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SECURITIES REGULATION IN GERMANY AND THE U.S.

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JOINT SEMINAR PAPER ON CORPORATE GOVERNANCE –
A COMPARATIVE PERSPECTIVE BETWEEN THE US AND GERMANY, WINTERTERM 15-16
CONDUCTED BY PROF. J. FISH AND PROF. DR. B. HAAR LL.M. (UNIV. CHICAGO)

SECURITIES REGULATION

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TRAVIS TIPTON
MARVIN FECHNER

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Abbreviation

AktG Aktiengesetz

BaFin Bundesanstalt für Finanzdienstleistungsaufsicht

BAWBundesaufsichtsamt für Wertpapierhandel

BGB Bürgerliches Gesetzbuch

BGBL. Bundesgesetzblatt

BoersG Börsengesetz

CFTC Commodities Futures Trading Commission

EUR Euro

EC European Commission

ESMA European Securities and Markets Authority

et. al. et altera

EU European Union

FAQ Frequently Asked Questions

FED Federal Reserve of the United States

FDIC Federal Deposit Insurance Corporation

FinDAG Finanzdienstleistungsaufsichtsgesetz

FINRA Financial Industry Regulatory Authority

FSA Financial Services Authority

GG Grundgesetz

HÜSt Handelsüberwachungsstelle

JOBS Jumpstart Our Business Startups

KapMuG Kapitalanleger-Musterverfahrensgesetz

OwiG Ordnungswidrigkeitengesetz

KAAG Kapitalanlagegesellschaftengesetz

para. Paragraph

SEC Securities and Exchange Commission

SOX Sarbanes-Oxley Act of 2002

SRO Self Regulating Organization

StPO Strafprozessordnung

UK United Kingdom

US United States of America

VwVfG Verwaltungsverfahrensgesetz

VwVG

WpHG

WpPG

WpÜG

Verwaltungsvollstreckungsgesetz

Wertpapierhandelsgesetz

Wertpapierprospektgesetz

Wertpapiererwerbs- und Übernahmegesetz

A. Securities Regulation in Germany

Securities law as a distinguished field of law did not exist in continental Europe prior 1980. Due to the pressure to implement European directive into national law did securities eventually emerge from the shadows. While a US securities regulation system has already been advanced in the sixties the European system has not been able to catch up such a lead.¹

I. Introduction to securities law and regulation in Germany

This paper is trying to give an overview on German securities regulation law. Securities regulation and capital markets law are used synonymously in Germany and describe the same regulatory scope.² To introduce the topic the spotlight shall be briefly on the historic development of securities regulation before policy goals and principles of regulation are explained. The process of rule-making, the supervision of security markets and its participants as well as the enforcement of securities law as core elements will be examined in more detail. To conclude the topic, the regulatory response of the European legislator to the financial crisis of 2007-09 will be outlined.

1. Regulated self-regulation of the security market

The term regulation is broad and therefore leaves room for different explanatory approaches. One approach that also describes a function of regulation is the concept of administrative regulated self-regulation as described by the German term ‘Gewährleistungsverwaltung’: ‘meaning measures that secure functionality of a certain field of business by activating and shoring action-guiding criteria.’³ The field of regulation regarding the capital market is a German and European security market that describes principles and rules which target the public trade of capital goods, for example securities, stocks, bonds et al..⁴ The regulation to be examined is therefore the regulation of the market as described in § 2 V WpHG⁵. New developments like the ‘lex prokon’ that target regulation regarding the ‘grey capital market’ in order to achieve higher standards of consumer protection are beyond the scope of this paper. On the international level, securities market law is often divided into two main subcategories: ‘regulation’ and ‘supervision’. ‘Regulation’ refers to rule-making whereas ‘supervision’ deals with the application

¹ *Veil*, in: *Veil, Europäisches Kapitalmarktrecht*, 2.ed (2014), § 6 para.1.

² *Veil*, in: *European Capital Markets Law* (2013), § 2, para. 2.

³ *Bumke*, *Regulierung am Beispiel der Kapitalmärkte* (2008), 108; *Schmidt-Aßmann*, *Verwaltungsrecht in der Informationsgesellschaft* (2000), 405 (425).

⁴ *Bumke*, *Regulierung am Beispiel der Kapitalmärkte* (2008), 110.

⁵ Wertpapierhandelsgesetz – WpHG, as of November 20 2015, BGBl. 2029.

of rules to specific cases.⁶ Security regulation is distinct from the regulation of financial markets. Security regulation targets security markets while financial regulation refers to the oversight of Banks and similar actors.

2. Securities regulation policy

The primary aim of security regulation in Germany is to secure and preserve the functionality of capital markets. The protection of investors is considered to be ‘just a reflex’ but not a primary goal.⁷ Thus the task of investor protection is subordinate. The European approach to harmonize security regulation targets the protection of confidence and susceptibility to trouble by concentrating on investor protection (disclosure) and functionality of the security market.⁸

3. Brief introduction to the ‘history’ of German and European Securities Regulation

In 1993 a study book about European Company Law stated that ‘the public company structure has steadily lost importance in Germany over the last two decades. [...] In Germany one hears about the crisis of the corporation.’⁹ Nonetheless, securities law experienced a dynamic development due to an immense enlargement of corporate business activities and an increase in capital market products and services since the early nineties up until the bubble of the ‘new economy’ burst in 2000.¹⁰

Security regulation as one external factor of corporate governance has been in the focus of economic policy making in almost every industrial state since that time. The core question is how to achieve a statutory framework that both de jure and de facto promote good, responsible and sustainable value added corporate governance?¹¹

At the outset of the European project, the EC and the European Council claimed to be responsible for securities regulation legislation in order to accomplish the goal of one single European market.¹² The harmonization process in this field originates from the *Segré*-Report of 1966. That report intended to target the coordination of stock market and prospectus law and also effected the harmonization process and policy making of securities market law until the nineties. The original idea of a comprehensively harmonized capital market law for all member

⁶ *Wymeersch*, EBOR, 237 (242); *Moloney*, EC Security Reg., 2014, 1009.

⁷ BGH II ZR 80/12 para. 20, BT Drucks. 14/7034, 36.

⁸ *Follak*, in *Dausies*, Hdb. EU-Wirtschaftsrecht, F.III, para. 44,46.

⁹ *Aretz*, European Company Law (1994).

¹⁰ *Wittig*, 2011, 10.

¹¹ *Hopt*, ZHR, 2011, 444, (444).

¹² *Veil*, in: *Europäisches Kapitalmarktrecht*, *Veil*, 2014, § 1, para. 2; *Enriques/ Tröger*, ECGI 90/2007, 2008, 8.

states and one single oversight body was abandoned after the UK entered the European stage.¹³ Therefore the implementation of supervisory authorities was left to the Member states. An impetus to the overhaul of German capital market law was when the SEC criticized securities issued in Germany as being below Wall-Street-quality. Both practitioners and scientists in Germany promoted self-regulation up until this point.¹⁴ Consequently, the legislator introduced the second capital market promotion act, which included the BAW (*Bundesaufsichtsamt für Wertpapierhandel*), a federal administration created in 1994 to monitor securities trading.¹⁵ On the European level another milestone has been the *Lamfalussy*-Report of 2000, which criticized the slow process of law making as the major obstacle to one European capital market law.¹⁶ As a consequence of the reports recommendation, the EC passed the Prospectus Directive (2001/34/EC [2003] OJ L345/64) in 2003. It again addresses important aspects towards a maximum harmonization regarding prospectus law by leaving little space for national ‘*Sonderwege*’.¹⁷ In the aftermath of the financial crisis severe deficits of the global financial market system were revealed. The EC mandated a group presided by chairman *de Larosière* to work out recommendations for future Regulation and oversight of European Capital Markets.¹⁸ On the Basis of the *de Larosière*-Report, the Commission took measures to fight systemic risks on the financial market such as the establishment of the European Financial Stability Facility. Securities regulation law alias capital market law on a European level may be characterized by unity and diversity from a European perspective.¹⁹ Maximum harmonization aims at the elimination of all deviations in the capital markets law on national levels whereas minimum harmonization merely requires certain minimum requirements that must be met but may be exceeded.²⁰ Due to the process of European harmonization, German legislation on the field of capital market regulation is closely bounded to the Community’s rules. Nonetheless, securities regulation has always been and remains a matter for Member States.²¹ The milestones that formed the statutory framework of national security law alias capital market law during the past 26 years are four legislative reforms referred to as ‘Capital Market Promotion Acts’.²² As the name indicates, the acts primary goal is to promote Germany as a location of business in the

¹³ *Moloney*, EC Securities Reg. 2014, 22 f.

