COMMENT

West German Bank Secrecy: A Barrier to SEC Insider-Trading Investigations

Some investors use foreign bank secrecy to shield illicit transactions in United States securities from SEC scrutiny. Using West German bank secrecy as an example, this Comment explores the SEC's cooperative and compulsory investigative alternatives. The Comment argues for requiring investors who trade through foreign intermediaries to expressly waive their secrecy rights before trading in United States securities. The Comment suggests that adopting express waiver along with specified procedural safeguards would increase the effectiveness of SEC investigations. At the same time, this proposal accords greater respect to legitimate foreign interests in bank secrecy than do the SEC's investigative alternatives.

INTRODUCTION

The Federal Republic of Germany[1] is one of several countries that maintain bank secrecy.[2] West German law requires banks and their

---

[1] Hereafter referred to as "Federal Republic" or "West Germany."

[2] More than 20% of all nations provide for bank secrecy. Meier, *Banking Secrecy in Swiss and International Taxation*, 7 INT'L LAW. 16, 16 (1973). This shields accounts from foreign and domestic investigations. *Id.* However, most foreign investment in U.S. securities originates in only a few of these countries. *See, e.g.*, OFFICE OF THE SECRETARY, DEPARTMENT OF THE TREASURY, TREASURY BULLETIN 58 (Fall 1985) (itemizing by region and nation foreign purchases and sales of U.S. securities in 1984). For example, in 1983, 73% of all foreign purchases of shares issued by U.S. corporations came from five Western European nations (Switzerland, the Netherlands, Germany, Great Britain, Belgium) and Canada. Note, *Secrecy and Blocking Laws: A Growing Problem as the Internationalization of Securities Markets Continues*, 18 VAND. J. TRANSNAT'L L. 809, 817 n.32 (1985) (citing a letter from Sam Scott Miller, Vice President, General Counsel and Secretary, Paine Webber Group Inc. 3-4 (Dec. 12, 1984) (Comment on SEC Release No. 21,186, File No. S7-27-84 "Waiver by Conduct")) [hereafter Note, *Secrecy and Blocking Laws*]. Three of these nations (Switzerland, the Netherlands, and West Germany) protect banking secrecy. *See* Note, *The*

employees to keep confidential information related to the identity and banking transactions of account holders.[3] This secrecy obligation hinders United States Securities and Exchange Commission (SEC)[4] investigations of suspected insider trading[5] effected through West German banks.[6]

The SEC's enforcement staff investigates suspicious securities transactions for insider-trading violations.[7] The staff requests trading records[8] from brokers[9] to determine the legality of sales and purchases transacted through them.[10] However, transactions effected under cover of foreign bank secrecy block the staff's investigations.[11]

A hypothetical problem illustrates the effect of banking secrecy on SEC insider-trading investigations: Officer Gier of Hi-Tech Corporation learns, before the pertinent information is made public, that Lo-

---

SEC's Waiver by Conduct Proposal: A Critical Appraisal, 71 VA. L. REV. 1411, 1414 n.20 (1985) [hereafter Note, *Critical Appraisal*].

[3] See A. BAUMBACH, K. DUDEN & K. HOPT, HANDELSGESETZBUCH (7) Bankgeschaäftep I 4 A (26th rev. ed. 1985) [hereafter A. BAUMBACH]. Since the secrecy obligation extends to all account holders, it protects American citizens who trade U.S. securities through West German banks.

[4] The Securities and Exchange Commission operates under the authority of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982). The SEC's primary function is to protect securities investors. Quinn & Co. v. SEC, 452 F.2d 943, 947 (10th Cir.), *cert. denied*, 406 U.S. 957 (1971).

[5] "Insider trading" describes the act of purchasing or selling securities while in possession of material, nonpublic information about an issuer or the trading market for an issuer's securities. *See* 2 L. LOSS, SECURITIES REGULATION 1037 (2d ed. 1961); Janvey, *SEC Investigation of Insider Trading*, 13 SEC. REG. L.J. 299, 299-300 n.2 (1986).

[6] West German law does not limit banks to commercial and investment banking. *See* Gesetz über das Kreditwesen [KWG] § 1(1)(4)-(6), 1976 Bundesgesetzblatt [BGBl] I 1121. The West German Banking Law expressly includes transactions in securities as a banking activity. *Id.* U.S. law, in contrast, generally prohibits national banks from direct dealings in investment securities. *See* Glass-Steagall Act, 12 U.S.C.A. § 24 (West Supp. 1986).

[7] *See* Fedders, *Policing Internationalized U.S. Capital Markets: Methods to Obtain Evidence Abroad*, 18 INT'L LAW. 89, 93 (1984). For an in-depth look at the SEC's investigation procedures, see Janvey, *supra* note 5, at 301-19.

[8] U.S. securities laws impose extensive recordkeeping requirements on brokers, *see infra* note 171, and dealers, *see infra* note 172. *See* Securities Exchange Act of 1934, § 17, 15 U.S.C. § 78q (1982). Brokers and dealers must maintain records listing the name and address of each beneficial owner for whom the broker-dealer transacts. 17 C.F.R. § 240.17a-3(a)(9) (1986).

[9] For the definition of a broker under U.S. securities laws, see *infra* note 171.

[10] Fedders, *supra* note 7, at 93.

[11] *Id.*

Tech Corporation intends to take over Hi-Tech. Realizing that Lo-Tech will offer a price for Hi-Tech stock that exceeds its present market value, Gier buys a large quantity of Hi-Tech stock. After Lo-Tech publicizes its offer to Hi-Tech's shareholders, Gier sells the recently acquired Hi-Tech shares to Lo-Tech at a substantial profit. Had Gier used a broker in the United States, the SEC could readily discern his identity and transactions.[12] However, if Gier bought and sold the Hi-Tech shares through a West German bank, the SEC could identify only the bank that effected the securities transactions. The SEC could not even determine whether Gier was an American citizen.

To obtain information in an insider-trading investigation, the SEC could contact the German bank or the West German Government. If the bank were willing to disclose the account holder's identity and transactions, the SEC's investigation could proceed. However, a West German bank would refuse to comply with a request for voluntary disclosure, because West German law holds banks liable to customers for breach of secrecy.[13] Requesting the West German Government's assistance[14] in compelling the bank to disclose would normally fail because the Federal Republic does not recognize insider trading as a crime, which would justify compelling disclosure.[15]

To obtain the necessary information, the SEC could sue the West German bank in a United States district court.[16] The court would likely allow the SEC to compel discovery of the account holder's iden-

---

[12] Fedders, *Policing Trans-Border Fraud in the United States Securities Markets: The "Waiver by Conduct" Concept — A Possible Alternative or a Starting Point for Discussion?*, 11 BROOKLYN J. INT'L L. 477, 484 (1985)

[13] *See infra* notes 61-62 and accompanying text.

[14] For a discussion of American-German legal-assistance channels, see *infra* notes 83-94, 126-48, and accompanying text.

[15] For a survey of West German insider-trading regulation, see *infra* notes 41-54 and accompanying text.

[16] To proceed with the action; the district court would have to possess jurisdiction over the subject matter and over the bank. Leasco Data Processing Equipment v. Maxwell, 468 F.2d 1326, 1333, 1341 (2d Cir. 1972). If the German bank does continuous and substantial business in the United States through a branch or representative office, it is amenable to in personam jurisdiction for all actions, including those unrelated to its forum activity. Perkins v. Benguet Consolidated Mining Co., 342 U.S. 437 (1952); RESTATEMENT (SECOND) CONFLICT OF LAWS § 47(2) (1969). If the bank's business contacts are less substantial, the district court still could assert jurisdiction provided the bank has the requisite "minimum contacts" with the forum that directly relate to the cause of action. *See* International Shoe Co. v. Washington, 326 U.S. 310, 316-17 (1945); *see also* SEC v. Gilbert, 82 F.R.D. 723, 725 (S.D.N.Y. 1979) (holding nonresident foreign bank's maintenance of four accounts with three New York broker-dealers and with no other forum contacts sufficient to support jurisdiction).

tity.[17] The bank would then have to decide whether to comply. If it failed to comply with the United States court's discovery order, the bank would incur sanctions.[18] However, complying would subject the bank to civil liability in West Germany. This dilemma gives West German banks as well as the SEC an interest in resolving the bank secrecy issue.[19]

Using the Federal Republic of Germany as an example, this Comment discusses the problems that foreign bank secrecy creates for SEC insider-trading investigations. This Comment argues for adopting an express-waiver approach, proposed initially by the Commission,[20] which requires American and foreign investors trading through foreign financial intermediaries to waive their right to secrecy before transacting in American securities. Part I surveys American and West German insider-trading regulation. Part II discusses bank secrecy under West German law. The part also evaluates the current investigative measures the SEC uses to trace suspected insider trading conducted through foreign banks. Part III analyzes several options for improving current SEC investigative practices. Finally, part IV argues for adopting the express-waiver approach for investors who trade through foreign financial intermediaries.

I. Regulating Insider Trading

The United States and the Federal Republic of Germany both regulate insider trading, yet their approaches differ radically. This Part discusses the different approaches and demonstrates that this disparate treatment of insider trading prevents the SEC from using certain chan-

---

[17] *See infra* notes 104-05 and accompanying text.

[18] *See infra* note 104.

[19] Several German articles discuss the "sanctions or liability" dilemma of German banks. These articles uniformly criticize U.S. courts for their failing to understand the status of bank secrecy under West German law. *See, e.g.*, Bosch, *Das Bankgeheimnis im Konflikt zwischen US-Verfahrensrecht und deutschem Recht*, 4 Praxis des Internationalen Privat- und Verfahrensrechts 127 (1984); Eisner, *Das Bankgeheimnis im deutsch-amerikanischen Handelsverkehr*, 8 Wertpapier-Mitteilungen 198 (1969); Stiefel, *"Discovery"-Probleme und Erfahrungen im Deutsch-Amerikanischen Rechtshilfeverkehr*, 25 Recht der Internationalen Wirtschaft 509 (1979).

[20] The SEC first proposed the express-waiver approach in 1976. Securities Exchange Act Release No. 12,055, 8 S.E.C. Docket 1155, 41 Fed. Reg. 8075 (1976) [hereafter 1976 Release]; Securities Exchange Act Release No. 13,149, 11 S.E.C. Docket 1416, 42 Fed. Reg. 3312 (1977) [hereafter 1977 Release]. For a discussion of the SEC proposal, see *infra* notes 169-90 and accompanying text.

nels of legal assistance[21] to obtain confidential information from German banks.

A. United States

The Securities Exchange Act of 1934 (1934 Act)[22] governs insider trading in the United States. The insider-trading regulations fall primarily under section 16(b) of the 1934 Act,[23] and under rule 10b-5, which the SEC promulgated under authority of section 10 of the 1934 Act.[24]

---

[21] *See infra* notes 126-48 and accompanying text.

[22] 15 U.S.C. §§ 78a-78kk (1982).

[23] Section 16(b) provides:

> For the purpose of preventing the use of unfair information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1982).

[24] Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange (b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. § 10, 15 U.S.C. § 78j (1982).

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility or any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of

Section 16(b) requires insiders[25] to reimburse their corporations for profits made on the purchase and sale or sale and purchase of company stock executed within a six month period.[26] The SEC lacks authority to enforce section 16(b).[27] Rather, the corporation or a shareholder must bring an action and any recovery goes to the corporation.[28]

Section 10(b) of the 1934 Act authorizes the SEC to adopt regulations prohibiting the use of "any manipulative or deceptive device" in connection with the purchase or sale of a security.[29] Rule 10b-5 prohib-

---

business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986).

