SUMMARY

PROBLEMS OF ENFORCEMENT IN THE MULTINATIONAL SECURITIES MARKET ROUNDTABLE

1. Introduction — The Seminar

On March 27, 1987, the International Faculty of the University of Pennsylvania Law School conducted a symposium in Philadelphia, Pennsylvania, on the current problems in international enforcement of securities laws. The conference, organized and chaired by Robert H. Mundheim and Noyes E. Leech, included participants from Switzerland, France, the United Kingdom and Canada, and from the United States, representatives of the Securities and Exchange Commission (SEC or Commission), academia and private practice. This summary of the seminar’s proceedings is intended to reflect the opinions, recommendations and suggestions of the participants.

1.1. Background

Over the last decade the world’s securities markets have become increasingly internationalized. The Tokyo and London exchanges have grown dramatically and will soon rival Wall Street in volume. Advances in telecommunications permit instantaneous trading from nearly any point on earth. Multiple listing of securities on the major exchanges is becoming common, thus creating the potential for continuous trading of a particular security. It is increasingly apparent that securities violations in one country will have effects on the world market for securities: inside information obtained in London in the morning can be used that afternoon on the New York Exchange, and market manipulation of a stock traded in the United States market will also affect the market for that stock in London, Paris and Tokyo. Regulators worldwide are beginning to recognize the need for international cooperation in securities law enforcement.

1.2. Purpose

The purpose of the seminar was to identify areas of securities law enforcement practice and policy on which there was both general inter-
national agreement and disagreement. The United States and the SEC, with the broadest securities regulations and the most well-developed system of enforcement, were chosen as the basis from which to develop a recognition of problems and potential solutions. The papers presented to the seminar and the ensuing discussion focused on two hypothetical violations of United States securities law.

1.2.1. Hypothetical No. 1: Disclosure

The subsidiary of a United States corporation is incorporated in and conducts significant operations in a foreign country, Country X. The subsidiary is one of the largest corporations in Country X, employing many nationals of that country. Allegations are made that certain officers of the foreign-based subsidiary may have falsely booked sales of the subsidiary in order to conceal losses of the subsidiary which would have materially affected the overall financial position of the corporation. Before the allegations were made, accountants in Country X issued an opinion that the financial statements of the subsidiary had been prepared in accordance with generally accepted accounting principles.

Pursuant to the United States securities laws, the corporation filed consolidated financial statements with the SEC. The statements were covered by a United States auditor's report that did not make reference to the report issued by the accountants in Country X.

The SEC investigates the allegations to determine their validity. The SEC deposes the corporation's United States-based officers and United States-based accountants. As a result, the SEC staff obtains evidence which suggests that the earnings have been falsified by unknown individuals who are employed by the subsidiary and who reside abroad. It is unclear whether the person or persons (employed by the subsidiary) who falsified the records were acting independently or rather at the instance of United States-based officers. The SEC now needs access to documents and testimony of the foreign-based officers, employees and accountants in order to conduct a thorough investigation and determine who, if anyone, is liable.

The United States and Country X have both ratified the Hague Convention for the Taking of Evidence, but they have not negotiated any bilateral agreements that would relate to the investigatory activities of the SEC. Country X has enacted a "blocking statute" similar to that of either Great Britain or France.

1.2.2. Hypothetical No. 2: Market Transactions

An individual opens an account with a foreign bank or brokerage
firm which has no significant presence in the United States, and is domiciled in a country that has rigid bank secrecy or blocking statutes. Upon opening the account, the individual immediately places a large order to purchase securities of Company X, a New York Stock Exchange-listed company. The transaction is executed by an American brokerage firm (on the New York Stock Exchange) pursuant to a telex the firm received from the foreign institution; the telex directs both the trade and the amount of shares to be purchased. The foreign institution maintains and trades through an “omnibus” account in its own name at the American brokerage firm.

Within several hours of the execution of the order, the announcement of a tender offer for the securities of Company X causes the price of the stock to rise by $20 per share. Based upon the circumstances of the purchase, the SEC commences an investigation in the United States to determine whether the purchaser violated United States law by his placing the order while in possession of material, nonpublic information which related to the tender offer. The SEC learns from Company X that, during the two weeks prior to the announcement, critical acquisition negotiations were conducted, thus heightening the suspicion that the purchaser may have traded while he was in possession of material, nonpublic information.

2. The Seminar — Premises

The symposium operated under the premise that members would participate as individuals, rather than as representatives of their respective governments, agencies or firms, and that questions and issues would be explored, rather than any official positions be stated. The purpose was to develop a factual understanding of what information could and could not be obtained from foreign entities by the SEC and by foreign agencies from United States entities under the current regime of domestic and international laws, treaties and agreements, to pinpoint the types of information most difficult to obtain, and to identify areas of mutual understanding and agreement from which to develop solutions in an evolutionary manner.