¹⁴ *Hopt*, WM 2009, 1873 (1875).

¹⁵ *Hopt*, WM 2009, 1873 (1875); *Wymeersch*, EBOR 2007, 8, 237 (297).

¹⁶ *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 1, para. 17 f..

¹⁷ *Enriques/Tröger*, ECGI 90/2007, 2008, 11.

¹⁸ *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 1, para 34.

¹⁹ *Walla*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 4, para 28.

²⁰ *Walla*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 4, para 29.

²¹ *Enriques/Tröger*, ECGI 90/2007, 2008, 5.

²² *Wittig*, 2011, 10 f..

field of securities. The developments on the European and German level correlate with a changing policy of financing of both mid-sized and major German companies as well as the worldwide expansion of investment banking.²³ Aside the harmonization process – the ‘*Europeanization*’ of capital markets – structural changes forced the regulator to react. The German capital and security market evolved from being dominated by banks to being primarily focused on shareholder structure of external investors.²⁴

II. Policy goals and principles of regulation

Security regulation on the national level aims at two inseparable policy goals: 1) protection and functionality of the market and 2) protection of investors and debtors.²⁵ The European legislator explicitly says that he tries to reach a ‘high level of investor protection.’²⁶ On the European level regulation also serves as a vehicle to achieve one single European Market.²⁷ This again has been recently underlined by the EC.²⁸ While investor protection and market functionality have been considered to be policy goals aiming at an improvement of economic, political or social welfare, these goals have subsequently developed certain principles. This transformation from policy goals to principles is due to a process of legislative reform especially in the context of corporation law. The crucial difference between market functionality as a policy goal to its derivative principles is that principles describe rights whereas policy goals describe the ultimate goals those rights are intended to serve.²⁹

1. Policy goal of capital market protection and functionality

The regulator’s task is to keep the capital market efficient and to provide for a capital market friendly environment in the interest of the public. The interest of the public lies in the functionality and efficiency of the capital market that is to be achieved through supervision of supervisory authorities. There are three distinguishable aspects of market efficiency: allocation efficiency, operational efficiency and institutional efficiency.³⁰ Allocation efficiency involves the most efficient allocation of investable capital. That is, where it is the most profitable and thus

²³ *Rudolf*, in: Habersack/ Mülberr/ Schlitt, 2013, § 1, Rn. 66

²⁴ *Assmann*, in: Hdb Kapitalanlagerechts (2015), § 1, para 25.

²⁵ *Hopt*, Der Kapitalanlegerschutz im Recht der Banken, 52.

²⁶ Recital 5 and 7 to Directive 2004/109/EC.

²⁷ *Kalss/ Oppitz/ Zollner*, Kapitalmarktrecht, 2005, § 1, para. 17; Bumke, Regulierung am Beispiel der Kapitalmärkte (2008), 118.

²⁸ European Commission, EuZW, 2015, 731.

²⁹ Dworkin, Taking Rights Seriously, 1977, 22.

³⁰ Recital 1 to Directive 2004/109/EC, *Kalss/ Oppitz/ Zollner*, 2005, § 1, para. 20; Böse, Wirtschaftsaufsicht und Strafverfolgung, 2005, S.26.

benefits society most. For allocational efficiency, then, the legislator's task is therefore to set up an environment in which investors are informed and are given the opportunity to revise their investment decisions.³¹ Operational efficiency involves the minimization of transaction costs. The matter addresses the costs involved in the search for and completion of investment opportunities. Where costs cannot be eliminated, they should be borne by the cheapest cost avoider, or the party who can most cheaply bear the costs. Institutional efficiency involves investor confidence in the market integrity and stability.³² Therefore all possible risks have to be both transparent and measurable. Regulators can achieve this through rules that require transparency, regulate conduct and provide free access to the market.³³

2. Policy goal of Investor Protection

At the center of investor protection is the investor's investment decision. The stereotypical investor the legislator had in mind while designing the regulatory mechanism, is an individual or entity that seeks to invest upon a rational, informed basis framework according to the rational-optimistic market model in the theory of efficient capital markets.³⁴

There are four major tasks to achieve investor protection. First, the regulator has to provide for an environment where the investing party may decide rationally and upon complete information that is available to all investors. Second, no future change that the investor could not take in consideration should disadvantage the investor. Third, the regulator has to provide for a continuous flow of information so that an investor can revise his investment. Finally, an investor should be able to exit investments by selling his shares at prevailing market prices.³⁵

3. Capital Market Principles

The policy goals for securities regulation are addressed by adhering to several main principles. The prominent principle is the nondiscrimination precept regarding every market participant. The nondiscrimination precept requires that all investors receive the same information at the same time. Provisions that target the nondiscrimination precept that for example may be found in the § 83 BörseG³⁶, § 47a AktG³⁷. While § 47a AktG protects shareholders of the company

³¹ *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 2, para 74; *Kalss/ Oppitz/ Zollner*, *Kapitalmarktrecht*, 2005, § 1, para. 20 f..

³² Recital 1 and 2 to Directive 2004/109/EC; *Wüstemann/ Bischof/ Koch*, in: *Hopt et al.*, *Kapitalmarktgesetzgebung im Europäischen Binnenmarkt*, 2008, 3, 5.

³³ *Kalss/ Oppitz/ Zollner*, *Kapitalmarktrecht*, 2005, § 1, para. 23.

³⁴ *Langenbucher*, *ZHR*, 679 (680); *Pfisterer*, *Die neuen Regelungen der MiFID II*, 2016, 37.

³⁵ *Kalss/ Oppitz/ Zollner*, 2005, § 1, para. 24.

³⁶ Börsengesetz – BörsG as from November 22 2015, BGBl. 2007, 1330, 1351, BGBl. 2015 I 2029

³⁷ Aktiengesetz – AG as from November 22 2015, BGBl. I 1089, BGBl. 2015, 2565

the principle itself also includes the protection all participants in the market, including non-shareholders.³⁸

Another principle is market integrity. Market integrity requires an ongoing process to secure investor confidence in the market. Regulation in this field concentrates on setting up requirements for financial intermediaries as well as duties, obligations and limitations relating to activities such as insider trading, information obligations or market manipulation.³⁹ The 1966 *Segré-Report* already discussed transparency as a key principle of securities regulation.⁴⁰ The Transparency Guideline leaves no doubt that a ‘prompt and fair disclosure of information to the public’ must be provided.⁴¹ ‘The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.’⁴² In order to secure market efficiency, the regulator supports the free market and regulates through disclosure provisions to remove information asymmetries.⁴³

III. Rule-making, supervision and enforcement

1. Rule-making

Securities regulation law is subject to both European and national legislation. The latter is restricted to provisions regarding regulated markets.⁴⁴ National supervisory authorities play an important role in all three fields: rule-making, supervision and enforcement, for example in Germany the BaFin, the German Federal Financial Supervisory Authority.

a) Rule-making on a European level

In the center of European legislation is the so-called *Lamfalussy* Process that was introduced in 2002. The idea behind “*Lamfalussy*” is to achieve an efficient, flexible and faster legislation for securities regulation.⁴⁵ The process is divided into four levels of rule-making. On level one framework directives, which are broad enough to allow flexible application of the legislation

³⁸ *Kalss*, *Anlegerinteresse*, 249, *Kalss/ Oppitz/ Zollner*, *Kapitalmarktrecht*, 2005, § 1, para. 32.