[25] For purposes of § 16(b), an insider is an officer or director of a company that has a class of securities registered under the 1934 Act. Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1982). The 1934 Act requires registration of securities traded on a national securities exchange. *Id.* § 12(b), 15 U.S.C. § 78*l*(b) (1982). The 1934 Act further requires registration of equity securities traded in over-the-counter markets, if there are 500 or more shareholders of record in the class and the company's total assets equal or exceed $3,000,000. *Id.* § 12(g)(1), 15 U.S.C. § 78*l*(g)(1) (1982); 17 C.F.R. § 240.12g-(1) (1986). Equity securities include common stock and preferred stock carrying voting rights. *See* Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1982). Beneficial owners of 10% or more of a registered class of securities are also insiders under § 16(b). *Id.* § 16(b), 15 U.S.C. § 78p(a) (1982).

[26] Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1982). Two hypotheticals serve to illustrate how the § 16(b) prohibition operates:

> (1). On January 1 Officer Smith of Acme Company purchases 300 Acme shares. On May 1 Smith sells all these Acme shares at a profit. Section 16(b) mandates that Smith remit the profits to Acme, because Smith *purchased and sold* stock in her company within a six months period. (2). Section 16(b) also imposes liability for the *sale and purchase* of company stock within a six months period. Assume on January 1 Smith owned 200 Acme shares. On the same day, Smith sells these shares at $5 each. On May 1 Smith repurchases 200 Acme shares at $3 each. Again, under § 16(b), Smith must remit to Acme the profits ($400) from this transaction.

[27] *See* H. BLOOMENTHAL, 1986-87 SECURITIES LAW HANDBOOK 266 (1986) (private action brought directly by or derivatively on behalf of corporation is only means Congress provided for enforcing § 16(b)).

[28] Rasmussen, *An Overview of Insider-Trading Laws in the United States*, 9 INT'L BUS. LAW. 389, 390 (1981).

[29] Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1982). Manipulative conduct includes practices of rigging prices to stimulate trading and create unwarranted and unnatural market activity. *See* Piper v. Chris-Craft Indus., 430 U.S. 1, 43 (1977); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) ("manipulative connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"). Deceptive conduct includes fraudulent misstatements of fact, omissions, and concealment of information that indicates the misleading nature of a prior statement. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972) (bank employees concealed material facts to

its certain persons having access to nonpublic, corporate information from trading on their own behalf.[30] Formerly, anyone possessing material,[31] nonpublic[32] information had a duty to either disclose it or refrain from trading.[33] Recent judicial decisions have limited the "disclosure or abstain" rule to insiders who owe a pre-existing fiduciary duty to a company,[34] and to tippees[35] whose liability is derivative from insiders owing a fiduciary duty.[36]

Both section 16(b) and rule 10b-5 seek to promote fairness in securi-

---

induce stock purchases at less than fair value); Superintendent of Ins. v. Bankers Life Casualty Co., 404 U.S. 6, 9-10 (1971) (seller duped into believing it would receive proceeds).

[30] Matter of Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). Rule 10b-5 applies not only to traditional § 16(b) insiders and to securities registered on a national exchange, *see* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 818, 902 (1983), but also to purchases and sales of any security made in a fraudulent or misleading way, *id.*

[31] Material information is information that a reasonable man would consider important in determining his choice of action in the transaction in question. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976); List v. Fashion Park, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[32] Nonpublic information is information not generally known in the marketplace. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc) (before acting on material information, insiders must await disclosure sufficient to insure availability of information to investing public), *cert. denied*, 394 U.S. 976 (1969).

[33] 401 F.2d at 848.

[34] *See* Chiarella v. United States, 445 U.S. 222, 224 (1980). In *Chiarella*, the Court held that Chiarella, a financial printer's employee, who had discerned the names of target corporations from documents announcing takeover bids, did not violate rule 10b-5 when he purchased stock in the targets and sold the shares immediately after the takeover bids were publicized. The Court found that Chiarella had no duty to disclose the takeover plans to the target companies, because he was not a corporate insider and had not received confidential information from the companies. *Id.* at 231-32.

[35] Tippees are persons who receive nonpublic information from corporate insiders (tippers). H. BLOOMENTHAL, *supra* note 27, at 351.

[36] *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) (tippee liability attaches only when tipper (insider) has breached duty to shareholders by disclosing information to tippee, and tippee knows or should know of such breach). The Court in *Dirks* reversed an SEC finding of a 10b-5 violation by Dirks, a securities analyst, who had received a tip from an employee of Equity Funding that the company had engaged in massive fraud. Dirks selectively disclosed the information to his institutional clients, who immediately disposed of their Equity Funding holdings. The Court reasoned that Dirks' tipper did not seek personal gain; therefore, the tipper did not breach a fiduciary duty. Consequently, Dirks had no duty to refrain from using the information, even though he knew it was material and nonpublic. The Court followed *Dirks* in Bateman, Eichler, Hill, Richards, Inc. v. Berner, 472 U.S. 299, 313 (1985) (holding tippee's use of material nonpublic information does not violate rule 10b-5 unless tippee owes corresponding duty to disclose information).

ties markets. These provisions prevent persons with inside information from profiting at the expense of investors who do not have access to such information.[37] The SEC has broad investigative powers to enforce these insider-trading provisions.[38]

Enforcement problems arise when foreign bank-secrecy laws hinder the SEC's efforts to investigate insider trading. These problems are acute with regard to bank-secrecy jurisdictions, such as West Germany, which do not recognize insider trading as an illegal activity.[39] Absent an insider-trading agreement with the United States, these nations normally will not lift the secrecy cover to enable prosecution.[40]

B. West Germany

The Federal Republic regulates insider trading primarily[41] through the "Insider-Trading Guidelines," the "Investment-Adviser Rules," and the "Rules of Procedure" (collectively Insider Rules).[42] Unlike

---

[37] *See* Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.) (holding purpose of § 16 is to counteract perceived unfairness of company insiders making short-term profits because they have unfair advantage over general body of shareholders), *cert. denied*, 320 U.S. 751 (1943); *see also* T. HAZEN, THE LAW OF SECURITIES REGULATION 414 (1985) (indicating that legislative history of § 16(b) reveals purpose of section was to prevent "unscrupulous employment of (corporate) inside information"). The congressional purpose behind § 10(b) was to prevent inequitable and unfair practices in securities transactions. 3 L. LOSS, *supra* note 5, at 1455-56.

[38] *See infra* notes 80-99 and accompanying text.

[39] *See infra* notes 42-43.

[40] *See infra* notes 126-46 and accompanying text.

[41] Other German laws indirectly regulate insider trading. The German Stock Corporation Act establishes liability of corporate organs for breach of duty to conduct business in an orderly way. Aktiengesetz [AktG] 1965 BGBl I 1089, §§ 93, 116. This remedy is not available to shareholders. Bremer, *Die Neufassung der Insider-Bestimmungen*, 21 DIE AKTIENGESELLSCHAFT 10, 11 (1976). The German Stock Corporation Act additionally establishes liability for disclosure and appropriation of commercial trade secrets. AktG § 404. This Act further subjects violators to criminal prosecution. *Id.* Criminal prosecution of insider trading is also possible under the German Penal Code. STRAFGESETZBUCH [StGB] §§ 263, 266. However, the Code's general fraud provision, StGB § 263, does not extend to most insider-trading situations, since the provision requires a pre-existing duty to disclose on the part of the alleged violator. A. BAUMBACH, *supra* note 3, at (16) InsiderRi 5 A. Similarly, the Code provision that imposes liability for breach of fiduciary duty, StGB § 266, is of little assistance, because it requires breach of duty of loyalty and pecuniary loss to the company. *Id.*

[42] In November 1970 the Commission of Stock Exchange Experts (*Börsensachverständigenkommission*), created by order of the Federal Minister of Economics (*Bundesminister der Wirtschaft*), drafted the Insider-Trading Guidelines, Insiderhandelsrichtlinien [Insiderhandels-Ri], the Investment Adviser Rules, Händler- und Beratungsregeln, and the Rules of Procedure, Verfahrensordnung. A. BAUMBACH,

American securities regulations, the German Insider Rules are not legal norms, but guidelines for self-regulation. The rules are enforceable only through private agreements.[43]

Publicly listed German companies normally enter into agreements containing the Insider Rules with their supervisory board members[44] and authorized representatives.[45] When the company itself is an insider, such as a financial institution or a stockbroker, it executes a similar agreement with the West German Banking Association (*Bundesverband deutscher Banken*).[46] The insider company in turn executes agreements containing the Insider Rules with each of its supervisory board members and authorized representatives.[47]

---

supra note 3, at (16) InsiderRi 1. The Commission revised the Insider Rules in July 1976 *inter alia* expanding the definition of "insider" to include employees of financial institutions. INSIDER-REGELN: ERLÄUTERUNGEN UND VERFAHRENSORDNUNG 3 (Bank-Verlag GmbH ed. 1976). The pamphlet INSIDER-REGELN, *id.*, contains the Insider Rules and the Commission's comments.

[43] A. BAUMBACH, *supra* note 3, at (16) InsiderRi 2 A. The German Insider Rules constitute a "code of honor" that listed companies and institutional traders — banks and brokers — voluntarily follow. *Id.* The theory underlying self-regulation is that these companies and traders have a signficant interest in their reputations in the financial community. *See* Wall St. J., Nov. 14, 1986, at 26, col. 2. An insider-trading incident involving a company or broker would undermine the investing public's confidence in the company or broker affected. *Id.* The German investing public consists mostly of banks and other large institutional investors. Kraus, *Securities Regulation in Germany? Investors' Remedies for Misleading Statements by Issuers*, 18 INT'L LAW. 109, 125 (1984); Wall St. J., Dec. 2, 1986, at 40, col. 1. Thus, a web of private agreements extending to listed companies and banks arguably obviates the need for more sophisticated securities regulation. Kraus, *supra*, at 125.

Some German commentators argue that voluntary regulation is ineffective. *See infra* note 139 and accompanying text. Conversely, one influential American source, The Wall Street Journal, favors voluntary insider-trading regulation over the current U.S. approach. *See* Wall St. J., Nov. 14, 1986, at 26, col. 1 (editorial arguing federal securities laws are counterproductive because they interfere with in-house insider-trading investigations).

[44] A. BAUMBACH, *supra* note 3, at (16) InsiderRi 2 B. West German law bifurcates the functions that a U.S. board of directors performs. *See* H. WÜRDINGER, GERMAN COMPANY LAW 38 (European Commercial Law Library No. 3, 1977). The managing board (*Vorstand*) is an executive organ. *Id.* The supervisory board (*Aufsichtsrat*) elects the managing board and oversees the corporation's broad policy-making function. *Id.* For a helpful discussion of this division of duties, see F. JUENGER & L. SCHMIDT, GERMAN STOCK CORPORATION ACT 10-12 (1967).

[45] A. BAUMBACH, *supra* note 3, at (16) InsiderRi 2 B. Authorized representatives include officers, directors, and other persons empowered to enter agreements on the company's behalf. *See* HANDELSGESETZBUCH [HGB] §§ 48-58.

[46] A. BAUMBACH, *supra* note 3, at (16) InsiderRi 2 B.