2.1. Disclosure Hypothetical

2.1.1. Preliminary Investigation

The morning session was devoted to exploring the foreign accounting hypothetical, where a foreign subsidiary of a domestic corporation may have misstated material financial information which was subsequently reported in the parent’s financial statements. It was agreed that
the SEC would need to seek information by three methods: (1) by a review of the foreign auditor's papers to ascertain whether proper procedures were followed; (2) by obtaining substantial documentation from the subsidiary; and, (3) most important, by deposing the subsidiary's chief financial officer and other key employees, as well as the auditors and other non-employees of the subsidiary, if questions were raised by the preliminary investigation. Although the United States corporation might begin by cooperating, it is likely that the SEC would eventually be required to proceed formally. Once formal proceedings were initiated, the SEC would attempt to obtain the books and records and to take depositions of key officers of both the parent and the subsidiary by subpoenas issued and, if possible, served in the United States. The attempt to forcefully obtain information will probably conflict with the interests of the foreign government and with its laws.

At the informal investigatory stage, a United States parent that does not cooperate in the investigation can take a position to hinder the SEC's attempts to obtain the requested information: first, it can assert that production of the subsidiary's books and records is precluded by a foreign blocking or secrecy statute; second, it can be asserted that although the parent holds the subsidiary's stock, it does not control the subsidiary and therefore cannot force it to produce information. In such situations the SEC has in the past been able to arrange with the parent a satisfactory procedure by which the parent produced the requested information from the subsidiary. With major corporations the SEC is often able to use its influence (e.g., approval of quarterly and yearly financial reports) to obtain production of information.

A second potential area of conflict is likely to be encountered before formal proceedings are initiated, namely in obtaining information from foreign auditors who were not affiliated with the United States auditor who prepared the consolidated financials, but upon whom the United States auditor relied. Further conflict is anticipated in obtaining testimony from employees of both the auditor and the subsidiary, who participated in the preparation of the report, but were no longer employed by either company. Since 1980 there has been a resurgence of accounting issues and it appears that serving a subpoena on the United States parent will often reveal that the required documents are, in fact, located in the United States. In addition, the SEC has often been able to obtain enough information domestically to fashion a remedy without the necessity of going into the foreign country to obtain evidence. It was agreed, however, that significant problems would be encountered if the SEC sought from third parties located in foreign countries information essential to determining if a violation has
occurred.

There was a consensus among the foreign participants that obtaining documents from either the foreign subsidiary or auditor was often possible. It was also agreed that blocking statutes tended not to be invoked to prosecute foreign citizens, but rather, were in place to provide foreign citizens an excuse not to produce documents. There was general agreement, however, that if the SEC first contacted and then worked with the foreign agency regulating securities or with the foreign government itself, the necessary documents could, with few exceptions, be produced. It was stressed that material misrepresentation of corporate financial statements was a crime in all of the jurisdictions represented and that each foreign country would have a strong interest in identifying and eliminating such practices.

A more formidable problem was obtaining testimony from a foreign national, particularly if the individual were no longer employed by one of the parties and could not, therefore, be induced to testify by the party. Canada's blocking statute, for example, guarantees certain personal rights which would enable an individual to invoke the statute to avoid testifying. It was agreed that any procedure to obtain such testimony must necessarily be negotiated informally.

It was suggested that a possible solution to the documentation problem would be to amend United States reporting requirements to require that a United States auditor maintain, physically in the United States, all foreign reports and working papers on which it relied. Working papers, even if falsified, were regarded as helpful in any investigation. In response to a suggestion that uncooperative foreign auditors be blacklisted to prevent future use of their reports by United States companies, it was pointed out that such a course of action would give rise to numerous new "accounting" blocking statutes.

2.1.2. Formal Proceedings

The focus of the discussion next shifted to the situation in which the SEC has obtained enough information to issue a formal order of investigation. Skepticism was expressed about the willingness of foreign authorities to discipline domestic auditors, when the only persons injured were foreign investors. The general response was that all jurisdictions represented had laws against fraud, and that if information indicating fraud were obtained there would be an investigation in the foreign country. Common sense indicated that an auditor willing to falsify the financials of the subsidiary of a foreign parent would be equally or more willing to do the same for a purely domestic corporation.
It was agreed that foreign securities regulators lacked criminal enforcement powers and that any criminal investigation and prosecution must be conducted by a separate justice ministry or department. Consensus was again reached that foreign governments would conduct investigations in nearly all cases if the SEC sought cooperation and provided inculpatory information. There was also consensus, however, that no foreign government or agency would permit the SEC to mandate enforcement policy or procedure. In fact, it was agreed that any unilateral United States action against a foreign entity (e.g., blacklisting, seeking information in a foreign country without government approval) would ensure that no foreign cooperation would be forthcoming. Finally, it was suggested that the SEC could as a practical matter be given access to the results of foreign investigations and that informal assistance by the various securities regulatory bodies would often be forthcoming.

