcement mechanisms available to the SEC and private persons discussed throughout this Article which allow for the prosecution of insider trading violations in the United States.

In the context of the German reforms, however, a rejection of the misappropriation theory by the United States Supreme Court would affect the relative powers of the German Securities Trading Supervisory Authority in comparison with the United States counterparts which have served as a model for the German Authority. Within its jurisdiction, the German authority would have *more direct authority* than the U.S. authorities to prosecute primary insiders<sup>464</sup> for trading violations. The rationale behind this analysis is that the German system imposes strict liability for illegal trading, as does section 16(b) of the U.S. Securities and Exchange Act.<sup>465</sup> If Rule 10b-5 always requires a showing of scienter or deception as formulated by the Fourth Circuit, rather than implying false motives to all trading by persons with a fiduciary relationship, the standard for punishing insider trading in the United States under this provision would be stricter than the new standards in effect in Germany. Prosecutors would be forced to prove the additional element of deceit as well as the trading and nonpublic information elements common to both systems. Although somewhat speculative, this last point shows the benefits of a clear definition of "insider" and

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<sup>460</sup> 15 U.S.C. § 78j(b) (1994).

<sup>461</sup> *Rebrook*, 58 F.3d at 966.

<sup>462</sup> *Id.*

<sup>463</sup> *United States v. Rebrook*, 58 F.3d 961 (1995), *cert. denied*, 1995 U.S. LEXIS 7525 (1995).

<sup>464</sup> Ambiguity in the ability of the German Authority to prosecute third persons in possession of nonpublic information is discussed *infra* Part VI.C.

<sup>465</sup> *See supra* note 436.

a clear delineation of the duties imposed upon such persons. In this respect, Germany has succeeded in establishing a clear and visible sign of its commitment to combatting insider trading.

A comparison of the German and U.S. regimes for the prohibition of insider trading reveals two primary differences. There is no German counterpart to section 16(b), which allows the corporation to recover profits from its insiders, whether or not they traded on nonpublic information. This law serves as a prophylactic against abuse of information by insiders. The more important distinction, however, is the absence of any private right of action for victims of insider trading to sue for the pecuniary damages they suffered. This difference makes the German Authority appear more interested in the protection of the markets than in the investors themselves. The German prohibition on insider trading clearly promotes the interests of investors as a whole by discouraging illegal trading practices. Although this reduces the chances of an investor getting hurt, once an individual investor has been hurt by such illegal insider trading the Securities Trading Act provides no mechanism for the innocent investor to recover damages.<sup>466</sup> Since the effectiveness of the prohibition of insider trading in Germany will depend upon civil and criminal enforcement proceedings, the following Part of this Article delves more deeply into that process.

### C. *Enforcing the Insider Trading Prohibition; Third Parties and the Knowledge Requirement*

Although the German Securities Trading Act has implemented the EU Insider Directive in its entirety, the key to enforcement is ongoing supervision.<sup>467</sup> The new Authority has the competence and power to pursue investigations and require market participants and issuers to submit documentation of their actions.<sup>468</sup> Nonetheless, the effectiveness of the German prohibitions will depend upon the exercise of these enforcement powers. While the most egregious forms of abuse of insider information will presumably be caught and punished—e.g., the president of a company selling stock the day before the announcement of poor earnings—intuition suggests that the largest part of the abuse

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<sup>466</sup> Once again, this Article does not intend to say that other legal means for recovery, such as a possible fraud claim, are unavailable, but merely that the very existence of any private right of action for damages caused by insider trading remains unclear at best.

<sup>467</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 16(1).

<sup>468</sup> See *id.* § 16.

of nonpublic information is much more subtle. The deeper issue of the liability of “tippees” remains (a tippee is a person who has received a “tip” about nonpublic information). As stated earlier, the Insider Directive and the implementing German Act impose liability on a comprehensive range of persons defined as insiders, as well as upon third parties who trade based upon knowledge of inside information.<sup>469</sup>

### 1. Third Parties

The prohibition of trading by third parties who have knowledge of nonpublic information was not altered from the draft bill through the final codification of the Securities Trading Act.<sup>470</sup> The text of the Securities Trading Act makes no distinction as to the direct source of the information—for instance, whether someone defined as an “insider” had informed the third person directly, or if the information had been passed along through a number of persons before it reached the third person at issue. Therefore, the text appears to impose liability upon persons trading upon knowledge of nonpublic information, regardless of their tippee “generation.”<sup>471</sup>

Nonetheless, during the legislative review process, the Bundesrat expressed concern over whether or not this same provision of the Securities Trading Act also prohibits third persons from passing on the nonpublic information with a recommendation to purchase or sell. Neither an insider nor a third party may trade on behalf of another person,<sup>472</sup> but, in addition, the Act specifically prohibits insiders from passing on such information<sup>473</sup> or recommending that others buy or sell.<sup>474</sup> The Bundesrat could find no apparent reason to tolerate a third

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<sup>469</sup> See *supra* notes 146–48, 214 and accompanying texts (discussing the relevant provisions in the Insider Directive and the German Act, respectively).

<sup>470</sup> Compare Gesetzentwurf, *supra* note 7, at 8–9 (art. 1, § 14(2) of the Zweites Finanzmarktförderungsgesetz) with Wertpapierhandelsgesetz, *supra* note 5, § 14(2) (“*Einem Dritten, der Kenntnis von einer Insider Tatsache hat, ist es verboten, unter Ausnutzung dieser Kenntnis Insiderpapiere für eigene oder fremde Rechnung oder für einen anderen zu erwerben oder zu veräußern.*”) This may be translated as follows: A third person, who has knowledge of inside information, is forbidden to take advantage of this knowledge to acquire or dispose of insider securities for one’s own account, on behalf of another, or for another person.

<sup>471</sup> “The way the S.E.C. counts such generations is that anyone told by an insider who had legitimate access to the information of a pending takeover is a first-generation tippee. Anyone that person tells is a second-generation tippee. And so on.” Floyd Norris, *The Labyrinth of 2 Insider Cases*, N.Y. TIMES, Mar. 8, 1995, at D1.

<sup>472</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 14(1) (insider), 14(2) (third person).

<sup>473</sup> *Id.* § 14(2).

<sup>474</sup> *Id.* § 14(3).

person's passing of inside information; the Bundesrat characterized this discrepancy as a significant loophole.<sup>475</sup> Upon consideration of this comment, the federal government merely answered that it would in further legislative proceedings determine whether in balancing all points of view it is important to also forbid third persons from passing on inside information and a buy or sell recommendation.<sup>476</sup> The legislative history makes no further mention of this issue, which has been left unresolved, as no changes were made to this section in the final version of the Securities Trading Act.

One could assume from the context of the insider trading prohibition that third persons in possession of inside information should be prohibited from passing this information to others. Otherwise, it would seem odd that outsiders could be held liable for trading upon information that it is neither illegal for them to pass on nor for them to have received from another outsider.

Even if successive generations of tippees were liable under German law, as generations of tippees pass along the nonpublic information, the chain becomes much more difficult to trace, and these persons ultimately become more difficult to prosecute based upon these connections. Moreover, while the German Federal Securities Trading Supervisory Authority has broad powers to obtain information from credit institutions and other securities trading institutions already subject to reporting obligations,<sup>477</sup> the Authority has less ability to request information from issuers and persons in possession of nonpublic information,<sup>478</sup> and perhaps even less control over third persons and subsequent generations of tippees.<sup>479</sup>

Since insider trading prohibitions rely on the threat of punishment to deter such practices, the amount of insider trading should be in-

<sup>475</sup> Stellungnahme des Bundesrates, *supra* note 165, (explanation (*Begründung*) accompanying comment no. 2, to art. 1, § 14(2) of the Zweites Finanzmarktförderungsgesetz), *reprinted in* Gesetzentwurf, *supra* note 7, at 94.