[47] *Id.* To monitor insider trading, the Insider Rules established Investigatory Com-

The West German Insider Rules recite the substantive elements of an insider-trading violation.[48] In many respects, these rules are similar to American securities regulation.[49] However, unlike American securi-

---

mittees (*Prüfungskommissionen*) for each of the eight regional German stock exchanges. Verfahrensordnung § 1(1). The Admission Authority (*Zulassungsstelle*) for the respective exchanges elects five members for each such Committee. *Id.* § 1(4). The Committee Chairman is a judge experienced in commercial matters. *Id.* § 1(3). Four panel members represent publicly listed business and industrial corporations. *Id.* § 1(4). An Investigatory Committee examines *ex officio* or upon notification suspected violations of the Insider Rules. *Id.* §§ 2,3. For the elements of an insider-trading violation under West German law, see *infra* note 49. If a Committee strongly suspects a violation of the Insider Rules, it can demand information from all suspects. Verfahrensordnung § 3(4)(b). A suspect must provide the Committee with the name of her bank and must release the bank from its secrecy obligation for purposes of Committee investigations. Insiderhandels-Ri § 3. However, this consent requirement applies only to person who have signed agreements acknowledging the Insider Rules. Verfahrensordnung § 2(2).

A complete investigatory proceeding consists of a preliminary investigation, Verfahrensordnung § 3(4)(b), conducted by the Committee, and a main proceeding, *id.* § 4. The involved company conducts the main proceeding. *Id.* At the end of the main proceeding, the Committee determines whether a violation has occurred. *Id.* The Committee then reports its findings to the suspect, the chief executive officer of the company, and the Federal Ministry of Economics (*Bundeswirtschaftsministerium*). *Id.* § 4(3).

[48] *See* Insiderhandels-Ri § 1.

[49] The Insider Rules prohibit insiders from trading for their own benefit or for a third party's benefit in insider securities based on nonpublic information acquired by virtue of their positions. *Id.* The definition "insider" includes supervisory board members, *supra* note 44, authorized company representatives, *supra* note 45, and financial advisers to the company. Insiderhandels-Ri § 2(1). "Insider securities" refers to securities listed on public exchanges or over-the-counter markets. *Id.* § 2(2). Bond issues are not insider securities. A. BAUMBACH, *supra* note 3, at (16) InsiderRi 3 A. The Insider Rules set forth an exclusive list of corporate activities, knowledge of which is classified as inside information. Insiderhandels-Ri § 2 comment 3.

The Insider Rules also regulate damages for insider-trading violations. *Id.* § 4. The Insider Rules require violators to surrender all resulting pecuniary gains, including losses avoided, to their companies. *Id.* Institutional violators must surrender all gains to the company whose security was the object of the insider transaction. *Id.* Buyers and sellers of securities who suffer damages because of trading by corporate insiders have no claim for relief under the Insider Rules. A. BAUMBACH, *supra* note 3, at (16) InsiderRi 3 B. The Insider Rules create liability only between insiders and their corporate contract partners. *Id.* Recovery of gain from insiders does not bar the company from instituting civil proceedings against the insider. Insiderhandels-Ri § 4(1).

Until June 1986 the Investigatory Committees had never investigated an insider-trading violation in West Germany. Wall St. J., Aug. 21, 1986, at 26, col. 2. In June 1986 the Frankfurt Investigatory Committee charged Dr. Klaus Kuhn, Chairman of the Supervisory Board of AEG, a large German electronics concern, with a violation of the Insider Rules. *Id.* Kuhn had purchased shares in his company shortly before an-

ties regulation,[50] a tippee[51] is not liable under the German Insider Rules,[52] and a tipper[53] is liable only when a tippee acts on the tipper's behalf.[54]

West Germany's self-regulation of insider trading obviates the need for a government enforcement agency.[55] Thus, there is no West German equivalent to the SEC to aid in investigations. Therefore, in investigating suspected insider trading effected through West German banks, the SEC must overcome two hurdles: lack of a West German counterpart and the barrier of West German bank secrecy.

II. SEC Investigations of Insider Trading Involving Secrecy Jurisdictions

A. West German Banking Secrecy

Bank secrecy in the Federal Republic is a recognized, yet not clearly defined, legal obligation.[56] West German law does not expressly define banking secrecy,[57] nor does any West German statute uniformly mandate the secrecy obligation.[58] However, the obligation exists and com-

---

other German company publicized a tender offer to acquire AEG. *Id.* After publication of the offer, Kuhn sold his shares at a profit amounting to $7,800. Frankfurter Allgemeine Zeitung, July 8, 1986, at 15, col. 1. The Insider Commission ordered Kuhn to disgorge this sum to AEG. *Id.*

[50] *See supra* notes 22-40 and accompanying text.

[51] *See supra* note 36 and accompanying text.

[52] A. Baumbach, *supra* note 3, at (16) InsiderRi 3 A.

[53] *See supra* note 36 and accompanying text.

[54] Insiderhandels-Ri § 1 comment 1.

[55] The Federal Republic of Germany also lacks an agency similar to the SEC because "wide sectors of the German capital markets are not subject to any legislative or regulatory control." Kraus, *supra* note 43, at 110. Although German law prescribes certain accounting and publicity practices regarding corporate financial statements, it does not stress disclosure requirements for publicly offered shares. N. Horn, H. Kötz & H. Leser, German Private and Commercial Law 267 (1982). For a discussion of these requirements, see generally Kraus, *supra* note 43 (arguing that the existing German disclosure requirements adequately protect investors).

[56] Judgment of Nov. 25, 1953, Landgericht, Frankfurt am Main, 7 Neue Juristische Wochenschrift [NJW] 688, 689 (1954) (recognizing bank secrecy as a German legal institution).

[57] S. Sichtermann, S. Feuerborn, R. Kirchherr & R. Terdenge, Bankgeheimnis und Bankauskunft 65-66 (3d rev. ed. 1984) [hereafter S. Sichtermann].

[58] *Id.* at 29; Rehbein, *Rechtsfragen zum Bankgeheimis*, 149 Zeitschrift für das Gesamte Handelsrcht und Wirtschaftsrecht 139, 140-41 (1985). West German lawmakers have rejected proposals to provide expressly for banking secrecy. *See* Schork, *Der Entwurf eines Gesetzes über das Kreditwesen*, 30 Wertpapier-Mit-

pliance has important consequences: Bank owners and employees must refuse to testify in civil proceedings.[59] Moreover, to protect the customer's constitutional right of privacy, West German law prohibits bank disclosure of customer-related information.[60] Such disclosure engenders liability under contract[61] and tort law.[62] West German law re-

---

TEILUNGEN (SONDERBEILAGE II) 14, 14 (1959). Such legislation would interfere with the commonly practiced interbank exchange of customer credit information. *Id.* The existing system is preferable because it allows banks greater flexibility in exchanging credit information. *Id. But see* S. SICHTERMANN, *supra* note 57, at 68-69 (arguing statutory regulation of insider trading is necessary for uniform treatment of problem).

[59] *See* Judgment of Oct. 26, 1953, Bundesgerichtshof, 8 DER BETRIEBS-BERATER 993, 993 (1953) (holding that privilege of refusing to testify in civil matters flows from secrecy obligation); *see also* A. BAUMBACH, W. LAUTERBACH, J. ALBERS & P. HARTMANN, ZIVILPROZESSORDNUNG § 383 3 E (43d rev. ed. 1985) (privilege of refusing to testify extends to bank employees) [hereafter A. BAUMBACH & W. LAUTERBACH].

The West German Civil Procedure Code extends the privilege of refusing to testify to "persons who by virtue of their occupation have knowledge of facts which, by their nature, are to remain confidential." ZIVILPROZESSORDNUNG [ZPO] § 383(1)(6). The privilige covers all facts coming within the secrecy obligation. Judgment of Oct. 26, 1953, Bundesgerichtshof, 8 DER BETRIEBS-BERATER 993, 993 (1953). However, German criminal law does not protect bank secrecy. The German Penal Code enumerates certain confidential relations. *See* STGB § 203(1). Breach of confidentiality in such instances creates criminal liability. *Id.* This exclusive list does not include the bank-customer relationship. Bosch, *supra* note 19, at 133. Therefore, bank employees must testify in criminal proceedings. *See infra* notes 66-70 and accompanying text.

[60] The West German Basic Law (Constitution) protects the absolute privacy right of every person. GRUNDGESETZ [GG] arts. 1, 2 (W. Ger.); *see also* H. SCHÖNLE, BANK- UND BÖRSENRECHT 36 (1971); S. SICHTERMANN, *supra* note 57, at 111. Recent commentaries on West German banking law view this privacy right as the basis of the secrecy obligation. Bosch, *supra* note 19, at 130 n.28; Rehbein, *supra* note 58, at 143-45. West German cases, however, are silent on this point, with one exception. *See* Bosch, *supra* note 19, at 130 (citing Judgment of Aug. 23, 1982, Landgericht Kiel, *reprinted in* 4 PRAXIS DES INTERNATIONALEN PRIVAT- UND VERFAHRENSRECHTS 147, 147 (1984) (indicating bank secrecy enjoys constitutional protection of articles 1 and 2 of the Grundgesetz)). Whether the secrecy obligation has a constitutional basis is significant in determining if bank secrecy is a vital national interest of West Germany. U.S. courts consider vital national interests as one factor in determining whether to exercise jurisdiction and compel a foreign person to violate foreign law. *See infra* note 107.

[61] The bank's secrecy obligation flows from its express or implied contracts to provide banking services to individual customers. H. SCHÖNLE, *supra* note 60 at 36; *see also* A. BAUMBACH, *supra* note 3, at (7) Bankgeschäfte I 4 A. The secrecy obligation is an "obvious accessory obligation" of the banking-services agreement. 27 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN 241, 246 (1958). When an express banking-services contract specifically refers to the secrecy obligation, the obligation is an "independent accessory obligation" of the contract. Judgment of Oct. 26, 1953, Bundesgerichtshof, 8 DER BETRIEBS-BERATER 993, 993 (1953). A bank's

quires banks to dispense with secrecy in only three instances: criminal proceedings,[63] cases of necessity,[64] and with the customer's consent.[65]

In criminal proceedings, the bank-secrecy privilege does not justify refusal to testify.[66] Bank employees must testify under oath on details of individual account transactions.[67] West German law further requires

---

breach of this obligation constitutes partial impossibility of performance and enables the customer to rescind the contract. H. SCHÖNLE, *supra* note 60, at 36. When an express banking-services contract does not refer to the bank's duty to maintain secrecy, the obligation is a "dependent accessory obligation." *Id.* Failure to comply with this obligation constitutes a breach of contract and allows the customer a damages remedy. *Id.* When an express banking-services contract is not present, the bank's secrecy obligation flows from the general business relationship between the bank and customer. A. BAUMBACH, *supra* note 3, at (7) Bankgeschäfte I 4 A.

[63] Violation of the bank secrecy obligation creates an actionable tort claim and allows a damages remedy or injunctive relief. S. SICHTERMANN, *supra* note 57, at 111. West German legal experts disagree on the precise legal basis of this tort claim. Some authors view the secrecy obligation as included in the "other right" (*anderes Recht*) sounding in tort under the German Civil Code, BÜRGERLICHES GESETZBUCH [BGB] § 823(1). *See* S. SICHTERMANN, *supra* note 57, at 111; *see also* H. SCHÖNLE, *supra* note 60, at 36. The term "other right" encompasses rights valid against the entire world (*ausschliessliche Rechte*) such as patent rights. O. PALANDT, BÜRGERLICHES GESETZBUCH § 823 6 (45th rev. ed. 1986). It excludes rights valid against only specific parties such as contract rights. *Id.* For a helpful discussion of the "other right" concept, see N. HORN, H. KÖTZ & H. LESER, *supra* note 55, at 149-51. Other German commentators hold that banking secrecy is not an "other right," but one of the "rights protecting an enterprise" (*Unternehmensrechtschutz*), which German tort law, BGB § 823(1), does protect. *See* A. BAUMBACH, *supra* note 3, at (7) Bankgeschäfte I 4 A.