³⁹ *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 2, para. 78; *Kalss*, *Anlegerinteresse*, 249, *Kalss/ Oppitz/ Zollner*, *Kapitalmarktrecht*, 2005, § 1, para. 31.

⁴⁰ *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 12, para. 1

⁴¹ Recital 24 to Directive 2003/16/EC

⁴² Recital 1 to Directive 2004/109/EC

⁴³ *Wüstemann/ Bischof/ Koch*, in: *Hopt et al.*, *Kapitalmarktgesetzgebung im Europäischen Binnenmarkt*, 2008, 5; *Veil*, in: *Veil*, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 12, para. 14.

⁴⁴ *Walla*, in: *Veil*, *European Capital Markets Law* (2013), § 4, para. 4.

⁴⁵ *Walla*, in: *Veil*, *European Capital Markets Law* (2013), § 4, para. 7.

during the later stages but specific enough to give the implementing bodies direction, are created. The original idea was to have frameworks with only basic principles to be concretized on consecutive level two and three.⁴⁶ On level two, the framework directives are concretized through regulations and directives of the commission. In this stage the Commission also adopts delegated acts that are drafted by the European Supervisory Body the European Securities and Markets Authority (*ESMA*).⁴⁷ ESMA is an independent EU Authority with three objectives: investor protection, orderly markets and financial stability. The authority assesses risks to investors, markets and financial stability. Specifically, it completes a single rulebook for EU financial markets, promotes supervisory convergence and directly supervises specific financial entities. Supervisory convergence is promoted to ensure a ‘level playing field of high quality regulation and supervision without regulatory arbitrage or race to the bottom.’⁴⁸ On Level three of the *Lamfalussy* process, ESMA enacts Guidelines and Recommendations for a Pan-European consistent interpretation of securities regulation law. ESMA recommendations and guidelines are non-binding. Nonetheless, their significance lies in its importance as an interpretation tool for all European regulators and market participants.⁴⁹ On Level four, ESMA evaluates and monitors the national enforcements of level one and level two rules on capital markets law. If national legislators do not comply with the Community’s rules the Commission may commence an infringement proceeding against the Member State.⁵⁰

b) Rule-making on a national level

European directives must be implemented by the Member States, hence member state law is derivative of primarily European Law.⁵¹ National provisions may address further aspects and interpret directives into more concrete terms, especially regarding means of enforcement. The Member states have, disregarding rules of the concept of maximum harmonization, a large degree of flexibility in the implementation of the directives. Thus national legislators may orientate their legislation according to national concepts.⁵²

aa) Sources of German securities regulation law

⁴⁶ Walla, in: Veil, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 4, para. 9.

⁴⁷ Walla, in: Veil, *European Capital Markets Law* (2013) § 4, para. 29.

⁴⁸ *ESMA*, <https://www.esma.europa.eu/about-esma/who-we-are> (as from 18th Feb 2016)

⁴⁹ Walla, in: Veil, *Europäisches Kapitalmarktrecht*, 2.ed (2014), § 4, para. 21.

⁵⁰ Walla, in: Veil, *European Capital Markets Law* (2013), § 4, para. 24.

⁵¹ Walla, in: Veil, *European Capital Markets Law* (2013), § 4, para. 45.

⁵² Walla, in: Veil, *European Capital Markets Law* (2013), § 4, para. 45 f..

The Stock Exchange Act (BörsG), the Securities Trading Act (WpHG), the Securities Prospectus Act (WpPG⁵³) and the Securities Acquisition and Takeover Act (WpÜG⁵⁴) are the main sources of federal securities law in Germany that is passed by the federal legislator. Most important regarding oversight of capital markets and enforcement of its governing rules is the Securities and Trading Act, which regulates the scope of function and the duties of the German Federal Financial Supervisory Authority (*BaFin*). These are supplemented by regulations.⁵⁵ Additionally, WpHG is supplemented by eight ordinances.

bb) German Federal Financial Supervisory Authority (BaFin)

Aside from the national legislator and the Department of Treasury (*Bundesministerium der Finanzen*), the BaFin, as an executive authority, has a restricted power of rule-making while its primary task is in the field of securities law enforcement.

(1) Mission and general policy

The BaFin is financed through an apportionment procedure of Parties that participate in the capital markets according to § 16 I FinDAG⁵⁶ as well as fees and charges according to § 15 FinDAG. In return, the government administration supervises the market in the best interest of the general public. The service of the BaFin is therefore a general legal infrastructure service that operates to maintain market mechanisms and to secure an orderly commerce, both of which are in the interests of the consumer.⁵⁷ The BaFin itself states that its responsibility is to monitor listed companies and market participants to ensure that they comply with various regulations under the WpHG. Individual stock exchanges are not subject to the supervision authority of BaFin.⁵⁸ Its task according to the WpHG is also danger defense § 4 I, II) as a “prophylaxis” against violation of the WpHG.⁵⁹

(2) Institutional structure

The BaFin is an institution under federal government control and is governed by the authority of the Department of Treasury according to § 1 I 1 FinDAG. Its concept is in the tradition and

⁵³ Wertpapierprospektgesetz – WpPG as from November 20 2015, BGBl. 2005, 1698, BGBl. 2015 I, 2029

⁵⁴ Wertpapiererwerbs- und Übernahmegesetz – WpÜG as from November 20 2015, BGBl 2001, 3822, BGBl. I 2029

⁵⁵ Walla, in: Veil, European Capital Markets Law (2013), § 5, para. 18.

⁵⁶ Finanzdienstleistungsaufsichtsgesetz – FinDAG as from November 11 2015, BGBl. 2002, 1310

⁵⁷ Bumke, Regulierung am Beispiel der Kapitalmärkte (2008), 112;

⁵⁸ BaFin, [http://www.bafin.de/EN/Supervision/StockExchanges Markets/stockexchangesmarkets_artikel.html;jsessionid=A050FB5BAB52DC1D4F4EC7D36AEACB46.1_cid298](http://www.bafin.de/EN/Supervision/StockExchanges%20Markets/stockexchangesmarkets_artikel.html;jsessionid=A050FB5BAB52DC1D4F4EC7D36AEACB46.1_cid298) (as from 08.02.2016, 12:39)

⁵⁹ Lenenbach, in: Albrecht/ Karahan/ Lenenbach, FAHdb., Bank- und Kapitalmarkrecht, 2010, § 44, para 6.

historic context of the founding of the British FSA and other European regulation authorities in the nineties a single supervisory system.⁶⁰ Within the organization of the BaFin as a single supervisory authority exist separate supervisory branches in charge of banks, insurance companies and capital markets.⁶¹ Strictly separated from the BaFin is the stock market supervision. The reason for the separation is a question of competence between the federal legislation and state legislation. Capital market law is subject to federal law while stock market law is subject to state law according to Art. 74 I 11 GG⁶². Since 2011, the European Supervisory body ESMA monitors the BaFin's monitoring.

(3) Rule making power

The BaFin has certain fields in which it can enact ordinances and guidelines. Aside from this power to legislate it can act through informal administrative means, as well as administrative acts (gm. § 35 I VwVfG⁶³).