A brief examination indicated that, like its foreign counterparts, the SEC would be limited in the assistance it could provide to a foreign government seeking information in the United States concerning a violation of foreign securities law. Without a clear indication that a United States law had been violated, the SEC would be unable to conduct a formal investigation. The foreign government would have to obtain the needed information under a formal treaty, if it existed, or perhaps through the Justice Department's foreign enforcement arm.

Certain anomalies in the SEC's position concerning investigations of securities law violations were highlighted. While the SEC desires to conduct its own investigations in foreign countries—a procedure foreign participants found objectionable—the SEC is unwilling and unable to allow or meaningfully assist a foreign country's investigation in the United States. It was suggested that this jealous guarding of national borders and jurisdiction went to the heart of the problem, and that increasing internationalization of securities markets with its concomitant need for international regulation presented an opportunity for increased multinational cooperation.

2.1.3. International Enforcement Recommendation

As a means of addressing this problem, it was proposed that each country have an agency or assigned group of persons that within its jurisdiction would assist foreign investigations of foreign securities law violations. The agency or group would have enforcement authority and would be cognizant of common securities enforcement problems. The existence of an identified group within each country would promote relationships of trust and common experience. As a consequence, the
duplication of effort would be lessened, the sharing of information expedited and the investigation time decreased by hastening the recognition of false or misleading evidence. Although some progress toward such a system could be made informally, full scale implementation would require legislation and would likely be difficult to achieve in the short term.

3. The Trading Hypothetical

The afternoon session was devoted to discussion of the insider trading hypothetical. A United States individual effects a trade, using either a foreign bank or broker which has no significant presence in the United States, of the shares of a United States corporation shortly before the corporation announces a merger; the announcement of the merger increases the United States corporation's stock price dramatically. Such a situation would be prima facie evidence that something illegal has taken place. It was noted that all recent insider trading cases in the United States have had at least some aspects that would be illegal in all the foreign participating jurisdictions.

3.1. Preliminary Investigation

In such a situation, the SEC would again start with informal inquiries in the United States; these inquiries would yield the identities of all entities engaged in the trading and of all participants in and of most individuals with knowledge of the merger. At this point in the preliminary investigation, the SEC would seek from the foreign jurisdiction the following information: (1) the identity of the customer who ordered the stock purchases; (2) relevant customer documents from the foreign bank to aid in identifying the purchaser and his relationship to the foreign institution; (3) information from employees of the bank and those making the purchases; (4) information from any foreign individuals or entities involved in the merger; (5) documentation from hotels, airlines and the like regarding phone calls, credit card use and any other circumstantial evidence relevant to the case.

The SEC has frequently sought the information it needs by proceeding in the United States against a foreign entity such as the intermediary bank which has a branch or subsidiary in the United States. Foreign participants in the seminar found this practice to be coercive. It was noted at this point in the discussions that the political and social climate in the United States toward insider trading had hardened and may make this approach to developing information more successful for the SEC. Courts seem more inclined today to pressure foreign banks
(by freezing assets they hold in the United States) for information and to disregard the foreign banks' claim that providing such information will subject them to penalties under blocking and secrecy statutes. The SEC was warned by United States and foreign participants that taking advantage of the existing attitude in the courts was not wise. It represented a unilateral effort which would spawn resentment and encourage retaliatory responses. It was considered highly desirable that effort be devoted to developing a timely and effective means of cooperative international investigation.

Initially, the SEC would seek voluntary cooperation from the foreign banking institution. It was recognized that the problems with this approach included: (1) the refusal of some foreign banks to cooperate; (2) the possible destruction of inculpatory documents if the bank had participated in illegal activity; (3) the permitted withdrawal of funds because of loyalty to the customer; (4) the fear of civil liability for the cooperating institution. The SEC has had only limited success in obtaining voluntary cooperation from foreign banks, especially in jurisdictions having bank secrecy laws. In addition, in situations where, for example, a Swiss parent bank has a Bahamian branch, the SEC would possibly confront two different bank secrecy statutes with little likelihood that even a cooperating parent would be able to produce information from its branch office.