[63] *See infra* notes 66-70 and accompanying text.

[64] *See infra* notes 71-77 and accompanying text.

[65] *See infra* notes 78-79 and accompanying text.

[66] The German Criminal Procedure Code enumerates professions that confer the privilege of refusing to testify. *See* STRAFPROZESSORDNUNG [STPO] § 53 (including clericals, attorneys, auditors, accountants, doctors, dentists, pharmacists, family-planning advisers, state and national legislators, and journalists). This strictly construed provision does not list banking as such an occupation. *Id.*; T. KLEINKNECHT & K. MEYER, STRAFPROZESSORDNUNG § 53 margin note 3 (37th rev. ed. 1985).

[67] STPO § 59; *see also* S. SICHTERMANN, *supra* note 57, at 325. Judicial sanctions for refusal to testify include fines and arrest. STPO § 70(1). Failure to appear to testify, *id.* § 55, may lead to compelled appearance, *id.* § 51(3). Bank employees must also testify before public prosecutors on confidential matters. S. SICHTERMANN, *supra* note 57, at 326. Sanctions for unjustified refusal to testify, or for failure to appear before the public prosecutor, also include fines and compelled appearance. STPO §§ 161a(2), 51, 70, 77. Unlike a judge, however, the public prosecutor cannot order imprisonment for contempt. *Id.* § 161(2)(2). Bank employees may refuse to testify before police authorities. *Id.* German law vests the police, as "auxiliary officials" of the public prosecutor, with certain powers of the public prosecutor. GERICHTSVERFASSUNGSGESETZ [GVG] 1975 BGBl I 1077, § 152, STPO § 161. However, these powers do

banks to reproduce account information at the request of criminal investigative authorities.[68] However, a court order is necessary to compel surrender of documents.[69] In preliminary investigations of customers or employees, banks must produce all pertinent information and employees must testify regarding all relevant facts.[70]

While necessity can justify bank disclosure of confidential information,[71] a bank may excusably breach its secrecy obligation only when disclosure is unavoidable.[72] For example, necessity justifies disclosure during legal proceedings when a bank-defendant raises a defense that unavoidably reveals information which the secrecy obligation otherwise protects.[73] Necessity does not protect bank disclosure of confidential information during commercial transactions.[74] A United States court's discovery order justifies disclosure under the necessity privilege only when the threat of sanctions is imminent and the bank has made diligent efforts to prevent disclosure.[75] After a United States court has commenced contempt proceedings for noncompliance with a discovery order, a bank arguably may justifiably disclose confidential information.[76] However, compliance with a "mere" subpoena does not justify

---

not include the ability to compel testimony. *See* S. SICHTERMANN, *supra* note 57, at 326.

[68] HGB § 47a; *see also* T. KLEINKNECHT & K. MEYER, *supra* 66, at § 95 margin note 6.

[69] STPO § 98.

[70] Judgment of Jan. 10, 1978, Landgericht, Hamburg, 31 NJW 958, 958-59 (1978).

[71] Most German commentators argue that a "greater moral obligation" or an "important interest" compelling disclosure releases a bank from its secrecy obligation. A. BAUMBACH & W. LAUTERBACH, *supra* note 59, § 383 3 D; *see also* S. SICHTERMANN, *supra* note 57, at 180-81; Bosch, *supra* note 19, at 131. Some commentators further view the bank disclosure of confidential information as justified when nondisclosure would bring substantially greater harm to the bank than would disclosure to the customer-obligee. Bosch, *supra* note 19, at 131. The legal rationale for this conclusion is that the "good faith performance" doctrine, BGB § 242, limits a bank's obligation to maintain secrecy. Therefore, the secrecy obligation exists only to the extent that the customer may fairly expect the bank to maintain secrecy. Bosch, *supra* note 19, at 131; *see also* United States v. First City Nat'l Bank, 396 F.2d 897, 900 (2d Cir. 1968) (German doctrine of performance impossibility and the lenient good faith performance requirement provide complete defenses to customer claims for relief based on confidential information).

[72] S. SICHTERMANN, *supra* note 57, at 181.

[73] *Id.*

[74] *Id.*

[75] Bosch, *supra* note 19, at 131.

[76] *Id.* By threatening judicial sanctions against foreign banks, U.S. government enforcement agencies have occasionally obtained the information they sought. *See, e.g., In*

disclosure.[77]

A bank's customer may expressly consent to bank disclosure of her account information.[78] The customer may specify which account information shall remain confidential and the persons to whom the bank may disclose.[79] As the following discussion indicates, express consent to disclosure is essential to effective SEC investigations.

B. Current SEC Investigative Practices

As discussed above, the Securities Exchange Act of 1934 aims to preserve the fairness and integrity of American securities markets.[80] The 1934 Act grants the SEC broad investigatory powers to achieve this goal.[81] This section discusses the cooperative and compulsory measures that the SEC uses to implement investigations.

1. Cooperative Measures

To investigate suspected insider trading effected through banks in secrecy jurisdictions, the SEC may use letters rogatory[82] or the Hague

---

re Grand Jury Proceedings (Bank of Nova Scotia), 691 F.2d 1384 (11th Cir. 1982) (tax and narcotics investigation), *cert. denied*, 462 U.S. 1119 (1983); *In re* Grand Jury Proceedings (Field), 532 F.2d 404 (5th Cir.) (tax investigation), *cert. denied*, 429 U.S. 940 (1976); *In re* Grand Jury 81-2, 550 F. Supp. 24 (W.D. Mich. 1982) (illegal sales of diesel engines). Courts have refused to order disclosure. *See, e.g.*, United States v. First Nat'l Bank of Chicago, 699 F.2d 341 (7th Cir. 1983) (tax investigation); Trade Dev. Bank v. Continental Ins., 469 F.2d 35 (2d Cir. 1972) (suit on fidelity bond). Despite occasional successes, this approach wastes judicial resources. Moreover, no West German bank to date has apparently invoked the necessity privilege to justify disclosure. See Bosch, *supra* note 19, at 131.

[77] Bosch, *supra* note 19, at 131.

[78] A. BAUMBACH & W. LAUTERBACH, *supra* note 59, § 383 3 D.

[79] S. SICHTERMANN, *supra* note 57, at 163.

[80] *See* Fedders, *supra* note 7, at 90.

[81] *See* Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u (1982) (authorizing the SEC "in its discretion [to] make such investigations as it deems necessary to determine whether any person has violated, is violating or is about to violate any provision of this chapter [or] the rules or regulations thereunder"). Moreover, the SEC may institute informal ("preliminary") investigations of suspected securities fraud. 17 C.F.R. § 202.5(a) (1986).

[82] A letter rogatory is:

> a judicial request addressed to a foreign court that a witness be examined within the latter's territorial jurisdiction by written interrogatories or, if the foreign court permits, by oral interrogatories . . . and procedure [as to letters rogatory] is under control of the foreign tribunal whose assistance is sought in the administration of justice.

Volkswagenwerk Aktiengesellschaft v. Superior Court, 33 Cal. App. 3d 503, 506-07,

Convention on the Taking of Evidence Abroad.[83] Unfortunately, both letters rogatory and cooperation under the Hague Convention are ineffective in SEC investigations.

The SEC rarely uses letters rogatory for several reasons. First, it must file suit in a United States district court before it can request issuance of a letter rogatory.[84] Second, compliance with a letter rogatory depends on foreign cooperation, which may not be forthcoming.[85] Third, the letters rogatory procedure takes considerable time.[86] Most importantly, in processing an incoming request for legal assistance, foreign courts apply their own procedural rules,[87] including those allowing

---

109 Cal. Rptr. 219, 221 (1973).

To initiate the letters rogatory procedure, the SEC must apply to a federal district court for issuance of a letter rogatory. FED. R. CIV. P. 28(b); FED. R. CRIM. P. 15(d), (e). The court then issues the letter rogatory "on terms that are just and appropriate." FED. R. CIV. P. 28(b). The court may transmit the letter rogatory directly to a foreign court, officer, or agency, 28 U.S.C. § 1781(b)(2) (1982), or do so indirectly through the Department of State, *id.* § 1781(a)(2).

[83] Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, *opened for signature* March 18, 1970, 23 U.S.T. 2555, T.I.A.S. No. 7444 [hereafter Hague Convention]. The United States ratified the Hague Convention in 1972. *Id.* West Germany ratified the Convention in 1977. 1977 BGBl II 1453. Article 2 of the Hague Convention specifies the procedure by which one signatory may request legal assistance from another signatory. *Id.* art. 2, 23 U.S.T. at 2562. This procedure is similar in principle to the letters rogatory procedure with one important distinction: The Convention lists grounds on which a signatory may refuse to comply with a request for legal assistance. Hague Convention, *supra*, at art. 12, 23 U.S.T. at 2562; *see also infra* text accompanying note 91. For a discussion of the Hague Convention, see generally Radvan, *The Hague Convention on Taking of Evidence Abroad in Civil or Commercial Matters: Several Notes Concerning its Scope, Methods and Compulsion*, 16 N.Y.U. J. INT'L L. & POL. 1031 (1984).

[84] *See* FED. R. CIV. P. 1. Moreover, the West German Government has stated that it will only grant foreign requests for legal assistance that emanate from *judicial* instances and are directed to West German judicial authorities. Bundestag-Drucksachen 9/2401, at 2-3, *reprinted in* 36 DER BETRIEB 1086, 1086 (1983).

A case now pending before the U.S. Supreme Court will affect future use of letters rogatory. *In re* Societe Nationale Industrielle Aerospatiale, 782 F.2d 120 (8th Cir.), *cert. granted*, 106 S. Ct. 2888 (1986). The Court will decide whether a U.S. court may disregard the Hague Convention's procedures for ordering production of foreign documents located abroad from foreign nationals over whom the court has jurisdiction. *Id.*

[85] Fedders, *supra* note 7, at 99.

[86] *Id.*

[87] The Hague Convention, *supra* note 83, incorporates this principle. Article 9 of the Convention provides that "[t]he judicial authority which executes a Letter of Request shall apply its own law as to the methods and procedures to be followed." *Id.* art. 9, 23 U.S.T. at 2561; *see also* Eisner, *supra* note 19, at 199 (German courts will apply Federal Republic's procedural rules to foreign requests for legal assistance).

refusal to testify.[88]

American-German cooperation under the Hague Convention creates even greater barriers to SEC penetration of West German bank secrecy. The prinicipal difficulty is that West Germany ratified the Hague Convention subject to the reservation that it would not allow pretrial discovery in its territory.[89] Even if the Federal Republic allowed pretrial discovery in its territory, a German court still would deny a request under the Hague Convention for information protected by West German bank secrecy. This is because the Hague Convention allows persons subject to discovery to invoke any privileges available under the laws of either the requesting or the requested state.[90] Furthermore, the Hague Convention allows the requested state to deny legal assistance if compliance prejudices the sovereignty or security of the requested state.[91] The Federal Republic considers foreign interference with the privilege of refusing to testify a violation of West German sovereignty.[92] Therefore, German government authorities probably would not suspend these privileges to comply with the request,[93] and

---

[88] For a discussion of the relevant West German law, see *supra* note 59 and accompanying text.