<sup>476</sup> *Gegenäußerung der Bundesregierung*, *supra* note 166, *reprinted in* Gesetzentwurf, *supra* note 7, at 101 (response to Bundesrat comment no. 2, to art. 1, § 14(2) of the Zweites Finanzmarktförderungsgesetz) (“Die Bundesregierung wird im weiteren Gesetzgebungsverfahren prüfen, ob es unter Abwägung aller Gesichtspunkte notwendig ist, auch Dritten die Weitergabe einer Insider Tatsache und die Veräußerungs- oder Erwerbsempfehlung zu verbieten.”).

<sup>477</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 16(2), (3). For a discussion of the transactions reporting requirements, see *supra* notes 232–48 and accompanying text.

<sup>478</sup> See Gesetzentwurf, *supra* note 7, at 50 (explaining art. 1, § 16(4) of the Zweites Finanzmarktförderungsgesetz).

<sup>479</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 16(5). For example, individuals must be informed of their right to refuse to provide incriminating information. *Id.* § 16(6).

versely proportional to the product of the severity of the punishment and the threat of being caught. For example, if the punishment were merely to return any illegal profits and the chance of getting caught were only one out of ten, then the expected return based upon the illegal trading would be ninety percent of any change in the value of the securities when the information becomes public.<sup>480</sup> When the deterrence measures include possible imprisonment,<sup>481</sup> the attractiveness of insider trading falls precipitously.<sup>482</sup> While statutes detail maximum punishments for insider trading in Germany, the actual punishments imposed within these limits remain to be seen. Assuming a significant punishment, deterrence still depends upon the probability of getting caught, which in turn, depends upon both the ability and desire of the Federal Securities Trading Supervisory Authority to pursue investigations of suspected violators. Only time will reveal the success of the new authority, but the following example from the United States shows the size of the tasks ahead.

A recent investigation by the SEC illustrates how seriously authorities in the United States consider the mandate to prosecute third parties knowingly trading on nonpublic information. The events that created

<sup>480</sup> Consider the following basic statistical formula:

$$\text{Expected value of insider trading} = (\text{change in value of stock}) - (\text{the probability of getting caught}) \times (\text{fine for insider trading}).$$

Adapting this formula to the above scenario, and assuming that the change in the value of the stock purchased by the insider between the time of the trading and the public dissemination of the stock equals \$1000, yields the following result:

$$E[\textit{insider trading}] = \$1000 - (0.10) \times (\$1000) = \$900.$$

Therefore, the insider can expect to reap \$900 from such a trade. The individual insider may subjectively value this benefit at less than \$900, because the "costs" of getting caught may exceed the mere fine. These costs may include the expenses of defending a lawsuit, the possibility of losing one's job, emotional distress, or even future losses resulting from social or professional ostracization. The values of these additional variables depend upon the individual's risk aversion.

Note also that the potential gain (i.e., in this case, the \$1000) reflects the accuracy and relevance of the nonpublic information, which the insider can normally assess.

<sup>481</sup> Recall that punishment under the German law may include up to five years in prison. See *supra* note 215 and accompanying text.

<sup>482</sup> In terms of the formula mentioned, at *supra* note 480, once again the potential "cost" of imprisonment depends upon an individual's risk aversion beyond more quantifiable measures such as lost income. For example, someone might abhor the notion of going to prison so much that he would theoretically pay \$10,000,000 to avoid that fate. Assuming the other factors of the above example with a punishment of repaying the gain and a certain prison term, the illegal trade would have a value of negative \$999,000 to that individual, calculated as follows:

$$E[\textit{insider trading}] = \$1000 - (0.10) \times (\$10,000,000) = \$-999,000.$$



the nonpublic information were two entirely unrelated takeover attempts of two entirely unrelated companies, back in 1990. The SEC eventually uncovered the passage of nonpublic information through chains of friends, relatives, neighbors, and coworkers and filed both criminal and civil charges.<sup>483</sup>

In the Norton Company takeover, ten individuals have been charged in insider trading along nine generations of tippees. In the other case, which involved the takeover of Motel 6, a total of twenty-nine people were accused of insider trading, comprising seven generations of tippees.<sup>484</sup> A remarkable factor links the two cases: "Although there is no evidence that [the original insiders] had ever heard of each other, or even that they had common friends, the information eventually came to some of the same people. And in the process it traveled across the country and to Europe quite rapidly."<sup>485</sup> Of those involved in the illegal trading in both cases, persons as far down the chain as fifth generation in one case and sixth or seventh generation in the other have pleaded guilty to criminal charges. On the civil side, no complaints have been settled beyond a third generation tippee in one of the cases.<sup>486</sup>

The insider who leaked the nonpublic information on the Norton takeover was Christopher M. Garvey, then a paralegal for the law firm of Skadden, Arps, Slate, Meagher & Flom, which represented an unsuccessful bidder in the takeover battle.<sup>487</sup> "He is said to have gotten a total of \$7,000 out of tips on a series of deals. He was sentenced to three years' probation and community service."<sup>488</sup> Although not an "insider" in the sense of an employee of Norton, German law would nevertheless deem Garvey liable as an insider, by virtue of the fact that he gained knowledge of nonpublic information through duties of his occupation.<sup>489</sup> If convicted in a German criminal trial, he would be punished either by up to five years imprisonment and/or by the imposition of a fine.<sup>490</sup>

<sup>483</sup> See Norris, *Labyrinth*, *supra* note 471, at D1, D8.

<sup>484</sup> See *id.* at D1.

<sup>485</sup> See *id.* at D8.

<sup>486</sup> See Patrick J. Lyons, *Winding Trails of Insider Tips*, N.Y. TIMES, Mar. 8, 1995, at D1 (diagram accompanying Norris, *Labyrinth*, *supra* note 471, at D1).

<sup>487</sup> Norris, *Labyrinth*, *supra* note 471, at D8.

<sup>488</sup> *Id.*

<sup>489</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 13(1)(3); see also *supra* notes 146–48, 214 and accompanying texts (discussing the relevant provisions in the Insider Directive and the German Act, respectively).

<sup>490</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 38(1); see also *supra* note 215 and accompanying text.

The Motel 6 case poses a more difficult situation for regulators. The SEC claims that the insider was Hugh Thrasher, a former vice president of Motel 6.<sup>491</sup> The difficulty stems from the fact that Thrasher did not trade on this information himself, but allegedly passed the nonpublic information to a friend.<sup>492</sup> Moreover, the friend and alleged "first link" in the seven tippee generation chain, passed away before a resolution of Thrasher's disclosure.<sup>493</sup> If Thrasher had conveyed this information, or had recommended that his friend trade in the securities, or had traded on behalf of his friend, these actions would violate both German and U.S. laws.<sup>494</sup> While primary and secondary insiders or third person tippees may be subject to the same maximum punishments for violations,<sup>495</sup> the standards for successful prosecution of the tippees of someone such as Thrasher are less clear under German law.

## 2. The Knowledge and Execution Requirements

In addition to ambiguities in the liability and prosecution of third persons, a further unknown factor in the German prohibition of insider trading is the existence of a requirement that the trader have actual knowledge that the information was nonpublic. In the United States, "the courts have indicated that to violate the law a trader must not only have inside information, he or she must also know it came from someone who was violating a duty not to disclose it."<sup>496</sup> The German law, in contrast, prohibits trading by a third party upon insider information, but contains no analogous requirement that the third party know of the illegality of the disclosure.<sup>497</sup> But if one were unaware of the source of the information, how could one assess its value? Although a third party might seek to avoid liability by not asking for the original source of the information, a lack of verification would

<sup>491</sup> Norris, *Labyrinth*, *supra* note 471, at D8.

<sup>492</sup> *See id.* ("His lawyer maintains that he did not intentionally release the information, but might have let something out inadvertently.")

<sup>493</sup> *See id.*

<sup>494</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 14(1); *see also supra* notes 146–48, 214 and accompanying texts (discussing the relevant provisions in the Insider Directive and the German act, respectively).