There was a consensus among foreign participants that a SEC investigatory procedure that cooperated with the foreign agency's regulating banks and securities firms would produce the best results. United States practitioners stressed that accommodation was best for long term relations and that the resentment caused by United States behavior in the antitrust uranium cases was cumulative and would hinder enforcement. Although the United States judicial process could produce many victories for the SEC, the SEC would not in the long run obtain the foreign information it needed. Many believed that the opportunity for cooperation was present and that to obtain more bilateral agreements similar to the United States-Swiss Treaty and Memorandum of Understanding (MOU) served as a helpful model for the future.

General foreign concern was expressed about the limited amount of preliminary evidence required by the United States courts to permit the SEC to pursue information in foreign jurisdictions. There was much concern with the United States assertion of jurisdiction on the mere allegation of wrongdoing. Similarly, it was felt that discovery should not be allowed simply for "fishing expeditions." It was also believed that where a foreign agency sought facts in aid of SEC requests, results of its investigation must be accepted by the SEC as definitive.
3.2. Memoranda of Understanding

The discussion next turned to the effectiveness of the United States MOUs with the United Kingdom and with Switzerland, and whether the MOUs could serve as models for future agreements. The strengths of the Swiss MOU were considered to be the ability to freeze assets quickly, to set a time frame in which all procedures must be completed, and to allow a Swiss group to make all decisions concerning when to pursue a case and under what rules. The Swiss MOU was viewed by participants as too limited (it deals almost exclusively with insider trading) to serve as a model for future agreements, and participants preferred instead a model based on the United Kingdom MOU. By contrast, the United Kingdom MOU covers all types of market violations. Participants felt it critical that the SEC be willing to accept the establishment of an independent panel in each country signatory to a MOU-type agreement in deciding whether information requests or investigations were valid.

3.3. Inadequacies of Coercive Jurisdiction

Assuming it is desirable, in the long term, for the SEC to forego recourse to the courts in exchange for help from regulatory agencies of a country, on which foreign investigatory cooperative procedures should the SEC insist? It was suggested that the SEC should accept the fact that a foreign government will not allow the United States to make the final determination as to whether evidence could be compelled from one of its nationals, and that the key agreement would be one whereby the foreign agency would pursue an investigation when the SEC had facts which met a certain threshold level. The agency would conduct such an investigation if the acts were in violation of United States law, indeed for the agency to conduct an investigation, the acts would also have to be a violation of a foreign country’s law (dual criminality); other participants thought that dual criminality should not be the determinant, but rather that some restraints against political criminals should be retained.

Such a procedure would work well between countries that have well-developed and similar securities laws. The important aspect of the model would be to allow each country to make its own jurisdictional decision — to control its own sovereignty. Given this premise, an agency composed of securities regulators would be much more willing to recognize the importance of cross-border securities problems. Such a system would require legislation both in the United States and abroad. For example, it may be appropriate for the SEC to initiate an investi-
gation to develop information solely because it is requested by a foreign regulator. However, as countries recognize that a common problem exists, they may be more willing to pursue a common approach.

The discussion then focused on the potential, assuming the previously discussed agreements were implemented, for "a rush to the bottom" — a flight by questionable traders and business entities to countries without either securities regulation or regulatory agreements with either the United States or with other countries with active securities markets, and with strong secrecy and blocking statutes. The SEC stated that if a substantial number of agreements were negotiated, "dirty" business would be driven to havens. Suggestions for dealing with this problem ranged from black-listing entities trading from havens, to placing more pressure on parent banks to obtain requested information from branches located in the havens.

Finally, the current status and future potential of bilateral treaties were examined. Although most current SEC investigation in Switzerland is conducted under the United States-Swiss MOU, satisfactory results have also been achieved under the 1973 Treaty Between the United States of America and the Swiss Confederation on Mutual Assistance in Criminal Matters. However, it is expected that in 1988 insider trading will become a crime in Switzerland and that the MOU will cease to have effect. Potential problems may then arise in securities enforcement if a form of securities violation occurs that is not covered by the Treaty, and by the opportunities for delay in asking a court to interpret unclear terms in the Treaty.

Participants agreed that a bilateral treaty also appeared to be necessary to effect investigatory cooperation between the SEC and France. The French securities regulatory agency, the Commission des Opérations de la Bourse (COB), has little enforcement power and the French government is opposed to the SEC's taking evidence in France. It was noted that France currently has a well-developed system of securities regulation and that the political climate is tending toward recognition of the necessity for international securities regulation.

4. Conclusion

In conclusion, it was noted that the MOU, on the one hand, has proved to be a flexible and beneficial instrument; treaties, on the other hand, might be more rigid instruments because treaty changes are virtually impossible to accomplish in any meaningful manner. In the very dynamic and developing area of international securities regulation, there is a substantial risk that a treaty could soon prove to be more of a hindrance than a help.