(a) Ordinances and guidelines

The BaFin has no general right to enact ordinances under the WpHG. Nonetheless, it has the right to enact certain ordinances such as those regarding cooperations with foreign supervisory authorities, according to § 7 VIII WpHG, or publication and information about insider information, according to § 15 VII WpHG, among other fields. Since the BaFin is not entitled to enact ordinances the Department of Treasury delegates its legislative power to the supervisory authority.⁶⁴ According to §§ 29, 35 IV WpHG the BaFin may enact guidelines. The nature of guidelines is subject to debate and is considered to be either a legal rule similar to an ordinance, on one hand, or, on the other hand, as an interpretation of rules with no external regulatory effect. The predominant opinion currently considers guidelines to be internal administration acts with no external regulatory effect that actualizes regulation.⁶⁵ Nonetheless, guidelines may have an impact outside the administration according to Art. 3 I GG and the principle of self-commitment (*Selbstbindung*).⁶⁶

(b) Informal acts of administration

⁶⁰ Walla, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 20

⁶¹ Walla, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 21

⁶² Grundgesetz – GG as from December 23 2014, BGBl III, 100-1, BGBl. 2014, 2438

⁶³ Verwaltungsverfahrensgesetz – VwVfG as from November 11 2015, BGBl. 2003, 102, BGBl. 2015, 2010

⁶⁴ Buck-Heeb, Kapitalmarktrecht (2014), para. 837, 859; Walla, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 52

⁶⁵ BVerwGE 72, 300; Schwark, in: Schwark/Zimmer, Kapitalmarktrechtskommentar (2010), § 35 WpHG para. 11.

⁶⁶ Schwark, in: Schwark/Zimmer, Kapitalmarktrechtskommentar (2010), § 29 WpHG para. 4.

A tendency that may be observed not only in the field of regulation law but also in other fields of administrative behavior in Germany is a shift from so called legal-act-centering (*‘Rechtsaktzentrierung’*) towards behaviour-centering (*‘Verhaltenszentrierung’*).⁶⁷ By publishing its administrative actions, the BaFin sets – even though they are not legally binding - abstract generalized factual standards of behavior for those that are subject to BaFin supervision.⁶⁸ Different actions are considered to be an informal act of administration. These include casual communiques, information sheets (*‘Rundschreiben’*), announcements, information regarding frequently asked questions (FAQ) on BaFin’s Website as well as the collection of assisting interpretation guidelines.⁶⁹ The German Federal High Court of Justice considers those informal acts just as administrative regulations for implementing standards.⁷⁰ Considering that informal acts are legally non-binding, the complex process of consultation between BaFin and market participant’s information sheets and announcements are designed is remarkable.⁷¹ This process underlines its factual rule-making character.

The issuer guideline is one of the most important informal acts. It is a collection of assisting interpretation regarding the Securities Trading Act that is, in its latest version, only available in German.⁷² It was designed to promote legal certainty as well as predictability of legal decisions regarding Supervision for national and international issuers.⁷³ Informal acts of administration of the BaFin are non-binding and are not legal acts with an external regulatory effect.⁷⁴ Like guidelines, informal acts may have an external regulatory impact according to Art. 3 I GG if requirements of the administrative principle of self-commitment are (*‘Selbstbindung’*).⁷⁵ Therefore administrative provisions are in principle subject and not standard to judicial control.⁷⁶ This is proven by the fact that civil courts have ruled inconsistent with BaFin administrative provisions.⁷⁷ In conclusion, it may be said that the BaFin possesses certain expertise and is neutral regarding legal questions on the field of securities regulation since its mandate is bound to the

⁶⁷ *Bumke*, *Relative Rechtswidrigkeit*, 2004, 255.

⁶⁸ *Walla*, *Die Konzeption der Kapitalmarktaufsicht in Deutschland*, 2012, 59.

⁶⁹ *Giesberts*, in *KK-WpHG*, 2. Ed., § 4, para 28.

⁷⁰ BGH, verdict 25th Feb 2008 – II ZB 9/07, para 24.

⁷¹ *Walla*, *Die Konzeption der Kapitalmarktaufsicht in Deutschland*, 2012, S. 59; *Möllers*, *NZG* 2008, 330 (331).

⁷² *BaFin*, http://www.bafin.de/SharedDocs/Downloads/DE/Leitfaden/WA/dl_emittentenleitfaden_2013.html?nn=2799916, (as from 10th Feb 2016, 09:57).

⁷³ *Merkner/Sustmann*, *NZG* 2009, 813 (814); *Claussen/ Florian*, *AG* 2005, 745 (747).

⁷⁴ Hessian Higher Administrative Court, verdict 31st May 2006, para. 71.

⁷⁵ *Schwark*, in: *Schwark/Zimmer*, *Kapitalmarktrechtskommentar* (2010), § 29 WpHG para. 4.

⁷⁶ BVerwGE 107, 33, para. 15; *Niermann ZBB*, 400 (404).

⁷⁷ OLG Düsseldorf, verdict 15th Jan 2010, para.66.

public interest; hence market participants shall be able to rely on informal acts of the BaFin that are available to the public and hereby created good faith is worthy of protection.⁷⁸

(c) General decree

What should be considered a means of enforcement instead is also used as a form of action for rule-making. General decrees may be based upon the sweeping clause of § 4 I 3 WpHG resp § 4 II 2 WpHG.⁷⁹ General decrees, in contrast to the standard legal act of § 35 VwVfG, target the general public, not an individual addressee, but do target a specific issue.⁸⁰ A prime example is the prohibition of uncovered short sales and the prohibition of credit default swaps. The BaFin enacted these general decrees at the peaks of the financial crisis in order to protect to stability of financial markets.

c) Coexisting rule makers in a federal system

This examination has shown that on a national level, aside from the legislator, the executive body of the BaFin, as a single supervisory authority, has the power of executive rule-making with its particular ability to act via informal acts. Supervision and rule-making are both bound to the public interest respectively the functionality and stability of capital markets. From a European perspective, it is obvious that legislative actions on the field of securities regulation taken in Brussels trigger a cascade of reactions in the Member states that eventually end at the BaFin, where it has to be concretized and enforced while on a horizontal level the BaFin must communicate with other European Supervisory Authorities as well as the ESMA to achieve one single European market. At the same time, Germany has its own capital markets law that deviates from the European directives. Thus, the phenomenon of two coexisting regimes of securities regulation is a peculiarity of European Securities Law.⁸¹ This development is intentional and is not considered to be an obstacle of the realization of one single European capital market.⁸²

⁷⁸ *Bedkowski*, BB 2009, 1482 (1483); *Fleischer* DB 2009, 1335 (1337).

⁷⁹ *Walla*, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 68.

⁸⁰ *von Alemann/Scheffczyk*, BO-VwVfG, (2016), § 35 para. 247 f., *Maurer*, VwR (2011), § 9, para. 30.

⁸¹ *Walla*, in: *Veil*, Europäisches Kapitalmarktrecht, § 4, para. 45.

⁸² *Parmentier*, EuZW 2016, 45 (49)

2. Supervision and Monitoring

Regulation is operated through supervision, which is a “hands on business.”⁸³ Supervision from an ex-ante perspective is the first line of defense against a destabilization of the market.⁸⁴ Another important actor on the field of securities regulation is the supervision of stock markets. The supervision of stock markets is subject to the supervision of the stock exchange administration, the stock exchange supervision of the states (such as Hesse), and the BaFin. Every stock exchange has to install a so called trading monitoring department (‘Handelsüberwachungsstelle’ abbrev. ‘HÜSt’) according to § 7 I 1 Stock Market Code (BörsG). The HÜSt is an organ of the stock exchange.⁸⁵ Its task in the framework of stock exchange self-administration is to monitor the trading at the stock exchange and as well as the execution of transactions. The states are in charge of the supervision of stock exchanges. The idea behind the installation of the HÜSt was to meet international standards.⁸⁶ Market participants, especially investors, may contact the HÜSt in order to report irregularities in the process of price determination via (e-) mail or telephone.⁸⁷

The HÜSt has the duty to record and analyze the stock exchange data and to conduct investigations if necessary according to § 7 I BörsG. In case HÜSt investigates facts that suggest that the exchange bylaws or rules have been violated in the conduct of a market transaction at the exchange, the HÜSt has to report to the stock exchange supervision authority of the particular state.⁸⁸ Notably, the intention of the implementation of the Authority of the HÜSt is exclusively to protect the functionality of the stock exchange while investor protection is a reflex.⁸⁹

The stock exchange supervision authority’s task is to monitor the exchanges - especially the HÜSt - to ensure that they comply with their bylaws, to ensure that market participants and issuers comply with exchange rules and that the holding of the stock exchange complies with its duty to conduct business properly.⁹⁰

⁸³ Moloney, EC Securities Reg., 2014, 944

⁸⁴ Moloney, EC Securities Reg., 2014, 946

⁸⁵ Beck, in: Schwark/Zimmer, Kapitalmarktrechts-Kommentar, § 7 BörsG, para. 1; *Börse Frankfurt*, <http://www.boerse-frankfurt.de/inhalt/grundlagen-steuerung-huest>(as from 11th Feb 2016, 08:59).