<sup>495</sup> *See* Gesetzentwurf, *supra* note 7, at 52 (explaining art. 1, § 31(1) of the draft bill, codified at art. 1, § 38(1) of the Zweites Finanzmarktförderungsgesetz).

<sup>496</sup> Norris, *Labyrinth*, *supra* note 471, at D1.

<sup>497</sup> *See Wertpapierhandelsgesetz, supra* note 5, § 14(2) ("Einem Dritten, der Kenntnis von einer Insideratsache hat, ist es verboten, unter Ausnutzung dieser Kenntnis Insiderpapiere für eigene oder fremde Rechnung . . . zu erwerben . . .").

undermine the value of the information, leaving the third party with little more than a market rumor.<sup>498</sup>

One would expect early investigations of the German Federal Securities Trading Supervisory Authority to focus upon trading by actual insiders, whose identities are more readily verifiable. As the Motel 6 case shows, the links among generations of tippees may move farther and farther away from the source. Especially in the case where the insiders themselves have been cleared of any wrongdoing in trading, it may not prove to be worth the costs to follow leads that involve possible information leaks to third parties. Although enforcement agencies must show their commitments to enforce the laws,<sup>499</sup> they also must make choices in the allocation of scarce resources. The reliance upon other agencies further complicates the matter—once the Supervisory Authority has garnered evidence to support its suspicions of insider trading, it notifies the responsible public prosecutor's office.<sup>500</sup> Necessarily, the prosecutor's office must then independently weigh the merits of pursuing criminal charges; a willingness to prosecute will affect the overall deterrence of the insider trading prohibitions.

The experience and reputation of the new German agency will only be built over time, but the decision over the status of generations of tippees under the Securities Trading Act is extremely important in terms of the overall effectiveness of the prohibition on insider trading. Even without trading by the insider, the sums of money involved can be substantial: "All told, the S.E.C. says total insider trading profits of \$7 million were realized from information that came from Mr. Thrasher."<sup>501</sup> This discussion has shown the problems of enforcing the

<sup>498</sup> "It would seem that a tippee of the third or fourth generation ought to simply not ask where the information came from. But that flies against the desire to know just how solid the information is before investing on it." Norris, *Labyrinth*, *supra* note 471, at D1.

<sup>499</sup> See, e.g., Norris, *Labyrinth*, *supra* note 471, at D1 (Robert Blackburn, the deputy director of the SEC commission's New York regional office stated in reference to the nine generations of tippees charged in the two cases, "It is indicative of the commitment the agency has to see it through." *Id.*).

<sup>500</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 18(1). The Securities Trading Supervisory Authority monitors trading for suspicious activities. Upon suspicion, the Authority begins its own internal investigation up until there is broad evidence or knowledge of wrongdoing. At that point, the competence of the Authority has ended. The department of public prosecution will then investigate. When the department of Public Prosecution is also confident of the merits of the action, it will bring a charge in the courts. From that point the Authority shall only function as an information provider, although the Authority must be informed of any criminal indictments and the outcomes of all proceedings, under § 18(2) of the Act. Ultimately, only independent courts can impose criminal punishment. Dreyling Interview, *supra* note 222.

<sup>501</sup> See Norris, *Labyrinth*, *supra* note 471, at D8.

prohibition of insider trading against those who traded on the non-public information, and against insiders such as Thrasher who passed on such information; the possibility of punishment of third persons for passing on the nonpublic information remains unclear.

The final issue concerns attempted insider trading—should someone be punished if their efforts to use nonpublic information to their benefit were unsuccessful. This issue was raised by the Bundesrat in its review of the draft bill. In fact, the Bundesrat suggested amending the section detailing the criminal punishments for insider trading to say that in the case of an attempt by an insider or a third person to trade on nonpublic information, such attempt shall be punishable.<sup>502</sup> The federal government rejected this amendment as unnecessary in light of the other prohibitions against an insider on passing on the inside information or recommending trading to others.<sup>503</sup> Once again the legislative history makes no further mention of this issue, which has been left unresolved since no changes have been made to this section in the final version of the Securities Trading Act. Even if one were to agree with the federal government that the prohibition against an insider passing on nonpublic information acts as an inchoate prohibition, the issue discussed earlier of the legality of a third person passing on information remains unresolved.

#### D. *What “Price Relevant Circumstances” Must Be Disclosed?—Defining Materiality in Practice*

In attempting to define nonpublic information in terms of who is an insider, the government explanation of the draft bill says that when made public, the information should “materially influence” (“*erheblich beeinflussen*”) the value of the security.<sup>504</sup> As examples of material influence, the government lists a reduction of capital, conclusion of a controlling agreement or profit transfer agreement, as well as important discoveries or contractual agreements.<sup>505</sup> To answer the question of whether information might materially influence the value of the security, the

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<sup>502</sup> Stellungnahme des Bundesrates, *supra* note 165, (explanation (*Begründung*) proposing comment no. 6, to art. 1, § 31(1a) of the draft bill, codification rejected for art. 1, § 38(1a) of the Zweites Finanzmarktförderungsgesetz), *reprinted in* Gesetzentwurf, *supra* note 7, at 95.

<sup>503</sup> *Gegenäußerung der Bundesregierung*, *supra* note 166, *reprinted in* Gesetzentwurf, *supra* note 7, at 102 (response to Bundesrat comment no. 6, to art. 1, § 31(1a) of the draft bill of the Zweites Finanzmarktförderungsgesetz).

<sup>504</sup> See Gesetzentwurf, *supra* note 7, at 46 (explaining art. 1, § 13(1) of the Zweites Finanzmarktförderungsgesetz).

<sup>505</sup> See *id.*

issuer must draw upon previous experience, and possibly the advice of the underwriting credit institution or other experts on the capital markets.<sup>506</sup> Knowledge of what need not be disclosed helps a little; since the provision requires only the disclosure of nonpublic information, reports by the business press or news agencies release the corporation from a disclosure requirement.<sup>507</sup>

Fortunately for the Germans, the learning process has already begun. The first test for the Federal Securities Trading Supervisory Authority occurred in only its second week of existence. On January 8, 1995, the London Sunday Times reported speculation about an impending joint venture between the German firm VIAG and British Telecom.<sup>508</sup> The VIAG stock price on the German exchanges rose two percent the following day, following an upwards drift in previous trading sessions.<sup>509</sup> That night, Monday, the directors of both companies approved the joint venture. Pursuant to section 15 of the Securities Trading Act,<sup>510</sup> on Tuesday morning at seven a.m., VIAG reported this agreement as a “price-relevant circumstance” to the Federal Securities Trading Supervisory Authority and the stock exchanges, followed by a public announcement through a Reuters electronic information dissemination service.<sup>511</sup> The Supervisory Authority began an immediate investigation to see whether the disclosure met the new standards.<sup>512</sup>

This example shows that a relatively simple concept—encouraging early disclosure of circumstances with the potential for abuse by insiders—yields geometrically growing ambiguities and questions when translating the concept into practice. For example, although *prima facie* VIAG followed the correct procedures for disclosure, what about the company’s timing? Should disclosure only be made after final approval of a project? It would be nonsensical and overly burdensome for companies to reply to each and every rumor. This example of ambiguity in the proper timing for disclosure is just one small aspect of the

<sup>506</sup> See *id.* at 48 (explaining art. 1, § 15(1)).

<sup>507</sup> See *id.* The only caveat is that these reports have to set forth actual happenstances rather than mere presumptions or rumors. *Id.*

<sup>508</sup> See *British Telecom und VIAG an einem Strang*, SÜDDEUTSCHE ZEITUNG, Jan. 10, 1995, available in LEXIS, Nexis Library, Zeitung File.

<sup>509</sup> See *id.*

<sup>510</sup> See *supra* note 232 and accompanying text.