[89] 1977 BGBl II 1453; 23 U.S.T. 2555, T.I.A.S. No. 7444. The Hague Convention states that "[a] contracting State may . . . declare that it will not execute Letters of Request issued for the purpose of obtaining pre-trial discovery of documents as known in Common Law countries." Hague Convention, *supra* note 83, art. 23, 23 U.S.T. at 2568.

[90] Hague Convention, *supra* note 83, art. 11, 23 U.S.T. at 2562. As one German author indicates, U.S. courts and government authorities must acquaint themselves with the German privileges to refuse to testify, as set forth in the German Civil Procedure Code, ZPO § 383(1)(6). *See* Eisner, *supra* note 19, at 198-99.

[91] Article 12 of the Hague Convention provides that "the execution of a Letter of Request may be refused only to the extent that . . . (b) the State addressed considers that its sovereignty or security would be prejudiced thereby." Hague Convention, *supra* note 83, art. 12, 23 U.S.T. at 2562.

[92] Eisner, *supra* note 19, at 200; *see also* A. ROSENBERG, LEHRBUCH DES DEUTSCHEN ZIVILPROZESSES 24 (9th ed. 1968); 2 A. SCHNITZER, HANDBUCH DES INTERNATIONALEN PRIVATRECHTS 859 (4th ed. 1957). German commentators view article 12, *supra* note 91, as a public policy reservation that allows the Federal Republic to deny assistance if compliance would contravene West German substantive or procedural law. *See* von Hülsen, *Kanadische und Europäische Reaktionen auf die US-"pretrial discovery"*, 28 RECHT DER INTERNATIONALEN WIRTSCHAFT 537, 550 (1982); Martens, *Erfahrungen mit Rechtshilfeersuchen aus den USA nach dem Haager Beweisaufnahme-Übereinkommen*, 27 RECHT DER INTERNATIONALEN WIRTSCHAFT 725, 729 (1981).

[93] Eisner, *supra* note 19, at 200. German commentators disagree on whether the Hague Convention obligates West Germany to comply with a common-law nation's discovery request. *See infra* note 113 and accompanying text.

the bank could refuse to testify.[94]

2. Compulsory Measures

Rather than rely on West German cooperation,[95] the SEC may attempt to directly compel testimony or document production from banks in the Federal Republic. The SEC generally either serves its own investigative subpoena[96] or initiates civil proceedings.[97]

An investigative subpoena enables the SEC to conduct investigations as it deems necessary, to subpoena witnesses, and to require document production.[98] The SEC may invoke federal courts' aid if an addressee refuses to obey the investigative subpoena.[99] Service of the investigative subpoena within the United States is valid.[100] However, one United States court has questioned the validity of service abroad, on the ground that it might entail a violation of foreign sovereignty.[101] Moreover, direct service of the subpoena is valid only if the foreign country generally consents to service on its nationals of subpoenas from other nations, or if the foreign country consents to a particular request for service.[102] Since the Federal Republic considers direct service of the SEC investigative subpoena in its territory a violation of West German sovereignty,[103] this means of investigation does not aid the SEC.

Once the SEC enforcement staff completes an initial investigation, it may commence an enforcement action in a federal district court.[104] The

---

[94] Eisner, *supra* note 19, at 200.

[95] *See supra* notes 82-83 and accompanying text.

[96] *See infra* notes 98-99 and accompanying text.

[97] See *infra* note 104 and accompanying text.

[98] Securities Exchange Act of 1934, § 21(b), 15 U.S.C. § 78u(b) (1982).

[99] *Id.* § 21(c), 15 U.S.C. § 78u(c).

[100] Service of an investigative subpoena in compliance with the SEC Rules of Practice precludes challenges to the SEC's assertion of in personam jurisdiction and to the mode of subpoena service. *See* 17 C.F.R. § 201.14(b)(3) (1986).

[101] *See* FTC v. Compagnie de Saint-Gobain-Pont-a-Mousson, 636 F.2d 1300, 1313 (D.C. Cir. 1980) (service of investigative subpoena by direct mail upon foreign citizen abroad without resort to established channels of international judicial assistance intrudes on foreign sovereignty).

[102] *Id.* at 1313-14.

[103] The West German Government has stated that attempts by foreign judges or attorneys to take evidence in West Germany without the prior approval of the competent German authorities violates German sovereignty. Bundestag-Drucksachen 9/2401, at 2, *reprinted in* 36 DER BETRIEB 1086, 1086 (1983).

[104] Fedders, *supra* note 7, at 94. In insider-trading cases, the SEC initiates civil actions only. It refers insider-trading cases to the Department of Justice for criminal prosecution. Securities Exchange Act of 1934, § 21(d), 15 U.S.C. § 78u(d) (1982).

SEC can then use pretrial discovery in attempting to lift the cover of foreign bank secrecy.[105] However, several factors prevent the SEC from discovering confidential information from West German banks.

First, United States courts claim the power to order the production of documents located in foreign nations, if the courts have jurisdiction over the person possessing or controlling the material.[106] Extending jurisdiction over German bank branches in the United States to the bank's headquarters in Germany can provide the nexus necessary for United States court-ordered discovery of documents located abroad.[107] However, the Federal Republic rejects this extension.[108] German law recognizes foreign jurisdiction over "branch establishments" (*Zweigniederlassungen*) only for claims that relate to the branches' business activity.[109] Thus, absent West German government approval, courts

---

[105] Several U.S. courts have affirmed the power of the SEC and other U.S. law-enforcement authorities to obtain court orders requiring the production of documents and information located abroad. *See, e.g.*, United States v. Bank of Nova Scotia, 691 F.2d 1384 (11th Cir. 1982) (affirming order enforcing grand jury subpoena served on Canadian bank's Miami branch for documents held in a Bahamian branch despite Bahamian bank-secrecy laws), *cert. denied*, 462 U.S. 1119 (1983); United States v. Vetco, Inc., 644 F.2d 1324 (9th Cir. 1981) (affirming order enforcing Internal Revenue Service summons for documents held in Switzerland by U.S. firm's Swiss subsidiary, notwithstanding Swiss bank-secrecy laws); United States v. Field, 532 F.2d 404 (5th Cir.) (affirming order enforcing grand jury subpoena served upon Canadian citizen in the U.S. directing him to testify concerning his activities as managing director of bank located in Grand Cayman despite Grand Cayman bank-secrecy laws), *cert. denied*, 429 U.S. 940 (1976); *In re* a Grand Jury Subpoena Directed to Marc Rich & Co., A.G., No. M-11-188 (S.D.N.Y. 1983) (order imposing sanction following refusal by a Swiss corporation and its wholly-owned U.S. subsidiary to comply with subpoenas) *aff'd*, 707 F.2d 663 (2d Cir. 1983); SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981) (court order imposing sanction if Swiss bank continued to refuse to comply with court-ordered discovery).

Under the U.S. Federal Rules of Civil Procedure, parties may discover anything relevant to the subject matter of the pending action. FED. R. CIV. P. 26(b)(1). As a party to litigation, the SEC may subpoena witnesses, FED. R. CIV. P. (45)(d)(1), or request the production of documents, *id.* 34(a)(1). Morever, the SEC can seek a court order to compel production. *Id.* 37. Federal courts may impose sanctions, including contempt proceedings and fines, against witnesses who fail to comply with discovery orders. *Id.*

[106] United States v. First Nat'l City Bank, 396 F.2d 897, 901 (2d Cir. 1968); First Nat'l City Bank v. IRS, 271 F.2d 616 (2d Cir.), *cert. denied*, 361 U.S. 948 (1959).

[107] United States v. First Nat'l City Bank, 396 F.2d 897, 900-01 (2d Cir. 1968).

[108] *See* Bosch, *supra* note 19, at 132 & nn.43-44.

[109] ZPO § 21(1); *see also* von Dryander, *Jurisdiction in Civil and Commercial Matters under the German Code of Civil Procedure*, 16 INT'L LAW. 671, 676-78 (1982) (discussing jurisdiction over commercial enterprises).

there probably would refuse to enforce a United States court's discovery order.[110]

Second, the scope of permissible pretrial discovery in the Federal Republic is much less extensive than in the United States.[111] West German law actually prohibits both the assertion of less than fully substantiated claims and questioning an opposing party to obtain information

---

[110] A recent federal case, *In re* Grand Jury 81-2, illustrates the differing American and West German perspectives on the extraterritoriality of U.S. pretrial discovery. *See* 550 F. Supp. 24 (W.D. Mich. 1982). In that case a federal judge ordered a West German bank's U.S. subsidiary to comply with a grand jury subpoena calling for production of records located in West Germany. *Id.* at 29-30. The bank was neither a party to the grand jury investigation nor to the proceedings. *Id.* at 27. The bank argued that production of the records would violate West German law. *Id.* at 26. The court ordered the bank to comply with the subpoena or face sanctions, citing to RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 39(1) (1965):

> A state having jurisdiction to prescribe or enforce a rule of law is not precluded from exercising its jurisdiction solely because such exercise requires a person to engage in conduct subjecting him to liability under the law of another state having jurisdiction with respect to that conduct.

550 F. Supp. at 28.

To determine whether it should assert jurisdiction, the court applied the "balancing-of-vital-interests" test of the RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 40 (1965):

> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct on the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as:
>
> > (a) vital national interests of each of the states, (b) the extent and nature of the hardship that inconsistent enforcement actions would impose upon the person, (c) the extent to which the required conduct is to take place in the territory of the other state, (d) the nationality of the person, and (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

550 F. Supp. at 28 n.2.

The court concluded that the American interest in asserting jurisdiction outweighed any countervailing interest or hardship asserted by the bank. *Id.* at 29.

In response to the Michigan case, the West German Government publicized its nonrecognition of the extraterritorial effect of U.S. court orders and judgments for the West German territory. *See* Bundestag-Drucksachen 9/2401, at 2, *reprinted in* 36 DER BETRIEB 1086, 1086 (1983). German commentators also regard document production requests addressed to foreign banks with branch offices or subsidiaries in the United States as clear violations of international law. *See* Bosch, *supra* note 19, at 133.

[111] West German law does not impose a general duty to produce documents. Stiefel, *supra* note 19, at 512.

substantiating those claims.[112] Thus, the West German Government probably would refuse to enforce United States court-ordered sanctions for failure to comply with a discovery order.[113]

Third, a West German bank customer could initiate litigation in a German court to enjoin extraterritorial execution of a United States court's sanctions.[114] The German court's injunction would not necessarily prevent the United States court from imposing sanctions against the German bank's American subsidiary.[115] However, if the German bank obtained a protective order from a German court to deposit[116] or sequester[117] the pertinent documents, the bank's compliance with the United States court's discovery order would be physically impossible. In that event, the United States court probably would stay or dismiss the action against the bank,[118] unless it found that the bank and the customer had colluded in obtaining the German court's protective order.[119]

---

[112] A. BAUMBACH & W. LAUTERBACH, *supra* note 59, Introduction to § 284 6.

[113] *See* von Hülsen, *supra* note 92, at 550. *But see* Martens, *supra* note 92, at 729-30 (arguing West Germany's refusal to comply with common-law discovery request under Hague Convention would violate Convention).