⁸⁶ RegBegr 2. FMFG, BT-Drs 12/6679, S.59 f.

⁸⁷ *Deutsche Börse Group*, <http://www.deutsche-boerse-cash-market.com/dbcm-de/ueber-uns/organisation-der-fw/marktaufsicht> (as from 11th Feb 2016, 09:07)

⁸⁸ Beck, in: Schwark/Zimmer, Kapitalmarktrechts-Kommentar, § 7 BörsG, para. 15

⁸⁹ RegBegr 2. FMFG, BT-Drs 12/6679, 73 f.

⁹⁰ *Hessisches Ministerium für Wirtschaft, Verkehr und Landesentwicklung*, <https://wirtschaft.hessen.de/wirtschaft/boerse/aufgaben-der-boersenaufsicht> (as from 11th Feb 2016).

More important on the field of supervision is the BaFin. Its are stated in the WpHG. These tasks are to monitor deals with insider information in order to enforce the prohibition of insider dealing according to § 14 WpHG, to monitor the duty of notification (ad-hoc disclosure) according to § 15 WpHG as well as according to §§ 21, 26 WpHG, to monitor the compliance of market participants with the prohibition of market manipulation, to monitor compliance with reporting requirements and the rules of conduct according to §§ 31 – 35 WpHG as well as monitor Markets with financial instruments that originated outside Germany.⁹¹

Disclosure requirements as an instrument of securities regulation serve as a mean for investor protection. In the context of the financial crisis its importance has been decreasing due to market-structural, product orientated regulation as well as regulation targeting distributors of products respectively the institutions. Disclosure covers a wide range from disclosure regarding sales and distribution, event-driven disclosure so called Ad-hoc-disclosure as well as current reporting disclosure. Other requirements target disclosure of certain transactions in regard to shareholding in order to prevent stalking of a corporation thus strengthen the German financial center.⁹²

Other supervision powers derive from the WpPG, which focuses on fairness and transparency of takeovers for all investors according to § 21 WpPG or the KAAG, according to which BaFin has the competence to supervise collective fiduciaries.⁹³

The BaFin is also in charge of the supervision of takeovers and tender offers according to the WpÜG. Insider dealing is prevented according to § 14 WpHG by statutory disclosure requirements. Not only are primary insiders given insider status (management, supervisory board members) but also secondary insiders.⁹⁴ Ad-hoc disclosure is designed to create a high level of market efficiency.⁹⁵ The duty to publish facts regarding matters of business or corporate development have to be published without delay. On this basis investors may claim compensation in case of a breach of the duty of ad- hoc disclosure.⁹⁶ The idea behind the prohibition of directors' dealing is to increase transparency and market integrity.⁹⁷ The WpHG also prohibits market manipulation referring to price manipulation through the distribution of false or the withholding

⁹¹ *Buck-Heeb*, Kapitalmarktrecht (2014), para. 837.

⁹² *Assmann*, in: Hdb. Des Kapitalanlagerechts (2015) § 1, Rn 95

⁹³ *Fischer*, The SEC and Bafin, 146.

⁹⁴ *Assmann*, KK-WpHG Kommentar, § 14, para. 25.

⁹⁵ *Fischer*, The SEC and Bafin, 140.

⁹⁶ *Haar/ Grechening*, AG 2013, 653 (page).

⁹⁷ *Fleischer*, NJW 2002, 2977 (2978)

of information.⁹⁸ The only relevance is whether one has the intent to influence the market price but no need to demonstrate intent to defraud.⁹⁹

3. Enforcement

Government enforces securities law using a combination of three enforcement branches: administrative, which includes both preventative means and repressive means, criminal and private securities law enforcement.

a) Preventive administrative securities regulation enforcement

Federal supervision through the BaFin is the most effective mean to supervise and enforce capital ‘market law’.¹⁰⁰ In order to efficiently react to deficits in the field of the capital market, the BaFin has a variety powers. § 4 III WpHG is the sweeping clause according to which the BaFin may gather information from even unsuspecting persons. The BaFin may cite those affected and interrogate them.¹⁰¹ Furthermore, the BaFin has the power to investigate after a suspicion of violation of its governing law. BaFin analyzes data on all securities transactions in the trading market and reacts in case of rapid price movements or other suspect occurrences.¹⁰² The acquisition of information is limited by the principle of proportionality and the obligation of confidentiality.¹⁰³ According to the § 4 I 3 WpHG the BaFin may issue orders that are appropriate to target or prevent deficits or damages according to § 4 II 1 WpHG and to enforce securities law. The definition of “deficit” is considered to be closely related to the definition of ‘danger’ in administrative law.¹⁰⁴ BaFin may also prescribe law-abiding behavior to entities that are subject to supervision, for example according to § 36 b WpHG.¹⁰⁵

Since 2015 BaFin may also publish measures taken by it in response to violations of the Capital Investment Act in order to encounter concerns in regard to investor protection and may furthermore prohibit specific market participants for certain financial practices.¹⁰⁶

⁹⁸ *Fischer*, The SEC and Bafin, 143.

⁹⁹ *Trüg*, NJW, 2014 (1348).

¹⁰⁰ *Dolff*, Rechtsverlust gem. § 38 WpHG aus der Perspektive des Emittenten, 2011, 28

¹⁰¹ *Walla*, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, 81.

¹⁰² *Fischer*, The SEC and Bafin, 151

¹⁰³ *Walla*, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, 84.

¹⁰⁴ *Walla*, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 91.

¹⁰⁵ *Fischer*, The SEC and Bafin, 155.

¹⁰⁶ Bafin/ Bussalb, Retail Investors Protection Act: Improved transparency on the unregulated capital market, 2015, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2015/fa_bj_1501_kleinanlegerschutzgesetz_en.html (as from 18th Feb 2016, 16:56).