<sup>511</sup> *Das Aufsichtsamt prüft VIAG-Veröffentlichung*, SÜDDEUTSCHE ZEITUNG, Jan. 13, 1995, available in LEXIS, Nexis Library, Zeitung File. The actual public report by VIAG may also be found in this LEXIS file. *Deutschland: Ad Hoc-Mitteilung der VIAG AG*, REUTER GERMAN NEWS SERVICE, Jan. 10, 1995.

<sup>512</sup> See *Das Aufsichtsamt prüft VIAG-Veröffentlichung*, *supra* note 511.

central problem of defining a price-relevant circumstance. While an infinite number of facts can influence the valuation of a stock by an individual investor, each company must choose the most relevant non-public facts to disclose.

The one thing that appears clear is that the company will only be responsible to disclose circumstances about the company itself. For example, a company will not be required to disclose the fact that political unrest in major oil producing countries may raise world energy prices, thereby lowering profit projections. In contrast, the signing of an exclusive contract to receive inputs from a country in political turmoil may merit disclosure.

The supporting body of the Frankfurt stock exchange<sup>513</sup> has attempted to resolve some of the statutory ambiguity for public companies in a publication addressing the disclosure requirements.<sup>514</sup> This guide discusses the Securities Trading Act and the legal consequences of the Act.<sup>515</sup> Although the exchange specifically notes that listing all circumstances requiring disclosure would be impossible, the publication does provide a few examples, such as a change in the rate of dividends or an unfavorable decision in a product liability suit.<sup>516</sup> Yet even these examples are too general to be of much help: the former circumstance would most likely be disclosed under prior custom, while the latter raises questions about contingent liabilities. Neither of these examples resolve the question in VIAG of the proper moment in time for disclosure.

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<sup>513</sup> See *supra* note 119 and accompanying text; see also DEUTSCHE BÖRSE AG, 1993 DEUTSCHE BÖRSEN: ANNUAL REPORT 28 (1994). "Shareholders are those banks and [brokers] who are trading on the stock exchange. A stake of 10% is owned by the regional stock exchanges. Ownership is evidenced by registered shares which are transferable only with the company's consent." DEUTSCHE BÖRSE AG, ORGANISATION AND FUNCTION 9 (Mar. 1994).

<sup>514</sup> DEUTSCHE BÖRSE AG, INSIDERHANDELSVERBOTE UND AD HOC-PUBLIZITÄT NACH DEM WERTPAPIERHANDELSGESETZ (Oct. 1994). Although this guide does not have any official status in the sense of a government law or regulation, it has been agreed upon by all eight German stock exchanges, see *supra* Part II.C.1, and the respective national associations for all the major banking groups as well as the national associations of German industry, of retailers, of wholesalers and foreign traders, and of insurers. See INSIDERHANDELSVERBOTE UND AD HOC-PUBLIZITÄT at 4 ("Forward" to the guide). Since the membership of these organizations would appear to encompass all of the major market players affected by the new laws, one would expect industry-wide compliance with this guide.

<sup>515</sup> Compare the "New York Stock Exchange Listed Company Manual," which sets forth guidelines for public corporations, including examples of proper timing for allowable insider transactions in relation to public disclosure of material information. See HAZEN, *supra* note 384, at 750-51.

<sup>516</sup> See HAZEN, *supra* note 384, at 26-27.

As a test case, the VIAG situation gave the Supervisory Authority a chance to flex its muscles and show that it was serious about its mandate, while the case also provided a test run for the reporting and investigation process. More importantly, the public announcements of the Supervisory Authority regarding its investigation, now contribute precedent useful in interpreting the disclosure requirements. A little over a month after the investigation began, President Wittich of the Supervisory Authority reported that VIAG had not breached the reporting requirements.<sup>517</sup>

Public corporations and persons dealing in securities in the United States must also determine which nonpublic facts are price-relevant and, therefore, subject to disclosure under the U.S. securities laws.<sup>518</sup> In the United States, this discussion falls under the issue of “materiality.”<sup>519</sup> U.S. courts have partially resolved the ambiguity in this term through decades of caselaw.<sup>520</sup> Although a common law system of this type is largely foreign to a civil law country such as Germany, the Germans have properly recognized that relevancy or materiality are questions of experience. For now, the question of whether an individual circumstance is subject to disclosure is a matter for independent inquiry by the management of the company. The question of whether to disclose falls to management based on the rationale that a company’s management can best estimate the probable market reaction to such disclosure.<sup>521</sup>

Other, more specific, examples of how the managements of individual companies have interpreted the reporting requirement have already come in a deluge. By January of 1995, just four weeks into its

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<sup>517</sup> See *Wertpapieraufsichtsamt: VIAG verstieß nicht gegen Bestimmungen*, SÜDDEUTSCHE ZEITUNG, Feb, 18, 1995, available in LEXIS, Nexis Library, Zeitng File.

<sup>518</sup> See, e.g., 15 U.S.C. §§ 78l(b)(1)(I) (disclosure of “material contracts” in registration statements); § 78m(d)(2) (1994) (requiring amendments for any “material change” in earlier statements filed with the SEC).

<sup>519</sup> The SEC has defined material in Rule 12b-2: “The term ‘material,’ when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.” 17 C.F.R. § 240.12b-2 (1995). Unfortunately, this definition is not much more illuminating than the German request for “price-relevant circumstances.” Something that an investor would attach importance to in determining a buy or sell price is necessarily price relevant. The big difference in the American definition is the “reasonable investor” standard: this is an invitation to the courts to define what is material through common law in general and through a trial in a specific case.

<sup>520</sup> For a general discussion of the issue of materiality under the U.S. securities laws as addressed by the courts, see HAZEN, *supra* note 384, at 487–93.

<sup>521</sup> See Wittich, *supra* note 220.

existence, the Supervisory Authority had already received over 100 reports of material information.<sup>522</sup> For the first eleven months of 1995 over 1300 such reports have been made.<sup>523</sup> Public discussion of the reporting requirements is a positive sign, but further refinements will come only through the collective experience of the Supervisory Authority and market participants.<sup>524</sup> Although the Supervisory Authority has found that public companies have in general been observing the duty to disclose material nonpublic information, the greatest criticism from the agency is that the reports have been overly detailed and cumbersome.<sup>525</sup> In addition, the Supervisory Authority has freed ten companies from the disclosure obligations.<sup>526</sup>

Including the VIAG case discussed above, the German Federal Securities Trading Supervisory Authority had publicly disclosed a total of fifteen cases in the first nine months of 1995 in which it had investigated suspected insider trading violations.<sup>527</sup> There has been only one case in which someone has been prosecuted and found guilty of insider trading. That case involved a sixty-two year old official exchange broker on the Frankfurt Stock Exchange named Heinz Schwake.<sup>528</sup> He was accused of having made illegal trades in the name of his daughter, buying stock and then selling the same minutes later at a higher price.<sup>529</sup> This was a riskless transaction, because he only entered the trades into his order book later on, when executing a series of orders placed before him at the exchange.<sup>530</sup> He was suspended from his position on October 16, 1995, by the Ministry of Economics of the *Länd* Hessen, under whose jurisdiction the Frankfurt exchange falls.<sup>531</sup>

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<sup>522</sup> *See id.*

<sup>523</sup> *See Deutsche Börsenaufseher mit ihrer Zusammenarbeit zufrieden*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 1, 1995, at 32.

<sup>524</sup> *See id.*

<sup>525</sup> *See Wertpapieraufsichts meldet 15 Insider-Verdachtsfälle*, FRANKFURTER ALLGEMEINE ZEITUNG, Oct. 14, 1995, at 23 (statement by Vice President George Dreyling) [hereinafter *Insider-Verdachtsfälle*]. The Vice President stated that the transmission of whole reports is in no way necessary to conform to the law. *See id.*

<sup>526</sup> *See id.* The majority of these cases involved corporate reorganizations. Vice President Dreyling stated that keeping a corporate reorganization secret may be in the best interest of investors if the purpose of the reorganization is to keep the company in business. *See id.*

<sup>527</sup> *See id.*

<sup>528</sup> *See Kursmakler bleiben im Visier der Aufsicht*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 2, 1995, at 16 [hereinafter *Kursmakler Aufsicht*].