[114] In response to *In re* Grand Jury 81-2, 550 F. Supp. 24 (W.D. Mich. 1982), the German bank's customer, whose account records the federal court had subpoenaed, obtained a German court's order enjoining bank disclosure. *See* Judgment of Aug. 23, 1982, Landgericht, Kiel, *reprinted in* 4 PRAXIS DES INTERNATIONALEN PRIVAT- UND VERFAHRENSRECHTS 147, 147 (1984) (upholding temporary restraining order). The German court enjoined bank disclosure because no German court or government authority had ordered testimony or document production. *Id.*

[115] The federal judge in *In re* Grand Jury 81-2, 550 F. Supp. 24 (1982), ordered a German bank to comply with a grand jury subpoena, *id.* at 29-30, despite a German court order enjoing bank disclosure. *See supra* note 114.

[116] The West German Civil Procedure Code grants courts discretion to issue temporary injunctions. *See* ZPO § 938(1). Such an order could require a bank to deposit the pertinent documents with the court. Bosch, *supra* note 19, at 132.

[117] The West German Civil Procedure Code authorizes courts to order surrender of documents to the custody of a court-appointed receiver. *See* ZPO § 938(2).

[118] Bosch, *supra* note 19, at 132.

[119] *Id.* Collusion occurs when a German bank and its customer agree in advance that the customer shall sue in a German court to enjoin bank disclosure to U.S. authorities. *See id.* In addition to the factors listed in the "balancing-of-vital-interests" test, RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 40 (1965), U.S. courts consider whether a subpoenaed foreign party has made a good faith effort to comply with a discovery order. *See, e.g.*, Societe Internationale Pour Participations Industrielles et Commerciales v. Rogers, 357 U.S. 197 (1958) (good faith dealing with foreign government over document release found only after petitioner negotiated with Swiss Government for two years).

The § 40 test may disappear with adoption of the Restatement (Revised) of Foreign Relations Law of the United States. Under the Revised Restatement, a court may re-

Fourth, court-ordered discovery of confidential information located abroad — whether through letters rogatory or the Hague Convention — confines assistance requests to judicial channels. Unlike government authorities, courts lack the competence to consider political criteria such as comity [120] or German-American "friendship."[121] Such political considerations might influence a government's decision whether to comply with a friendly government's request for legal assistance.

Last, seeking disclosure of confidential information through court-ordered discovery misallocates judicial resources by requiring a case-by-case approach. Moreover, court-ordered discovery cannot guarantee that a party will obtain all requested documents and information.[122] Rather than rely on pretrial discovery, letters rogatory, or Hague Convention requests, the SEC should consider using other means to obtain information.

III. Alternatives to Current SEC Investigative Practices

To penetrate German bank secrecy, the SEC could use the existing West German Act on International Legal Assistance in Criminal Matters[123] or the planned bilateral treaty on such legal assistance.[124] However, as the following analysis indicates, each of these investigative mechanisms harbors faults and potential problems. The problems inherent in these approaches would be absent in a system that requires investors trading through foreign financial intermediaries to expressly waive their secrecy rights before trading in American securities markets.[125]

---

quire a party ordered to disclose information to make "a good faith effort to secure permission from the foreign authorities to make the information available." Restatement (Revised) of Foreign Relations Law of the United States § 437(2) (Tent. Draft No. 6, 1985). As long as a party makes this effort, the court "ordinarily" will not impose a sanction. *Id.* Adoption of this provision may limit the threat of sanctions available under Fed. R. Civ. P. 37. *See* Von Mehren, *Discovery Abroad: The Perspective of the U.S. Private Practitioner*, 16 N.Y.U. J. Int'l L. & Pol. 985, 989 (1984) (discussing § 437's predecessor, § 420).

[120] Comity is a willingness to grant a privilege, not as a matter of right, but out of deference and good will. Black's Law Dictionary 242 (5th rev. ed. 1979).

[121] Bosch, *supra* note 19, at 135.

[122] Fedders, *supra* note 7, at 98-99.

[123] *See infra* notes 126-40 and accompanying text.

[124] *See infra* notes 141-48 and accompanying text.

[125] *See infra* notes 165-203 and accompanying text.

A. *Cooperation under the West German Act on International Legal Assistance in Criminal Matters*

The West German Act on International Legal Assistance in Criminal Matters (ILA)[126] governs the Federal Republic's processing of requests for international legal assistance in criminal matters.[127] The ILA establishes procedures for questioning witnesses, searches and seizures, and surrendering possession of evidence,[128] referred to collectively by the ILA as "minor legal assistance."[129]To lift the cover of German bank secrecy in an insider-trading investigation, the SEC could seek legal assistance under the ILA.[130] The SEC could request that the bank surrender documents which reveal the identity and the account transactions of the suspected insider.[131] The competent German public prosecutor[132] would then decide whether to grant the request.[133]

Given the treatment of insider trading under West German law,[134] compliance with a request for assistance under the ILA is unlikely. While the "minor legal assistance" provisions of the ILA do not require reciprocity of assistance,[135] they do require that the matter under investigation be a criminal offense in *both* the requesting and requested

---

[126] Gesetz über die internationale Rechtshilfe in Strafsachen [IRG] 1982 BGBl I 2071. For a general discussion of the ILA, see Vogler, *Das neue Gesetz über die internationale Rechtshilfe in Strafsachen*, 36 NJW 2114 (1983).

[127] IRG §§ 59-67. The ILA also establishes mechanisms of international legal assistance for extradition from, and transit passage through, West Germany to foreign nations, *id.* §§ 2-47, for legal assistance through the exercise of enforcement jurisdiction in penal matters, *id.* §§ 48-58, and for West German requests for legal assistance, *id.* §§ 68-77.

[128] *Id.* §§ 59-67.

[129] *Id.*

[130] The ILA provides a fast and effective means for U.S. criminal prosecutors to obtain evidentiary information. Bosch, *supra* note 19, at 134. It takes about 60 days, and in urgent cases, only a few days for German authorities to comply with American requests for assistance. *Id. Contra In re* Grand Jury 81-2, 550 F. Supp. 24, 29 (W.D. Mich. 1982) (requests for legal assistance much less desirable than discovery and require unnecessary formalities).

[131] In fact, a competent German authority can confiscate potential evidentiary material, including records & documents, *prior* to receiving the request for assistance. *See* IRG § 67(1).

[132] The proper addressee of an ILA request is the public prosecutor for the judicial district where the objects sought are located. *See id.* § 66(3).

[133] *Id.*

[134] *See supra* notes 41-54 and accompanying text.

[135] 1 A2 A. WALTER, KOMMENTAR ZUM GESETZ ÜBER DIE INTERNATIONALE RECHTSHILFE IN STRAFSACHEN 2 (2d ed. 1983). The ILA does not obligate the requesting nation to grant an addressee's request in the reverse situation. *Id.*

nation.[136] Since insider trading is not a crime under West German law,[137] authorities there would refuse to comply with an SEC request for bank records.[138] The Federal Republic would have to outlaw insider trading before it would comply with an SEC request under the ILA. Although some German commentators favor this approach,[139] nothing presently indicates that the Federal Republic will change its system of voluntary regulation.[140]

B. The Planned U.S.-German Treaty on Mutual Assistance in Criminal Matters

The United States and the Federal Republic currently are negotiating a treaty on legal assistance in criminal matters.[141] Details of the planned treaty are not yet public, but the potential advantages of a bilateral solution to the insider-trading problem are evident. The planned treaty might overcome the problems resulting from the differing American[142] and West German[143] legal treatment of insider trading, thus facilitating SEC investigations.

However, cooperation under the planned treaty presupposes that both nations will reach agreement on uniform, or at least reciprocal, treatment of insider trading.[144] Since the planned treaty will apply exclusively to criminal matters, it could only promote cooperation con-

---

[136] *See* IRG § 66(2)(1).

[137] *See supra* note 43 and accompanying text.

[138] Technically, since the SEC lacks the authority to initiate criminal proceedings, the Department of Justice would have to request assistance. *See supra* note 104.

[139] *See, e.g.*, Holschbach, *Haftungs-Probleme im Bereich der Insider-Wertpapiergeschäfte*, 26 NJW 2006, 2008 (1973) (arguing voluntary regulation is inadequate to protect the investing public); Will, *Anlegerschutz durch Insiderhandels- Richtlinien?*, 26 NJW 645, 648 (1973) (labelling voluntary regulation a game of chance for insiders).

[140] *See, e.g.*, Barbier, *Soll denn Wissen Sünde sein?: Eine Plädoyer gegen enge Insiderregeln*, Frankfurter Allgemeine Zeitung, July 26, 1986, at 9, col. 1 (arguing voluntary regulation is more effective than any other system).

[141] Hereafter referred to as "planned treaty." Wall St. J., Oct. 31, 1985, at 32, col. 1. The United States and West Germany do not expect to complete the planned treaty before 1988. Telephone interview with Paul-Günter Pötz, Ministerial Director in the West German Ministry of Justice (July 15, 1986).

[142] *See supra* notes 22-38 and accompanying text.

[143] *See supra* notes 41-55 and accompanying text.

[144] Cooperation under the planned treaty is possible only if Germany outlaws insider trading, *see supra* note 139 and accompanying text, or if both nations agree on specific treatment of insider trading, as have the United States and Switzerland, *see infra* note 146.

cerning violations of American insider-trading regulations that are punishable under the German Penal Code as well.[145] To include forms of insider trading outside the scope of the German Penal Code, the Federal Republic and the United States would have to negotiate a supplementary memorandum of understanding.[146] Morever, the planned treaty probably could not eliminate problems, created by SEC requests for information, arising under the West German Criminal Procedure Code.[147] Finally, the West German prohibition of pretrial discovery within its territory limits potential cooperation under the planned treaty.[148] Rather than rely on foreign cooperation in insider-trading investigations, the SEC should act unilaterally and require investors trading through foreign banks to waive their secrecy rights.

---

[145] For a discussion of the German Penal Code's application to insider trading, see *supra* note 41.

[146] The planned treaty might track the Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302. Under that Treaty, assistance is available only for matters that are crimes in both countries. *Id.* art. 4, para. 2(a), 27 U.S.T. at 2028-29. Insider trading is not a crime in Switzerland. Jenckel & Rider, *The Swiss Approach to Insider Dealing*, 128 NEW L.J. 683, 684 (1978). Therefore, Switzerland and the United States signed a supplementary agreement, Memorandum of Understanding on Insider Trading (Aug. 31, 1982, United States-Switzerland), *reprinted in* 22 I.L.M. 1 (1983), as an expression of each nation's intent to cooperate in insider-trading investigations. *See generally* Honneger, *Demystification of the Swiss Banking Secrecy and Illumination of the United States-Swiss Memorandum of Understanding*, 9 N.C.J. INT'L L. & COM. REG. 1 (1983); Comment, *The Effect of Swiss Bank Secrecy on the Enforcement of Insider- Trading Regulations and the Memorandum of Understanding Between the United States and Switzerland*, 7 B.C. INT'L & COMP. L. REV. 541 (1984); Note, *Banking Secrecy and Insider Trading: The U.S.-Swiss Memorandum of Understanding on Insider Trading*, 23 VA. J. INT'L L. 605 (1983); *Recent Development*, 15 GA. J. INT'L & COMP. L. 135 (1985).