These measures may be enforced through administrative foreclosure such as execution by substitution and the charge of fines according to §§ 10, 11 VwVG¹⁰⁷. In addition, the BaFin may execute duties of market participants in substitution of the person or company responsible.¹⁰⁸ Another preventive power is stated in § 4a WpHG. The BaFin may “issue orders that are appropriate and necessary to eliminate or prevent undesirable developments that may be detrimental to the stability of financial markets or undermine confidence in the proper functioning of financial markets.” In order to achieve the policy goal of consumer protection, BaFin may prohibit or restrict the trade of certain products according to § 4b WpHG.¹⁰⁹ In principle, §§ 4, 4a WpHG contain sweeping clauses meaning that they apply subsidiary. After the 2005 Investor Protection Improvement Act, many special authorizations were eliminated and the general clauses are the administrative regulation basis.¹¹⁰ The affected companies and individuals may challenge decisions of the BaFin and may file suit in the recourse to the administrative courts. Courts do not act as sanctioners but as a level of jurisdiction for legal protection to those that are subject of BaFin supervision and enforcement powers.

b) Repressive administrative means and criminal situs

The BaFin, on the other hand, also has the competence not only to act preventively but to act repressively according to § 40 WpHG, § 36 I 1 OWiG¹¹¹. Legal violations according to § 39 WpHG may be punished according to § 65 OWiG. Therefore, the BaFin has a double role and is motivated by the reason of factual connection.¹¹² In this context the BaFin has to consider the “prohibition of role reversal”, meaning that criminal procedural rights may not be bypassed.¹¹³ Those subject to BaFin’s supervision may face fines up to an amount of EUR 1.000.000 and it may even exceed this cutoff in case the economic advantage of a breach of law or obligations exceeds the amount of EUR 1.000.000 according to § 17 IV OWiG. The opportunity to compound does not exist. Both legal entities as well as individuals may face fines. A “Deal” known from § 257 c STPO¹¹⁴ does not apply outside the criminal trial and is therefore not to be used in order to settle legal disputes.

¹⁰⁷ Verwaltungs-Vollstreckungsgesetz – VwVG as from November 25 2014, BGBl. 2014, 1770.

¹⁰⁸ *Dolff*, Rechtsverlust gem. § 38 WpHG aus der Perspektive des Emittenten, 2011, 29

¹⁰⁹ *BaFin/ Becker, Thorsten/ Yoo, Chann-Jae*, Produktintervention: Neue Aufgabe für die Wertpapieraufsicht, http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2015/fa_bj_1509_produkintervention.html?nn=5260906 (as seen 17th Feb 2016, 11:32).

¹¹⁰ *Walla*, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 85.

¹¹¹ Gesetz über Ordnungswidrigkeiten as from May 13 2015, BGBl. 1987, 602, BGBl. 2015, 706

¹¹² *Böse*, Wirtschaftsaufsicht, 499.

¹¹³ *Altenhain*, in WpHG KK, 2. Ed., § 40, para. 8.

¹¹⁴ Strafprozeßordnung – StPO as from December 21 2015, BGBl 1987, 1074, BGBl. 2015, 2525

Based on 2013/50/EU, Abl. EU L 294/13 Germany must reform its sanctioning regime in order to harmonize the regimes on a European level. The European legislator set up criteria that eventually defined the amount of a fine including the severity and duration of the violation as well as the degree of responsibility of the individual, financial capability of the individual, the cooperativeness of the individual and a possible history of prior violations. Fines will be considerably higher compared to the status quo in Germany. Another crucial sanction will be the introduction of fines that are related to corporation's sales and may be as high as 15% of annual sales.¹¹⁵

Also the fees that a subject to investigation has to pay in order to cover BaFin's expenses may be considered as a type of sanction.¹¹⁶ Another considerable sanction is "shaming." Information the BaFin collects about its supervised entities are protected according to § 8 WpHG as well as according to Art. 12 and 14 GG. An entity may not be worthy of protection regarding sensible information in case of criminal offenses or breaches of administrative regulatory law.¹¹⁷ The requirements are those of the 'corporate shaming' according to § 60b KWG¹¹⁸, § 40b WpHG.¹¹⁹ The institute of corporate shaming alias [...] censure will change due to European legislation. Sanctions will be published as a means of general-prevention.¹²⁰

In addition, the BaFin cooperates directly with prosecution authorities and criminal courts. The WpHG also provides, for severe offenses, sanctions of the criminal law according to § 38 WpHG in regard to insider trading. Due to European legislation both primary and secondary insiders will face criminal prosecution. Also, the punishment of market manipulation will be similar to the punishment of attempted insider trading.¹²¹ Nonetheless, criminal prosecution is a competence exclusively reserved to the prosecution authority.¹²² The BaFin is nonetheless involved in the process of criminal prosecution, must be informed about the opening of the trial and must be officially heard before the trial § 40a WpHG.

¹¹⁵ *Bafin*, http://www.bafin.de/SharedDocs/Downloads/DE/Jahresbericht/dl_jb_2014.pdf?__blob=publicationFile&v=8#page203 (as from 18th Feb 2016, 16:18).

¹¹⁶ *Fischer*, *The SEC and Bafin*, 156.

¹¹⁷ *BVerwG*, NVwZ 2009, 1114; *Gurlit*, NZG, 2014, 1161 (1165).

¹¹⁸ Gesetz über das Kreditwesen – KWG as from November 20 2015, BGBl. 1998, 2776, BGBl. 2015, 2029

¹¹⁹ *Gurlit*, NZG, 2014, 1161 (1165).

¹²⁰ *Bafin/ Melovski, Filip/ Ortkemper, Birgit/ Weisenfels, Michael*, http://www.bafin.de/SharedDocs/Downloads/DE/Jahresbericht/dl_jb_2014.pdf?__blob=publicationFile&v=8#page203 (as from 18th Feb 2016, 16:18)

¹²¹ *BaFin/ Melovski/Ortkemper/ et al.*, https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2016/fa_bj_1601_finanzmarktnovellierungsgesetz.html (as from 18th Feb 2016)

¹²² *Walla*, *Walla*, *Die Konzeption der Kapitalmarktaufsicht in Deutschland*, 2012, S. 114; *Ziouvas*, *Das neue Kapitalmarktstrafrecht*, 2005, 51 f.

c) Private enforcement

German securities law also provides for private enforcement as another external regulation mechanism for good corporate governance. Civil liability for example has the potential and task to complement supervisory action and to a certain degree substitute for.¹²³ Investors may sue the issuer of securities in case of a breach of duty regarding the prospectus according to §§ 32-35 WpPG may bring a derivative suit or a direct suit against a corporation.¹²⁴ Derivative suits are rarely used due to lack of attractiveness for an investor.¹²⁵ Direct suits, on the other hand, may be used against corporations to enforce liability in case of a violation of disclosure requirements. However due to the expenses that accompany a direct suit compared to the possible economic benefit in case the court decides in favor of the suing party. Thus private enforcement of disclosure requirements bears no attractiveness and furthermore due to ‘rational apathy’.¹²⁶ Nonetheless investor protection is considered to be an aim of public supervisory and enforcement action.¹²⁷

On a procedural level Germany therefore created the so called Capital Markets Model Procedure Act in 2005 (Kapitalanleger – Musterverfahrensgesetz, KapMuG¹²⁸). It provides - comparable to the U.S. class action - a procedural tool to enforce claims of a large number of investors more effectively by bringing a collective suit to court,¹²⁹ although it contradicts the basic idea of civil procedural law that is based upon a two party concept. So far its results are not convincing and it may be said that on the field of the KapMuG reform is necessary.¹³⁰ Private enforcement is also regarded a key factor in the context of market manipulation; courts dealt with the question whether § 20 a WpHG is a protective law according to § 823 II BGB¹³¹ (German civil code); so far courts ruled in the IKB Industriebank AG case that § 20 a WpHG is not a protective law.¹³² In other cases courts ruled in favor of investors and the members of the management were held liable because of a breach of duty regarding the notification according to § 826 BGB iVm § 15 WpHG i.e. case Infomatec, Comraod I-VIII, et.al..¹³³ Other aspects of private enforcement of security regulation may be found in § 37b, 37c WpHG; based upon these sections

¹²³ *Moloney*, EC Securities Reg., 2014, 950.

¹²⁴ *Brellochs*, *Publizität und Haftung von AGen*, 2005, 185.

¹²⁵ *Haar/Grechening*, AG 2013, 653 (662).

¹²⁶ *Hellgardt*, *Kapitalmarktdeliktsrecht*, 546 f..

¹²⁷ *Moloney*, EC Securities Reg., 2014, 950.

¹²⁸ *Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten (Kapitalanleger-Musterverfahrensgesetz – KapMuG)*, as of Febuary 18 2016, BGBl. 2009 I, p. 2182.