<sup>529</sup> *See Der Frankfurter Börse droht ein Insiderskandal*, FRANKFURTER ALLGEMEINE ZEITUNG, Oct. 27, 1995, at 19.

<sup>530</sup> *See id.*

<sup>531</sup> *See id.*



The Frankfurt public prosecutor began an investigation into suspected counts of insider trading, fraud, and false trading declarations.<sup>532</sup> The investigation was broadened by the public prosecutor to include five banks as well as multiple exchange brokers and traders.<sup>533</sup> After a criminal trial, Schwake was found guilty of twelve forbidden trades carried on for a third person over the period of January to July 1995, with profits ranging between 1,300 and 13,000 DM per trade.<sup>534</sup> The court established a one year probation period and required him to immediately pay 150,000 DM to a charitable organization, while reserving the right to impose a total criminal fine of 540,000 DM.<sup>535</sup> The whole process from his suspension from work through the criminal decision took only six weeks.<sup>536</sup> The Supervisory Authority viewed this decision as having set the wheels into motion and is currently examining trades by exchange brokers more closely.<sup>537</sup>

### E. *The Changing Nature of Oversight*

Part II.F of this Article provided a basic sketch of the oversight of financial markets in Germany. The Second Financial Market Promotion Act has significantly reformed this oversight system.<sup>538</sup> Since many of these reforms bestow government agencies with additional supervisory jurisdiction, concern has been expressed over whether this increased oversight may lead to redundant or overlapping functions.

This concern is especially poignant in Germany due to the universal banking system. These banks operate in traditional credit, securities, and investment service functions, thereby subjecting them to the oversight of both the German Federal Banking and Securities Trading Supervisory Authorities. Both new and increased disclosure requirements will impose a greater burden upon these market participants, which will be passed along to their customers in terms of higher prices. The ultimate costs of complying with these regulations will be a factor in the competitiveness of *Finanzplatz Deutschland*, which makes the regulatory burden of concern to the politicians as well as investors.

<sup>532</sup> See *id.*

<sup>533</sup> See *Ermittlungen wegen illegaler Börsengeschäfte*, FRANKFURTER ALLGEMEINE ZEITUNG, Oct. 31, 1995, at 19.

<sup>534</sup> See *Kursmakler Aufsicht*, *supra* note 528, at 16.

<sup>535</sup> See *id.*

<sup>536</sup> Mr. Schwake was suspended on October 16, 1995, and the report of the criminal decision appeared in the paper on December 2, 1995.

<sup>537</sup> See *Kursmakler Aufsicht*, *supra* note 528, at 16.

<sup>538</sup> See *supra* Parts V.A.2, V.B.

This Part will discuss the new system and the division of competence between the various supervisory authorities.

### 1. One Goal of Securities Oversight—Three Entities

Although the Securities Trading Act establishes a new federal authority to oversee securities trading activity, the draft bill of the Second Financial Market Promotion Act clearly states that the responsibility of the *Länder* for supervision of the stock exchanges remains undisturbed.<sup>539</sup> In addition, the amendments to the Stock Exchange Act establish a new Trading Control Board (“TCB”) to oversee activity from within the stock exchanges themselves.<sup>540</sup> At first glance, these provisions appear to create three agencies with overlapping authority. One might compare this to the system in the United States, where the states and the federal government often independently regulate the same securities trading activity.<sup>541</sup> As such, the state securities oversight agencies often form a redundant level of supervision below the SEC on the national level.<sup>542</sup> The SEC and the state authorities work together to try to minimize the costs to both the regulators and the regulated industry.<sup>543</sup>

A closer examination, however, reveals that the oversight activities of the three German entities complement rather than compound one another. The government specifically meant to preclude any overlap of competence between the federal Authority and the individual authorities of the *Länder*.<sup>544</sup> At the *Länd* level, the movement has actually been

<sup>539</sup> See Gesetzentwurf, *supra* note 7, at 39 (art. 1, § 1 of the Zweites Finanzmarktförderungsgesetz).

<sup>540</sup> See *supra* notes 272–79 and accompanying text.

<sup>541</sup> All 50 states have their own securities laws, generally referred to as “blue sky” legislation, the first examples of which preceded federal regulation in this area. See HAZEN, *supra* note 384, at 328. The federal securities laws specifically allow for continued state regulation. See 15 U.S.C. §§ 77r, 78a (1994).

<sup>542</sup> The most important case where state securities laws would provide an exclusive rather than redundant level of oversight is when the securities are exempted from federal registration as “part of an issue offered and sold only to persons resident within a single State . . . .” 15 U.S.C. § 77c (1994). In general, the state blue sky laws have a broad range of provisions, including securities registration and disclosure requirements, broker-dealer registration, and investment advisor regulations. See generally, HAZEN, *supra* note 384, at 328–45. Compare, e.g., 15 U.S.C. §§ 77f, 78l (1994) (federal registration requirements); § 77g (required disclosure in registration statement), § 78m (periodical and other reports); and § 78o (registration of brokers and dealers).

<sup>543</sup> See 15 U.S.C. § 77s(C) (1994) (authorizing SEC cooperation with state level counterparts).

<sup>544</sup> See Gesetzentwurf, *supra* note 7, at 40; see also *id.* at 59 (explaining art. 2, § no. 1 of the Zweites Finanzmarktförderungsgesetz amending § 1(3) of the Börsengesetz) (Fundamentally, there cannot be an overlap of competence with the Federal Securities Trading Supervisory Authority, which only must fulfill the duties listed in the Securities Trading Act.).

towards consolidation, with the previously independent State Commissioner's Office<sup>545</sup> now a part of the *Länd* Stock Exchange Supervisory Authority.<sup>546</sup> The duties of the *Länder* Stock Exchange Supervisory Authorities derive from the Stock Exchange Act and have been expanded by the Securities Trading Act. The duties of the newly established Federal Securities Trading Supervisory Authority, on the other hand, stem solely from the Securities Trading Act.<sup>547</sup> The competences of the Federal Authority are entirely new: supervision of insider activities; oversight of reporting duties; disclosure of securities turnover and holdings in exchange-listed companies; and international cooperation in securities oversight.<sup>548</sup> The *Länder* authorities, on the other hand, are responsible for supervision of stock exchange trading, over the trading participants, and over the electronic systems of the stock exchanges for establishing sales contracts (but excluding settlement systems).<sup>549</sup>

The third level of oversight by the newly established TCB at each stock exchange will concern the specific issues necessary for trading business. These duties include the oversight of price determination and trading volume, standing control over trading practices, observation of the trading of the *Kursmakler* for their own accounts, comparison of prices with other exchanges and trading systems (including price differentials due to the interaction of stock and futures exchanges), and the upholding of order on the exchange floor.<sup>550</sup> The TCB was established within the exchanges themselves to oversee trading, independent of the other exchange functions and decisionmaking. This does not in any way limit or interfere with the supervisory jurisdiction of governmental agencies. In fact, the government characterizes the existing structure as one establishing a "four-eyes-principle" for the area of stock exchange supervision.<sup>551</sup>

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<sup>545</sup> See *supra* note 120 and accompanying text.

<sup>546</sup> See Gesetzentwurf, *supra* note 7, at 59 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, amending § 1(3) of the Börsengesetz).

<sup>547</sup> See Gesetzentwurf, *supra* note 7, at 40 (explaining art. 1, § 4 of the Zweites Finanzmarktförderungsgesetz).

<sup>548</sup> See *id.*

<sup>549</sup> See Gesetzentwurf, *supra* note 7, at 59 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, amending § 1 of the Börsengesetz).

<sup>550</sup> See Gesetzentwurf, *supra* note 7, at 60 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, creating § 1b of the Börsengesetz).