[147] The German Criminal Procedure Code authorizes the public prosecutor to demand information from banks. *See* STPO § 161. However, German law compels private banks to disclose confidential information only when the prosecutor has issued a subpoena describing the "criminal matter" (*Strafsache*) under investigation. S. SICHTERMANN, *supra* note 57, at 340; T. KLEINKNECHT & K. MEYER, *supra* note 66, § 161a, margin note 3. Without this subpoena, the prosecutor lacks authority to compel disclosure by private banks. *Id.* § 161, margin note 4. If the Federal Republic does not outlaw insider trading, the public prosecutor would lack statutory authority to compel private banks to cooperate. In that case, a memorandum of understanding would have to provide that insider trading is a crime for purposes of the planned treaty. Only in this way could the SEC obtain the aid of German prosecutorial authorities in compelling private banks to divulge confidential information.

[148] *See supra* note 89 and accompanying text.

C. "Implying" Waiver of Secrecy from Foreign Investors' Conduct

To penetrate foreign bank secrecy, the United States could enact laws requiring foreign and American investors trading through foreign banks[149] to waive the protection of secrecy laws as a condition of transacting in American securities markets. The SEC could "imply" waiver of secrecy because the investor conducted a transaction in an American securities market.[150] Alternatively, the SEC could require these foreign and American investors to expressly waive their secrecy rights.[151] The waiver-by-conduct approach would put all investors on notice by operation of law that the act of effecting a securities transaction in the United States constitutes a waiver of all waivable secrecy provisions.[152]

The waiver-by-conduct approach has several advantages. The SEC easily could implement the approach by enacting the appropiate rule.[153] Waiver by conduct is a blanket solution that obviates the need to negotiate bilateral treaties with every secrecy jurisdiction. Moreover, the waiver-by-conduct approach avoids conflicts resulting from differences between American and foreign discovery systems.[154]

However, the potential disadvantages of the waiver-by-conduct approach considerably outweigh its advantages.[155] Nations with secrecy laws might view a statutory implied waiver of secrecy rights as an unacceptable expansion of the SEC's extraterritorial enforcement pow-

---

[149] Like their foreign counterparts, American insiders can shield their identity and transactions from SEC scrutiny by trading securities through foreign banks. *See supra* note 3 and accompanying text.

[150] The SEC first described the waiver-by-conduct approach in Securities Exchange Act Release No. 21,186, 49 Fed. Reg. 31,300, *reprinted in* SEC. REG. & L. REP. (BNA) 1305 (Aug. 3, 1984) [hereafter 1984 Release]. For subsequent discussion of the proposal, see Fedders, Wade, Mann & Beizer, *Waiver by Conduct — A Possible Response to the Internationalization of the Securities Markets*, 6 J. COMP. BUS. & CAP. MARKET L. 1 (1984); Note, *Critical Appraisal*, *supra* note 2. Waiver by conduct was the subject of a recent symposium: *Policing Trans-Border Fraud in the United States Securities Markets*, 11 BROOKLYN J. INT'L L. 475 (1985).

[151] *See infra* notes 165-203 and accompanying text.

[152] *See* Fedders, *supra* note 7, at 107 (arguing by analogy that fiction of implied consent to state jurisdiction, as developed in nonresident motor vehicle accident cases, is applicable to foreign investors in U.S. securities markets).

[153] The SEC has general rulemaking authority to implement its enforcement powers. *See* Securities Exchange Act of 1934, § 23, 15 U.S.C. § 78w (1982).

[154] For a comparative discussion of the U.S. and West German discovery systems, see *supra* notes 111-12 and accompanying text.

[155] *See* Note, *Secrecy and Blocking Laws*, *supra* note 2, at 860. Like West Germany, most nations with secrecy laws acknowledge implied consent only in very limited circumstances. *Id.*

ers.[156] Consequently, these nations might not recognize United States courts' discovery orders and judgments. Three additional reasons suggest that the Federal Republic would not recognize an implied waiver of German bank secrecy by operation of Unites States law.

First, waiver under German law requires an agreement (*Erlassvertrag*) between obligor and obligee through which the obligee waives a right.[157] The obligee's acts that imply intent to waive create a contract of waiver only upon a clear showing of intent to waive.[158] Waiver requires unambiguous action that the opposite party can understand as the waiver of a right.[159] The bank customer-obligee's act of transacting in American securities would not clearly demonstrate consent to disclosure to the German bank-obligor.[160] Second, the General Terms and Conditions of Trade (GTCT),[161] contained in German banking-service agreements, invalidate "feigned" (*fingierte*) declarations.[162] Thus, the German GTCT Law invalidates contractual provisions that infer terms binding on a bank customer from a specific act.[163] Third, German law might not recognize an implied waiver of bank secrecy since that obligation arguably derives from the constitutional right of privacy.[164] The SEC could avoid these problems inherent in implied waiver by adopting an express-waiver rule.

---

[156] The West German Government already refuses to recognize the extraterritoriality of U.S. court orders and judgments. *See supra* note 110 and accompanying text.

[157] O. PALANDT, *supra* note 62, § 397 1.

[158] *Id.* § 397 2.

[159] *Id.*

[160] The waiver-by-conduct approach is overbroad because it encompasses legitimate foreign investors who trade through German banks. Moreover, Germany would not recognize implied waiver when a customer was unaware that her bank had effected the transaction in the United States. *See* Note, *Secrecy and Blocking Laws*, *supra* note 2, at 855 n.245 (citing a letter from Günther van Well, the Ambassador of the Federal Republic of Germany 3-4 (Dec. 10, 1984) (Comment on SEC Release No. 21,186, File No. S7-27-84 "Waiver by Conduct")).

[161] Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen [AGBG] 1976 BGBl I 3317. The statutory GTCT are nonnegotiable terms and conditions of contract that one party presents to another when executing an agreement. AGBG § 1(1).

[162] AGBG § 10(5).

[163] *See id.*

[164] *See supra* note 60 and accompanying text. U.S. courts will not presume waiver of a constitutional right. Michigan v. Jackson, 106 S. Ct. 1404, 1409 (1986); Tague v. Louisiana, 444 U.S. 469, 470 (1980); Brewer v. Williams, 430 U.S. 387, 433 (1977); Johnson v. Zerbst, 304 U.S. 458, 464 (1938).

IV. Express Waiver of Secrecy

As a precondition to trading in American securities markets, the United States should require foreign investors' express consent to release their financial institutions from secrecy obligations.[165] Express waiver of secrecy, like waiver by conduct,[166] provides a global solution to the problem of obtaining information from investors trading American securities through foreign banks. Both implied and express waiver eliminate the need to negotiate bilateral agreements with each secrecy jurisdiction.[167] However, unlike waiver by conduct, the express-waiver solution altogether avoids problems arising from national differences in recognition of jurisdiction and discovery systems.[168] The SEC's proposed amendment[169] to existing rule 17a-3(a)(9)[170] embodies this express waiver.

Current rule 17a-3(a)(9) requires exchange brokers[171] and

---

[165] The U.S. requires foreign securities firms to register with the SEC as a condition of trading in American securities. H. Bloomenthal, *supra* note 27, at 629. These firms must expressly consent to service of process and produce their books and records at the SEC's request. 17 C.F.R. §§ 240.15b1-5, 240.17a-7 (1986).

[166] *See supra* note 152 and accompanying text.

[167] Enacting an amendment along the lines of proposed rule 17a-3(a)(9), *infra* notes 169-75 and accompanying text, would not preclude negotiating bilateral treaties, when necessary, with secrecy jurisdictions. For example, in Switzerland violations of banking secrecy are criminal. Meyer, *The Banking Secret and Economic Espionage in Switzerland*, 23 Geo. Wash. L. Rev. 284, 304 (1954). Thus, Switzerland has a cognizable interest, separate and distinct from privacy rights of Swiss citizens, in preventing disclosure of confidential banking information. Note, *Foreign Bank Secrecy and Evasion of the United States Securities Laws*, 9 N.Y.U. J. Int'l L. & Pol. 417, 447 (1977) [hereafter Note, *Foreign Bank Secrecy*]. A bilateral treaty is necessary to ensure the cooperation of Swiss authorities with the SEC in investigating violations of U.S. securities laws. In West Germany, unlike in Switzerland, violations of the banking secrecy obligation are civil only. Bosch, *supra* note 19, at 133. Thus, West Germany's interest in the confidential bank-customer relationship arguably is weaker than that of Switzerland. However, the constitutional basis of the German secrecy obligation supports the conclusion that Germany has an interest in maintaining the obligation. *See supra* note 60 and accompanying text.

[168] *See supra* notes 106-13 and accompanying text.

[169] 1976 Release, *supra* note 20; 1977 Release, *supra* note 20. Although the proposed amendment is 10 years old, the SEC still is considering its enactment. *See* Fedders, *supra* note 7, at 104 n.36. Adverse public reaction has delayed the proposal's adoption. *Id.* For a discussion of the public criticism, see *infra* notes 183-201 and accompanying text.

[170] 17 C.F.R. § 240.17a-3(a)(9) (1986).

[171] The 1934 Act defines a broker as any person engaged in the business of effecting securities transactions for the account of others. Securities Exchange Act of 1934, § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1982). This section expressly excludes banks from the

dealers[172] to record the names and addresses of persons authorized to transact in securities for joint or corporate accounts.[173] The rule compels American broker-dealers to record information about foreign banks that trade American securities for account holders.[174] However, it does not require American broker-dealers to record the identity of the account holder for whom the bank is transacting.[175] This loophole enables foreign and American investors to use bank secrecy to shield their identity and trading.

The proposed amendment to rule 17a-3(a)(9) would require American broker-dealers to obtain written agreements from foreign financial intermediaries, including banks, that deal in securities for their customers.[176] These agreements would obligate the intermediary to furnish, at the SEC's request, the name and address of each beneficial owner for whom the intermediary has traded.[177]

The proposed amendment in effect compels financial intermediaries in secrecy jurisdictions to obtain a waiver of secrecy rights from their clients as a condition of maintaining an account with an American broker-dealer.[178] An American broker-dealer would violate the rule by

---

"broker" definition. *Id.*

[172] Brokers and dealers are hereafter collectively referred to as "broker-dealers." The 1934 Act defines a dealer as any person engaged in buying and selling securities for his own account, through a broker or otherwise. Securities Exchange Act of 1934, § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1982). This section expressly excludes banks from the "dealer" definition. *Id.*

[173] Current rule 17a-3(a)(9) requires every broker and dealer to keep:

> A record in respect of each cash and margin account . . . indicating (i) the name and address of the beneficial owner of such account . . . *[p]rovided*, [t]hat, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.

17 C.F.R. § 240.17a-3(a)(9) (1986).

[174] German law authorizes banks to transact in securities. *See* KWG § 1(1)(4)-(6).

[175] *See* 17 C.F.R. § 240.17a-3(a)(9) (1986).

[176] The proposed amendment to rule 240.17a-3(a)(9) would require every broker or dealer to keep:

> A record in respect to each cash and margin account . . . containing the name and address of each beneficial owner of such account . . . [p]rovided, [t]hat, in the case of a joint account or an account other than an account of a natural person, such records are required only in respect of the person or persons authorized to transact business for such account *if such persons undertake to furnish, at the request of the Commission, the name and address of each beneficial owner of such account.*

1976 Release, *supra* note 20, at 8076-77 (emphasis added).

[177] *Id.*

[178] Note, *Foreign Bank Secrecy*, *supra* note 167, at 443. Like West Germany, most

trading for a foreign financial intermediary without the release agreement.[179] Names of foreign intermediaries that refused to sign the release agreement would appear on a "public list"[180] available to broker-dealers.[181] The amendment contains no specific sanctions. However, these are unnecessary, since brokers would normally eschew business with "listed" foreign intermediaries to avoid the risk of a disciplinary action under the 1934 Act.[182]

Due to adverse public reaction, the SEC has postponed enacting the proposed amendment to rule 17a-3(a)(9).[183] Critics of the proposed amendment argue that it is inadequate for several reasons.[184] First, the proposed amendment might divert foreign investment from the United States to other nations, because it would bar investors unwilling to consent to disclosure from trading in American securities markets.[185] Second, investors might avoid detection by inserting layers of nominees[186] between themselves and their bank-brokers.[187] Third, the proposed amendment ostensibly places an undue recordkeeping burden on American broker-dealers.[188] Fourth, nothing in the proposed amendment

---

secrecy jurisdictions recognize express waiver as a valid release from the secrecy obligation. Note, *Secrecy and Blocking Laws*, *supra* note 2, at 860.