¹²⁹ *Teigack*, in: *Veil*, *Europäisches Kapitalmarktrecht*, § 12 para. 11; *Hopt WM*, 2009, 1873, (1880).

¹³⁰ *Hopt WM*, 2009, 1873, (1880); *Wardenbach*, *GWR* 2013, 35 (38).

¹³¹ *Buergerliches Gesetzbuch – BGB*, as Febuary 18 2016, BGBl. 2002 I 42.

¹³² *Teigack*, in: *Veil*, *Europäisches Kapitalmarktrecht*, § 14 para. 91.

¹³³ *Hopt WM*, 2009, 1873, (1878).

investors may claim compensations in case an entity did not comply according to the governing rule regarding transparency.¹³⁴

IV. Aftermath of the 2008 crisis and its effects on securities regulation

In the Aftermath of the 2007 to 2009 financial crisis a lack of regulation has been identified. Subsequently both national and the European legislator started to close gaps on the field of regulation. The transformation is institutional and substantial.¹³⁵

From a more general perspective question arose in the post-crisis era about the social utility of markets as well as the value of untrammelled innovation. Moreover, the extent of regulation was questioned, so was the control of levels of financial developments.¹³⁶ Regarding institutional reform three new European supervisory authorities were introduced and a complex institutional arrangement of national and European authorities with different tasks and scopes has been installed. The reform agenda is concerned with the question how to achieve optimal supervisory organizations with the policy goal of pan-EU market stability.¹³⁷ The crisis lead to the adoption of retail market reforms targeting for example distribution regulation, disclosure, product intervention, etc. The new approach may be characterized as interventionist.¹³⁸

The European legislator also rethought his picture of an investor has shifted from a rational-optimistic market model towards a more paternalistic model.¹³⁹

In this complex supra-national regulatory system Member States of the European Union are collectively challenged. While on a national level regulatory authorities may only see fragments of a broader picture, the European Commission as the principle overseer with extensive bureaucratic competencies may shape the regulatory system according to its own preferences.¹⁴⁰

¹³⁴ *Teigack*, in: Veil, *Europäisches Kapitalmarktrecht*, § 12 para. 11.

¹³⁵ Moloney, 2015, 221 (221)

¹³⁶ Moloney, *EC Securities Reg.*, 6

¹³⁷ Moloney, *EC Securities Reg.*, (234.)

¹³⁸ Moloney, *EC Securities Reg.*, (225 f.)

¹³⁹ *Langenbacher*, *ZHR*, 2013, 679 (701).

¹⁴⁰ Ferran, in: Ferran/ Moloney/ Hill/ et. al., *Regulatory Aftermath*, 2012, 55

INTRODUCTION

Securities and financial regulation and enforcement in the US is composed of an alphabet-soup of regulatory institutions and a myriad of laws, rules, regulations, and interpretations by both courts and regulatory agencies. Overall, the financial industry is regulated by over ten federal, state, and industry regulatory bodies.¹⁴¹ The primary overarching philosophy is based on the precept that “light is the best disinfectant” companies are primarily required to ensure that they adequately disclose the financial state of the company.¹⁴²

Prior to the Great Depression, US Federal Securities law operated on a laissez faire basis, and most of the regulation was created by the states. The financial regulatory environment was likewise characterized by this hands-off philosophy, although the crash of [1907] had provided the impetus for the creation of the Federal Reserve.¹⁴³

The Great Depression of the 1930’s¹⁴⁴ provided the impetus for enhanced securities regulation by the Federal Government. Understandably, almost every single regulatory overhaul of the financial sector occurred in the wake of a financial crisis.

The two bulwarks of US Securities Law that were created in response to the Great Depression are the Securities Act of 1933 and the Exchange Act of 1934. Generally, the Securities Act relates to the original issuance of securities by companies whereas the Exchange Act relates to the trading of registered securities in the secondary market. The purpose of both are to promote efficiency, competition, and capital formation, as well as to ensure the public interest and the interest of investors, is protected.

Since then, these Acts have been amended. The most notable periods of altered financial regulation occurred after the dot-com boom of the early 2000’s, with the enactment of the Sarbanes-Oxley Act, and after the financial crisis of 2008, with the enactment of Dodd-Frank Act.

Institutionally, the Great Depression provided the impetus for the creation of the SEC and the Federal Deposit Insurance Corporation.

¹⁴¹ Schumer, Charles & Bloomberg, Michael, “To Save New York, Look to London,” Wall Street Journal, Nov 1, 2006, *available at* <http://www.wsj.com/articles/SB116234404428809623>.

¹⁴² U.S. Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwe do.shtml>.

¹⁴³ Although technically the Federal Reserve was created for, and for most of its history has had, the sole purpose of effectuating monetary policy, I include it as a financial regulator for two reasons. First, the impact of monetary policy on financial markets is unquestioned. Second, it was given significant regulatory and stability powers in the aftermath of the 2008 crisis.

¹⁴⁴ Technically, the stock market crash that spawned the Great Depression occurred on October 29, 1929 (known as “Black Friday”). The stock market lost around 25% of its value by the end of day October 30.

INSTITUTIONAL PLAYERS

Given the breadth of the US securities and financial regulatory system, it is beneficial to give a brief description of the primary institutional players that impact both the rule making process, the enforcement process, and that effect the overall regulatory environment. Although some of these institutions are not the primary focus of this Paper, they all impact the overall regulatory environment of the US financial system.

Security Exchange Commission

With over 3500 employees, the SEC is a relatively large financial regulatory power, even accounting for the size of the US capital market. Its headquarters are located in Washington, D.C. and has 11 regional offices. 5 Commissioners with staggered five year terms are appointed by the president, who also appoints one of those 5 as Chairman of the Commission. The staggered nature of the terms is designed to ensure institutional stability. A requirement that no more than 3 may serve in the same political party attempts to ensure bipartisanship.¹⁴⁵ There are 5 divisions of the SEC: Corporate Finance, Investment Management, Enforcement, Trading and Markets, and Economic and Risk Analysis. Moreover, the 2012 Dodd Frank Act created 5 specialized units to cover areas of particular concern.

The foundational authority for all SEC regulation and enforcement is statutory. There are eight statutes that grant the SEC its powers, the two most important of which are the Securities Act and the Exchange Act.¹⁴⁶ The SEC creates Rules regarding securities issuance and reporting requirements, proxy solicitation, and takeover procedures. Additionally, the SEC has supervisory and regulatory authority over FINRA, the Self Regulating Organization. Since the Credit Rating Agencies Reform Act (2006) the SEC also has some regulatory powers over credit rating agencies.

Its stated mission is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”¹⁴⁷

Federal Reserve

The Federal Reserve was created in 1913 with the dual mandate of maximizing employment while stabilizing prices, doing so through its open market operations (the buying and selling of US government bonds in order to affect interest rates and the overall speed of economic

¹⁴⁵ <https://www.sec.gov/about/whatwedo.shtml#org>

¹⁴⁶ Securities Act of 1933; Securities Exchange Act of 1934; Trust Indenture Act of 1939; Investment Company Act of 1940; Investment Advisers Act of 1940; Sarbanes-Oxley Act of 2002; Dodd Frank Wall Street Reform and Consumer Protection Act of 2010; and Jumpstart our Business Startups Act of 2012.

¹⁴⁷ <https://www.sec.gov/about/whatwedo.shtml#org>

growth). Since its inception its powers have been greatly enhanced and in 2009 it was given authority to regulate the conduct of banks as well as other important financial institutions.