<sup>551</sup> See Gesetzentwurf, *supra* note 7, at 60 (explaining art. 2, no. 1 of the Zweites Finanzmarktförderungsgesetz, creating § 1b of the Börsengesetz). The "four-eyes-principle" stands for the requirement that at least two individuals must be responsible for making important decisions

Separate competences should not prevent the federal and *Länder* authorities from cooperating with one another as foreseen by the drafters of the Act.<sup>552</sup> For example, in urgent circumstances that involve the prohibition of insider trading on the exchanges themselves, the authorities of the *Länder* may act under transferred administrative authority (*Organleihe*) from the federal Authority.<sup>553</sup> Similarly, although the TCB has investigatory powers, similar to that of the *Länder* authorities, an individual *Länd* authority may assume a particular investigation begun by the TCB within its jurisdiction if the authority so desires.<sup>554</sup> In the international context, the competences have also been divided. For example, the federal Authority serves as the representative of Germany in international cooperation measures, even in cases where the supervisory activity falls under the jurisdiction of the *Länder* authorities. The federal Authority acts as the sole representative in international negotiations, because most countries do not have such a division between the supervision of securities trading and stock exchange activities.<sup>555</sup> Overall, this complementary system represents a vital political compromise between the federal and *Länder* governments for the common goal of enhancing the international competitiveness of *Finanzplatz Deutschland*.<sup>556</sup>

The early cooperation between the three entities overseeing securities activities in Germany appears to have been successful. After eleven months of working experience, in a joint statement made before the Frankfurt Chamber of Commerce, the respective heads of the new

within a company; i.e., all four eyes must have approved the matter. This principle has come into use in the EU as a result of directives requiring the implementation of this principle. See, e.g., Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field, 1988 O.J. (L 147) art. 3(3) ("The direction of a firm's business must be decided by at least two persons meeting the above conditions [for an investment firm to receive authorization to carry on investment business.]").

<sup>552</sup> See Wertpapierhandelsgesetz, *supra* note 5, § 6(2).

<sup>553</sup> See *id.* This lending of administrative authority is a constitutionally permissible organizational form, whereby the federal Authority could operate with stock exchanges through existing *Länder* authorities. See Gesetzentwurf, *supra* note 7, at 41 (explaining art. 1, § 6(2) of the Zweites Finanzmarktförderungsgesetz). The procedure for such transfer shall be resolved in an agreement between the respective authorities. See Wertpapierhandelsgesetz, *supra* note 5, § 6(2).

<sup>554</sup> See *supra* note 274 and accompanying text.

<sup>555</sup> See Gesetzentwurf, *supra* note 7, at 42 (explaining art. 1, § 7(1) of the Zweites Finanzmarktförderungsgesetz). The exception is that the *Länder* authorities shall represent themselves in cooperation with foreign entities regarding specific provisions of the Stock Exchange Act and Sales Prospectus Act. *Id.*

<sup>556</sup> *Gegenäußerung der Bundesregierung*, no. 1 (general comments on the draft bill), *supra* note 166, reprinted in Gesetzentwurf, *supra* note 7, at 101.

Securities Trading Supervisory Authority, the State Commissioner's Office for the *Länd* Hessen, and the TCB of the Frankfurt Exchanges opined that the three level system of oversight had proved itself.<sup>557</sup> Commissioner Zemmler dismissed as ungrounded suggestions that the oversight restrained trading.<sup>558</sup> President Wittich of the Supervisory Authority noted the importance of his agency as a contact for foreign counterparts and believed the agency's work had increased the attractiveness of the Frankfurt stock exchanges.<sup>559</sup> This progress included increased transparency as a result of the reporting requirements and successful investigations of insider trading violations.<sup>560</sup> These early assessments bode well for Germany and its attempts to enhance *Finanzplatz Deutschland*.

## 2. Allocation of Oversight Between the Federal Securities Trading Supervisory Authority and the Federal Banking Supervisory Authority

Although the above-mentioned questions remain as to the ability of the German Federal Securities Trading Supervisory Authority to carry out its mandates, the general scope of those mandates in terms of discouraging insider trading and promoting market transparency and investor protection are relatively clear. Less clear, however, is the effect of the Second Financial Market Promotion Act on the competences of the Federal Banking Supervisory Authority. At first glance, the competences of the two agencies appear to overlap, since the securities market participants regulated by the former and the credit institutions overseen by latter, actually constitute the same institutions in a universal banking system.

The German regulatory system is less complicated than the American system both in terms of the number of regulators and in the scope of their activities. The system of regulation of financial institutions in the United States varies, based upon either the institution itself, the activities performed by the institution, or both. A characterization of the activities of the German system as overlapping illustrates an evaluation based upon one aspect of the American background—regulatory

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<sup>557</sup> See *Deutsche Börsenaufseher mit ihrer Zusammenarbeit zufrieden*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 1, 1995, at 32 [hereinafter *Börsenaufseher zufrieden*] (President Georg Wittich, Commissioner Regina Zemmler, and Deutsche Börse AG TCB Leader August Schäfer, respectively).

<sup>558</sup> *Id.*

<sup>559</sup> See *id.*

<sup>560</sup> See *id.*

division in the financial markets based upon a classification of credit institutions. In the United States, different types of commercial banks require operating licenses from different regulators, such as the Federal Reserve Board,<sup>561</sup> the Office of the Comptroller of the Currency,<sup>562</sup> and the individual state regulators.<sup>563</sup> In the United States, a single institution may not provide both commercial (deposit-taking and lending) and investment banking (underwriting, placing securities) functions.<sup>564</sup> Securities activities, on the other hand, are governed more by function than by type of institution, on both the state and federal levels. This is reflected by the test for whether or not the securities laws apply—the question of whether the financial instrument falls under the definition of a security.<sup>565</sup> Yet that test only reflects some aspects of

<sup>561</sup> The Board of Governors of the Federal Reserve System is responsible for the oversight of bank holding companies (12 U.S.C. § 1842 (1994)), state “member banks” (§§ 321–324), and national banks which are also required to be members of the Federal Reserve System (§ 222).

<sup>562</sup> The OCC charters national banks. 12 U.S.C. § 11 (1994).

<sup>563</sup> See, e.g., N.Y. BANKING LAW § 10 (Consol. 1994) (declaration of policy that state banks shall be regulated by the New York State Banking Department).

<sup>564</sup> The most important limitation stems from the Glass-Steagall Act, which essentially prohibits a mixture of commercial and investment banking functions:

The business of dealing in securities and stock by [a national banking association] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issues of securities or stock. . . . Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation . . . .

12 U.S.C. § 24 (Seventh) (1994). The premier exception which allows subsidiaries of Federal Reserve member banks to engage in securities trading functions stems from an interpretation of the Board of Governors of the Federal Reserve System. Order Approving Application to Engage in Commercial Paper Placement to a Limited Extent, 73 Fed. Res. Bull. 138 (Feb. 1987). Since the order interprets § 20 of the Glass-Steagall Act (12 U.S.C. § 377 (1994)), these daughter operations are generally referred to as “Section 20 subsidiaries.”

Section 20 prohibits member banks from being affiliated “with any corporation, association, business, trust or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . .” 12 U.S.C. § 377 (1994). The Federal Reserve Board interpreted this provision as a question of the degree of the connection to the securities activities rather than an outright ban on affiliation. In approving the application of Bankers Trust to establish an indirect subsidiary involved in the placement of commercial paper, the Board adopted a proper measure for the term “engaged principally”: the bank’s gross revenue derived from the affiliate’s securities activities as a percentage of total gross revenue. In this case, the Board approved the indirect subsidiary which was projected to provide not more than 5% of the total gross revenue of Bankers Trust. See Order Approving Application to Engage in Commercial Paper Placement to a Limited Extent, 73 Fed. Res. Bull. 138 (Feb. 1987).

<sup>565</sup> See *supra* Part VI.B.1 (discussing the definition of “security” and division of authority between the SEC and CFTC).