[179] 1976 Release, *supra* note 20, at 8076-77.

[180] The SEC would publish and circulate among broker-dealers a list of foreign financial intermediaries who failed to comply with the rule's disclosure requirements. 1977 Release, *supra* note 20, at 3316.

[181] *Id.*

[182] Note, *Foreign Bank Secrecy*, *supra* note 167, at 444.

[183] Fedders, *supra* note 7, at 104 n.36.

[184] *See infra* notes 185-90.

[185] Wall St. J., June 1, 1984, at 7, col. 1. Both waiver by conduct and express waiver might induce investors to trade U.S. securities through offshore funds. Spencer, *The Reaction of the Securities and Exchange Commission to the Internationalization of the Securities Markets: Three Concept Releases*, 4 B.U. INT'L L.J. 111, 114 (1986). Offshore funds are entities organized under foreign law that sell U.S. securities to foreign citizens exclusively outside the U.S. H. BLOOMENTHAL, *supra* note 27, at 655. The SEC does not police offshore funds' activities if they restrict their sales to foreign investors. *Id.* at 655-56. In 1983 existing offshore markets listed the following numbers of U.S. securities issues: London (150), Amsterdam (150), Zurich (91), Paris (43), Brussels (38), and Tokyo (12). 1984 Release, *supra* note 150, at 1315 n.45.

[186] A nominee is an individual, partnership, or corporation that holds title [to securities] on behalf of beneficial owners. Fischer, *The Mysterious Bank Nominee*, 89 BANKING L.J. 911, 913 (1972).

[187] *See Crime and Secrecy: The Use of Offshore Banks and Companies: Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs*, 98th Cong., 1st Sess. 331 (1983) (prepared Statement of John Fedders, Director of Enforcement, Securities and Exchange Commission).

[188] *Id.*

precludes investors from revoking their consent, once given.[189] Last, the amendment fails to specify the conditions under which the SEC may request disclosure.[190]

At first glance, the arguments against adopting the proposed amendment to rule 17a-3(a)(9) appear formidable. However, closer examination reveals that the proposed amendment would likely not encounter its alleged problems.

First, the proposed rule would not necessarily deter legitimate foreign investors from transacting in American securities markets. To the extent that express waiver would deter potential violators of United States law from investing, it would enhance the integrity of American securities markets.[191] The residual loss of legitimate foreign investors whom the express-waiver requirement would repel is arguably a fair price for maintaining the integrity of American securities markets.

Second, express waiver would in most cases enable detection of offenders despite layers of nominees.[192] American broker-dealers or foreign bank officials could require waiver agreements from each layer of nominees. Sophisticated inside traders might attempt to conceal their identities by operating through entities formed in nations that permit the principals of such entities to remain anonymous.[193] In extreme cases, express waiver admittedly could not guarantee disclosure of the true investors' identity. However, the SEC's existing investigative alternatives — requests for legal assistance, litigation, and waiver by conduct — similarly fail to resolve this aspect of the nominee issue. Even bilateral or multilateral negotiations between the governments of secrecy nations and the United States could not eliminate entirely the use of corporate entities to conceal fraudulent securities transactions.[194] Un-

---

[189] Note, *Foreign Bank Secrecy*, *supra* note 167, at 448.

[190] *Id.* at 447.

[191] Note, *Critical Appraisal*, *supra* note 2, at 1425-26.

[192] *See supra* note 196 and accompanying text.

[193] For example, an investor with inside information could create a corporation under the laws of Panama. Panamanian law permits companies to issue bearer shares. PANAMANIAN BUSINESS LAW 3 (Corporacion Fiduciara De Panama Ed. 1981). Unlike registered shares, bearer shares are stock certificates issued to holders whose identity is not registered on the issuer's books. *See* R. SCHLESINGER, COMPARATIVE LAW 766-68, 775 (4th ed. 1980). The inside investor then would open an account with a German bank in the Panamanian corporation's name and commission the bank to buy, then sell particular securities. Express waiver would enable the SEC to discern that a Panamanian corporation traded shares. However, the Commission could not identify the bearer shareholder who commissioned the securities transactions.

[194] Panama, for example, does not exchange information concerning Panamanian corporations with foreign governments. PANAMANIAN BUSINESS LAW, *supra* note 193,

like these alternatives, express waiver would at least enable the SEC to identify in an insider-trading investigation the entity for whom the bank traded.

One commentator has indicated that extending express waivers through layers of nominees is impracticable because it compels the American broker-dealer — and ultimately the SEC — to rely on the honesty of foreign bank officials who obtain the required waivers.[195] This challenge to the integrity of foreign banks doing business in the United States ignores that these banks have an interest in cooperating with the SEC to avoid litigation and possible sanctions.[196] Foreign banks presumably would exercise self-regulation to the degree necessary to achieve good faith compliance with American securities regulations.

Third, assistance by foreign banks would alleviate the recordkeeping burden that the proposed amendment imposes on American broker-dealers. If foreign banks cooperate with American broker-dealers, the broker-dealers can readily obtain the required express consent. Foreign banks would do their part to procure the express waivers from their customers.[197] They share a common interest with American securities dealers: realizing a profit by transacting in securities for bank customers.

Fourth, to address the problem created when investors revoke their consent, the written waiver should contain a notice provision. That provision should specify that the customer can revoke consent only pro-

---

at 3.

[195] Note, *Secrecy and Blocking Laws*, *supra* note 2, at 861 n.274.

[196] For a discussion of judicial action by the SEC, see *supra* note 104 and accompanying text.

[197] To implement the U.S.-Swiss Memorandum of Understanding, *supra* note 146, banks in Switzerland have obtained express waivers from their customers. Letter from Michael D. Mann, Chief, Office of International Legal Assistance, Division of Enforcement, Securities and Exchange Commission (Feb. 24, 1987) (on file with the U.C. Davis Law Review).

One U.S.-based international bank requires express consent to disclosure of U.S. and foreign applicants for trust accounts that the bank administers in secrecy jurisdictions. STAFF OF SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, 98TH CONG., 1ST SESS., CRIME AND SECRECY: THE USE OF OFFSHORE BANKS AND COMPANIES 99 (Comm. Print 1983). The client must consent to disclosure in the trust management agreement. *Id.* Counsel in secrecy jurisdictions recognize this as a valid waiver. *Id.* To investigate these trust accounts, federal authorities may approach the bank for access either with a grand jury subpoena or a court order, or may opt to write a letter of request. *Id.* Normally, the bank must notify the client of the pending federal investigation. *Id.* The client then may require the federal authorities to show cause in court to justify access. *Id.*

spectively and after receipt of notice by the SEC.

Last, the SEC should specify the circumstances under which it may request disclosure from American broker-dealers. Rule 17a-3(a)(9) should require the SEC to obtain a court order to compel disclosure of a foreign investor's identity from an American broker-dealer. To procure the disclosure order the SEC would have to comply with a discovery standard more stringent than the simple "relevance" test of Federal Rule of Civil Procedure 26.[198] Specifically, the SEC would have to show that the beneficial owner's identity it seeks to discover is directly relevant, material, and necessary to the matter under investigation.[199] The SEC could establish necessity by showing lack of alternative means to discover the investor's identity.

This proposal imposes a relatively small burden on the SEC and demonstrates greater respect for foreign interests in bank secrecy than the SEC's investigative alternatives. To compel discovery abroad, administrative agencies, including the SEC, already require court orders, because their own investigative subpoenas do not authorize foreign discovery.[200] Moreover, information gleaned from the SEC staff's preliminary investigations should enable the SEC to show readily the requisite direct relevancy, materiality, and necessity for a court order to issue.[201] Finally, a judicial determination compelling disclosure accords greater deference to legitimate foreign interests in bank secrecy than does an administrative decision by the SEC. This recognition might induce governments in secrecy nations to cooperate more fully with SEC insider-trading investigations reaching beyond the United States.

With regard to West German law, two features of express waiver merit emphasis. Express waiver comports with German law, which

---

[198] Rule 26 allows discovery of "any matter, not privileged, which is relevant to the subject matter involved in the pending action." FED R. CIV. P. 26(b)(1).

[199] Section 437 of the RESTATEMENT (REVISED) OF FOREIGN RELATIONS LAW, *supra* note 119, proposes this heightened discovery standard for U.S. courts when ordering discovery from nonresident foreign citizens subject to the U.S. court's jurisdiction. The Restatement would also require the U.S. court to consider "relevant foreign interests" that the discovery order might affect. *Id.* § 437 comment b. However, under this Comment's proposal, a U.S. court hearing the SEC's motion for a disclosure order would not directly consider foreign interests in bank secrecy. Under the express-waiver approach, the foreign investor would have waived the secrecy obligation *before* trading in U.S. securities. Therefore, foreign interests in protecting that obligation would be immaterial to the court's determination.

[200] *See, e.g.* Commodity Futures Trading Comm'n v. Nahas, 738 F.2d 487 (D.C. Cir. 1984); SEC v. Zanganeh, 470 F. Supp. 1307 (D.D.C. 1978); *see also supra* notes 101-02 and accompanying text.

[201] For a discussion of SEC investigations, see *supra* note 81.

recognizes a bank customer's waiver of the secrecy obligation.[202] Moreover, the express-waiver requirement parallels the German Insider Rule requiring suspects under investigation to expressly waive their right to secrecy.[203] Germans who trade in American securities markets should not be able to use the bank secrecy shield when they could not do so while investing in German securities.

The requirement of express waiver, in the form suggested here, is an effective alternative to current SEC investigative practices. By requiring investors to consent to bank disclosure before trading in American securities, the SEC can obtain information vital to successful insider-trading investigations.

CONCLUSION

Some investors in American securities markets use foreign bank secrecy in effecting transactions violating United States insider trading laws to avoid detection by the SEC. To eliminate that shield, the SEC should require all investors trading through foreign banks to expressly waive their secrecy rights for purposes of SEC investigations. The proposed amendment to rule 17a-3(a)(9) embodies this express-waiver approach. The amended rule would facilitate SEC investigations and eliminate the need to initiate litigation to compel bank disclosure. However, the SEC should modify the amendment to require SEC compliance with a heightened discovery standard before it may request disclosure from investors trading through foreign banks. This modification would promote recognition of the express waiver in secrecy jurisdictions that otherwise might view the SEC's investigative efforts as unfounded intrusions on the privacy rights of those nations' citizens. The express-waiver approach offers a global solution that obviates the need to negotiate numerous bilateral treaties with nations that protect bank secrecy in a variety of forms. Modifying and adopting proposed rule 17a-3(a)(9) would allow the SEC to enforce its mandate to insure the fairness and integrity of American securities markets.

Peter Q. Noack

---

[202] *See supra* notes 78-79 and accompanying text.

[203] *See supra* note 47.