SEC jurisdiction, not to mention the CFTC and state regulators. The regulation of insurance activities could be characterized both as functional and institutional, but this is entirely within the competence of the individual states.

The regulation of financial activities under the German system, on the other hand, divides regulatory duties based upon the type of activity rather than based upon the charter of the institution. In Germany, all credit institutions generically referred to as universal banks require an operating license from the Federal Banking Supervisory Authority.<sup>566</sup> In the future, the German Federal Banking Authority will also most likely be responsible for chartering an oversight of other types of non-traditional financial institutions. Hence, the sphere left to the new securities oversight authority deals with the securities activities themselves. Section 2(4) of the Securities Trading Act defines businesses engaged in securities activities to include certain credit institutions defined in the Banking Act, as well as other businesses admitted to trading on a German exchange. The connection between these credit institutions and other businesses is that they all render securities services.

The draft bill of the Second Financial Market Promotion Act itself states that it would be senseless to attempt to allocate duties in the oversight of securities trading between the German banking and Securities Trading Oversight agencies in terms of individual transactions, because of the different goals of banking and securities oversight.<sup>567</sup> The two agencies might view a single transaction entirely differently in terms of their mandates. For example, in the case of an underwriting of a new security by a universal bank, the banking authority may wish to protect the bank from excessive risk of carrying unsold securities on the bank's balance sheet; such a situation would provide the bank a large market risk in one security. On the other hand, the securities trading authority may focus on whether all of the proper disclosures regarding the security have been made. These interests do not overlap despite the fact that they refer to the same underlying transaction. Furthermore, although securities activities such as underwriting may begin with banks in Germany, the securities oversight activities of the new Authority extend far beyond the circle of the credit institutions, such as to public corporations and investors.<sup>568</sup>

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<sup>566</sup> Gesetz über das Kreditwesen § 32, BGBl. I, 1082 (June 30, 1993), last amended in BGBl. I, 3210 (Oct. 28, 1994).

<sup>567</sup> See Gesetzentwurf, *supra* note 7, at 35.

<sup>568</sup> See Gesetzentwurf, *supra* note 7, at 36.

The goal of creating converging, but not entirely overlapping, interests of the multiple financial oversight agencies in Germany is reflected in the provision of the Securities Trading Act that provides for cooperation of the Federal Securities Trading Supervisory Authority with the Federal Banking Supervisory Authority, the Federal Insurance Supervisory Authority, and the *Länder* Stock Exchange Supervisory Authorities.<sup>569</sup> The draft bill merely provided for cooperation in the form of sharing observations and determinations deemed helpful in the fulfillment of the agencies' individual duties.<sup>570</sup> The federal government believed that close cooperation would be important, because of the underlying, to some extent institutional, ties between the different types of financial service institutions and the growing importance of securities trading.<sup>571</sup> The finance committee of the Bundestag amended this provision to add the cooperation of the German Bundesbank to the extent that it was already cooperating with the Federal Banking Supervisory Authority.<sup>572</sup> The committee reasoned that the new Federal Securities Trading Supervisory Authority would address issues important to the Bundesbank in terms of the latter's bank oversight and monetary policy functions.<sup>573</sup>

This proposal for cooperation recognizes the overlapping actors and issues involved in the regulation of financial institutions, but also respects the fact that each agency has its own sphere of exclusive authority to supervise and to act. The Second Financial Market Promotion Act amendments to existing German laws have sent a signal that the oversight of securities trading shall be regarded as equally significant to other areas of the financial services sector.<sup>574</sup> The most fruitful cooperation between these agencies will most likely concern the exchange of information, which will help eliminate a redundancy

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<sup>569</sup> Wertpapierhandelsgesetz, *supra* note 5, § 6(3).

<sup>570</sup> See Gesetzentwurf, *supra* note 7, at 6 (art. 1, § 6(3) of the Zweites Finanzmarktförderungsgesetz).

<sup>571</sup> See *id.* at 41.

<sup>572</sup> See Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 17 (amending art. 1, § 6(3) of the draft bill of the Zweites Finanzmarktförderungsgesetz). Similar cooperation between the Banking Authority and the Bundesbank regarding the exchange of information derives from the German Banking Act. Gesetz über das Kreditwesen, § 7.

<sup>573</sup> See Beschlußempfehlungen und Bericht des Finanzausschusses, *supra* note 167, at 192.

<sup>574</sup> See *id.* at 270 (explaining the addition of art. 8b of the draft bill (Beschlußempfehlungen, at 157), codified at art. 13 of the Zweites Finanzmarktförderungsgesetz). This provision amends the *Bundesbesoldungsgesetzes*, the federal act for the remuneration of public officials, to include the President of the Federal Securities Trading Supervisory Authority. See Zweites Finanzmarktförderungsgesetz, *supra* note 3, art. 13.



of research and data processing and thereby allow a greater allocation of resources for other agency specific supervisory functions.

## VII. THE ONGOING PROCESS OF REFORM IN GERMANY

Despite the changes that have already occurred in the German marketplace, one area of consensus in Germany is that the reform movements are far from over. Public officials are well aware that further steps need to be taken to realize the concept of *Finanzplatz Deutschland*.<sup>575</sup>

### A. *The Third Financial Markets Promotion Act*

From the legislative side, there are more aspects of the EU Council directive on investment services in the securities field<sup>576</sup> which remain to be implemented into German law.<sup>577</sup> The broad purpose of this directive is to ensure mutual recognition throughout the EU Member States of an authorization from the home country for a credit institute or securities firm to provide investment services. To realize this goal, the Member States must also follow an authorization process based upon common criteria and create a prudential system of consolidated oversight for firms in their home country.<sup>578</sup> This directive requires Member States to adopt the necessary laws for implementation by July 1, 1995, and for these provisions to enter into effect no later than December 31, 1995.<sup>579</sup> Other related EU provisions to ensure the liquidity of financial institutions through capital requirements<sup>580</sup> must still be fully implemented into German law.

Since the German universal banks provide both commercial banking and investment banking as well as other investment services such as brokerage functions, the issue of an authorization to carry on investment business falls under the jurisdiction of the German Federal Banking Supervisory Authority.<sup>581</sup> These directives will be implemented

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<sup>575</sup> See, e.g., Gert Haller, *Verlorene Geschäfte verringern Liquidität und Attraktivität*, ZEITSCHRIFT FÜR DAS GESAMTE KREDITWESEN [KREDITWESEN] 9 (1995) (This article by the assistant secretary of the German Federal Ministry of Finance is part of a series of essays entitled "*Finanzplatz Deutschland: welche Wünsche sind noch offen?*").

<sup>576</sup> Council Directive 93/22 of 10 May 1993 on Investment Services in the Securities Field (*Wertpapierdienstleistungsrichtlinie*), 1993 O.J. (L 141).

<sup>577</sup> See Haller, *supra* note 575, at 9-12.

<sup>578</sup> See *id.*

<sup>579</sup> Council Directive 93/22, *supra* note 576, art. 31, at L 145.

<sup>580</sup> Council Directive 93/6 of Mar. 15, 1993 on the Capital Adequacy of Investments Firms and Credit Institutions (*Kapitaladäquanrichtlinie*), 1993 O.J. (L 141) 1.

<sup>581</sup> See *supra* note 267 and accompanying text.

primarily through a broad amendment and reenactment of the German Banking Act.<sup>582</sup> To this end, the German Federal Banking Authority and the German Federal Ministry of Finance have composed internal drafts of the amendments of the Banking Act. In addition to the thorough amendment and reenactment of the Banking Act, the final bill is expected to emerge in the form of a consolidated act, which will include numerous provisions to harmonize related banking and financial laws. This bill will also provide the first opportunity to amend the Securities Trading Act, including for the purpose of addressing deficiencies. As such, this coming piece of legislation is viewed as a successor to the Second Financial Market Promotion Act discussed in this Article and will most likely be commonly referred to as the *Third* Financial Market Promotion Act.<sup>583</sup> Before these changes go into effect, they must pass through all the stages of the legislative history of the Second Financial Market Promotion Act.<sup>584</sup> An optimistic view would place the draft bill before the German Parliament in the summer of 1996, with the laws as adopted entering into effect no earlier than January 1, 1997. As in the case of the Second Financial Market Promotion Act with the implementation of the Insider Directive, Germany has once again fallen behind the deadline set by the EU. Debate may begin over this future Act before the Federal Securities Trading Supervisory Authority has implemented all the guidelines required by the provisions of the Second Financial Markets Promotion Act discussed in this Article.

### B. *The Small Stock Corporation Act (Kleine Aktiengesellschaft-Gesetz)*

Even these far-reaching changes are only part of the ongoing reform movement in the German financial markets. For example, while the Securities Trading Act will promote transparency in publicly traded stock, it does not address the underlying liquidity problem in Germany—there are few public stock corporations in the first place. Of the over 500,000 public companies in Germany, the vast majority are private limited liability companies (*Gesellschaft mit beschränkter Haftung* (“*GmbH*”)); of the three thousand companies that are public stock corporations (*Aktiengesellschaft* (“*AG*”)) and limited partnerships (*Kom-*

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<sup>582</sup> Gesetz über das Kreditwesen, BGBl. I, 1082 (June 30, 1993), last amended in BGBl. I, 3210 (Oct. 28, 1994) (Fifth Act for the Amendment of the Banking Act and Other Regulations Regarding Credit Institutions) (full effective date Dec. 31, 1995). The draft amendments are commonly referred to as the Sixth Reenactment of the Banking Act (6. *KWG-Novelle*).

<sup>583</sup> For a description of the “first” Financial Market Promotion Act, see *supra* note 3.

<sup>584</sup> See *supra* Part IV.B.

*manditgesellschaft* (“KG”)), the stocks of barely a third are listed on the German stock exchanges.<sup>585</sup> Furthermore, less than a hundred German stocks are actively traded. This liquidity concern must be considered not just for individual stocks, but in terms of the entire market. Sophisticated investors require diverse investments to lower portfolio risk. In summary, the German markets need both more stock listings and more active trading of listed stocks.

Another German law passed in 1994, the Small Stock Corporation Act,<sup>586</sup> attempts to address one aspect of the liquidity problem by making equity financing more attractive to German businesses. The Act simplifies the process for small corporations to go public through selling equity stakes. More specifically, the Act “deregulates some of the more rigid provisions concerning formation, shareholders’ meetings, and employees’ co-determination,”<sup>587</sup> and changes the requirements for announcement of shareholder meetings.<sup>588</sup> Establishment of a corporation under this act is also easier: “Whereas under the old law formation required the participation of at least five shareholders, a single shareholder may now form a stock corporation.”<sup>589</sup>

Additionally, an important provision in the context of the reforms discussed in this Article lessens the burdens of public companies in raising more capital through sales of equity. Under the old law, the right of subscription (*Bezugsrecht*) required that current shareholders have the option to subscribe to new offers before a public offering, unless they waived the option. The new law allows the corporation to issue directly to the public if the offering price is not substantially less than the current stock exchange quotation and the new shares increase the corporation’s stock capital by no more than ten percent.<sup>590</sup>

A potential increase in the number of public stock corporations and the resulting increase in stock trading could strengthen the German exchanges and move Germany one step further in promoting *Finanzplatz Deutschland*.<sup>591</sup> Experts estimate on average that there are 2000 German companies, many of them still held by the founding family,

<sup>585</sup> See Detlef Burhoff, *Die kleine Aktiengesellschaft*, NEUE WIRTSCHAFTS-BRIEFE [NWB], Fach 18, 3349 (Aug. 29, 1994).

<sup>586</sup> Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts [*kleine AG*], BGBl. I, 1961 (Aug. 2, 1994).

<sup>587</sup> *Regional Developments: Germany*, 29 INT’L LAW. 228, 228 (1995).

<sup>588</sup> See *id.*

<sup>589</sup> *Id.*

<sup>590</sup> See *id.*

<sup>591</sup> See Burhoff, *Die kleine Aktiengesellschaft*, *supra* note 585, at 3349–50.

which are well suited to go public by selling shares.<sup>592</sup> But this potential remains to be realized. 1995 has been considered a banner year with twenty new issuances of securities worth a combined seven billion DM.<sup>593</sup> Up to this point, it remains unclear whether the Act will increase the number of companies going public or even listing on an exchange. In this context, one must recall that the obstacles facing the growth in the securities markets and underlying reliance on equity financing stem from the traditional cultural norms of debt and internal financing as well as the regulatory structure of the financial markets.

### VIII. CONCLUSION

The above reforms have certainly moved Germany toward the goal of increasing the attractiveness of the German financial markets. Although the ultimate goal of *Finanzplatz Deutschland* has yet to be reached, the enactment of the Second Financial Market Promotion Act was a giant leap forward that raised the oversight of securities trading activities in Germany to world standards. Global competition among the world-class financial markets for investment shall be left for the market participants to decide. One of the best aspects of these reforms is that they do indeed open the German markets up to global competition; hopefully these competitive forces will continue to provide pressure for progress. The real test of these reforms will be in the markets themselves, which have yet to fully digest the effects of the changes.

The reforms of the Second Financial Market Promotion Act attempt to remove the incentive for companies to list stock abroad which helped drive Daimler-Benz to the New York Stock Exchange.<sup>594</sup> By one measure, Germany appears to have been successful—Daimler-Benz remains the only German company directly listed on the New York Stock Exchange.<sup>595</sup> In this context, the German reforms look less like

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<sup>592</sup> Brun-Hagen Hennerkes, *Familienunternehmen und Börse*, FRANKFURTER ALLGEMEINE ZEITUNG, Dec. 4, 1995, at B4.

<sup>593</sup> See Uwe Lill, *Spren und WeizenTest bestanden*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 13, 1995, at 15. The reason for this upswing in new public issues has to do with the privatization of the German government telephone monopoly. In 1996, the first Telekom issue alone in Germany will be for approximately 15 billion DM. So the smaller issuers rushed to get their stock sold, so that tight pockets or even disinterest in the face of the larger Telekom offering would not hamper their sales. See *id.*

<sup>594</sup> See *supra* notes 126–28 and accompanying text.

<sup>595</sup> *Das Interesse deutscher Unternehmen an ADR-Programmen steigt*, FRANKFURTER ALLGEMEINE ZEITUNG, Oct. 20, 1995, at 30. This by no means translates into a total absence of German corporations from the American equities markets. Instead, other German corporations have

a move to “catch up” with the standards developed in the United States. Rather, the German reforms may be viewed as an attempt to make already strong financial markets more competitive with the best in the world.

At the very least, this Analysis has shown the existence of regulations and structures providing for reforms ranging from the liberalization of the Stock Exchange Act to the allowance of trading in financial futures and now commodities futures, to the development of a three tier securities and exchange oversight system. In the private sector, the effects of these reforms have already been felt, particularly in the context of the Rules of Conduct, where the market participants have begun to institute the internal safeguards necessary to protect their customers. Reform, however, requires more than a change in the regulatory or functional framework; true reform requires an acceptance and implementation of these changes, embodied in the behavior and way of thinking of market participants. In the case of insider trading, this Article has shown the importance not only of creating a statutory prohibition, but also of combining the ability to implement this prohibition and a willingness to enforce it.<sup>596</sup>

Only the future will reveal the success of these measures, but the mood in Germany has been optimistic. Broad consensus called for reform to further the clear goal of promoting *Finanzplatz Deutschland*. The German society is known for its adherence to rule and order. The experience surrounding the financial reforms has been positive; the Germans have both adopted the very strict laws and will follow them.

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preferred to raise capital in the U.S. markets in the form of American Depositary Receipts (“ADRs”)—a total of 16 German companies in 21 ADR offerings by late 1994. *See id.*

<sup>596</sup> *See supra* Part VI.B.2.