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) insures a fixed amount of bank deposits. As the insurer, it has special examination powers to examine and determine the condition of the banks it insures. It also aids in planning the resolution of financial institutions and, in the event of failure of an insured institution, will operate it in receivership to maximize the recovery resulting from the disposition of the institutions assets and minimize the burden to the taxpayer.¹⁴⁸

Self Regulatory Organizations

The Exchange Act contemplated that much of the enforcement of SEC Rules be done through Self-Regulatory organizations. Initially, and especially before the Great Depression, these entities were almost entirely self-run and voluntary. Now, however, they are more fully integrated into the federal regulatory scheme and are subject to SEC supervision.¹⁴⁹ The Exchange Act mandates that the SEC approve the rules and listing requirements of all of the Exchanges, albeit that those regulations mandated by the SEC must be in accordance with their statutory mandate.¹⁵⁰ The enforcement relating to the broker-dealer industry, specifically, has largely been left to SRO's. Until 2007, this was done largely through the rulemaking provisions of the NASD and the NYSE, but in 2007 the enforcement arms of each were consolidated under the merged entity now called the Financial Industry Regulatory Authority (FINRA).¹⁵¹

FINRA's stated goals are to provide rules and enforcement to ensure compliance and also to ensure market transparency and to educate investors. FINRA supervises the adherence to a voluntary code of ethics and also engages in the resolution of conflicts between its members and issuers.¹⁵² That said, critics have been skeptical of the efficacy of industry self-regulation and Congress has not granted SRO's much power outside of the broker-dealer relationship.¹⁵³

¹⁴⁸ FDIC, <https://www.fdic.gov/about/strategic/strategic/mission.html>; FDIC, Receivership Management Program, <https://www.fdic.gov/about/strategic/strategic/receivership.html>.

¹⁴⁹ Roberta Karmel, Should Securities Industry self regulatory organizations be considered government agencies?, Brooklyn Law Journal, 2008,

¹⁵⁰ Approaching Comparative Company Law, 154; *Bus. Roundtable v. S.E.C.*, 905 F. 2d 406, 411-13 (D.C. Cir. 1990).

¹⁵¹ Black, Barbara, Brooklyn Journal of Corporate, Financial & Commercial Law, 2013, 23, 23.

¹⁵² Fischer, The SEC an BaFin, 31.

¹⁵³ Congress has, however, directed the SEC to study the effects of expanding SRO regulation to other fields, including Investment advisers and mutual funds.

FINRA is now the self-proclaimed “leading non-governmental regulator for all securities firms doing business with the US public.” This seemingly schizophrenic aspect of US securities law reflects a fundamental goal of encouraging the formation of voluntary self-policing with a regulatory backdrop to ensure it actually works. While many question the efficacy of such SRO’s, Congress recognizes that the elimination of FINRA and the subjugation of its duties to the SEC would require massive resource expenditures, something that is not likely to happen soon.¹⁵⁴

Courts have made clear that SRO status is entirely derivative and that the SEC has full legal authority to review and correct the SRO decisions. The D.C. Circuit has called FINRA’s predecessor, the NASD, a “quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or [SEC] regulations issued pursuant thereto.”¹⁵⁵ Finally, the SEC can itself sanction FINRA and other SRO’s, which would be particularly harmful towards these regulatory bodies since membership is voluntary and benefits of membership are based on reputational perception of the body by the public.¹⁵⁶

In addition to levying fines against its members, FINRA also refers cases to the SEC for further investigation.¹⁵⁷

§15A of the Exchange Act allows for the establishment of National Security Associations as long as they meet the statutory requirements as well as other rules prescribed by the SEC.¹⁵⁸ Among these requirements are that they have a “fair procedure” for the discipline of its members. FINRA disciplinary decisions are subject to review on several levels. First, the National Adjudicatory Council (NAC) may hear an appeal. The NAC’s decision is considered final unless the Board of Governors of FINRA decides to review it.¹⁵⁹ Second, the entity subject to supervision can appeal the decision to the SEC, which will review it De Novo (as if no trial had been previously held).¹⁶⁰ Even if the SEC finds that a violation occurred, the statute indicates that, out of the interest of investors and the public interest, the SEC can mitigate or

¹⁵⁴ Fischer, *The SEC an BaFin*, 31.

¹⁵⁵ *SEC v. NASD*.

¹⁵⁶ Fischer, *The SEC an BaFin*, 32.

¹⁵⁷ <http://www.finra.org/about>

¹⁵⁸ Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, *Brook. J. Corp. Fin. Com.*, 23, 27.

¹⁵⁹ Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, *Brook. J. Corp. Fin. Com.*, 23, 27.

¹⁶⁰ Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, *Brook. J. Corp. Fin. Com.*, 23, 27.

even cancel the punishment if it deems that the punishment “imposes any burden on competition not necessary or appropriate. . .” or is “oppressive.”¹⁶¹

Commodities Futures Trading Commission

Created in 1936 (renamed and restructured from Commodity Exchange Commission in 1974) to regulate commodity futures and option contracts, the Commodities Futures Trading Commission (CFTC) eventually held regulatory power Over-the-Counter (that is, non-exchange-traded) derivatives. That said, due to an increased skepticism of regulation at the end of the 20th century and the widespread belief that derivatives were inherently beneficial, the CFTC began assuring banks that it would not require them to be traded on their exchange. Finally, under the Commodity Futures Modernization Act, many derivatives were excluded from regulation.¹⁶² The 2008 crisis, and derivatives role in it, provided the impetus for an expansion of powers of the CFTC and it now regulates non-security based swaps such as interest rate swaps and credit default swaps.¹⁶³

Department of Justice

The department of Justice prosecutes any criminal sanctions related to securities law.

Public Company Accounting Oversight Board.

Created by the Sarbanes Oxley Act, the Public Company Oversight Board is arguably in between an SRO and a government agency.¹⁶⁴ It oversees audits of public companies and other issuers. Since 2010, it also oversees audits of broker-dealers and compliance reports filed pursuant to federal securities laws. Rules must be approved by SEC.

Treasury

The US Treasury Department the Office of the Comptroller of the Currency, which regulates banks chartered by it, is a Bureau of Treasury.¹⁶⁵

¹⁶¹ Id, 29 (citing 15 U.S.C. § 78s(e)(1)(B) and §78(e)(2).)

¹⁶² Skeel, *The New Financial Deal: Understanding Dodd Frank and its (Unintended) Consequences*, 2011, 65.

¹⁶³ *Id.* at 68.

¹⁶⁴ Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies?*, *Brooklyn Law Journal*, 2008, 6.

¹⁶⁵ Fed PDF, 60.

RELEVANT SECURITIES ACTS

As noted above, there are 6 Acts which grant the SEC its rule making power in addition to the Securities and Exchange Acts. They are:

Trust Indenture Act of 1939

Requires minimum standards that must be met for the sale of bond issues.

Investment Company Act of 1940

Provides for registration and regulation of investment companies, which are companies engaged primarily in investing, reinvesting, or trading in securities and was designed to minimize the conflicts of interests that can arise in these situations.

Investment Advisers Act of 1940;

Regulates the registration, conduct, and reporting requirements of investment advisers, who are required to register with the SEC.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act was enacted in response to several high profile bankruptcies that many felt highlighted the inadequacy of American corporate law and dramatically enhanced the SEC's power. It has been named a "smorgasbord" of regulatory reform. Importantly, it created the PCAOB and also enhanced the enforcement powers of the SEC, attempting to direct enforcement towards more criminal prosecution.¹⁶⁶ Additionally, it increased auditing requirements, in part by requiring audit certification of internal management controls.¹⁶⁷ Significantly, it included a 'clawback' provision that could retroactively require the return of bonus, or equity based compensation plan, from executives in the event of a negative accounting restatement as a result of misconduct that caused material noncompliance with reporting requirements.¹⁶⁸

Dodd Frank Wall Street Reform and Consumer Protection Act of 2010

Enacted in response to the 2008 economic crisis, the primary purposes of Dodd Frank are to limit the risks posed by the shadow banking system and to limit the damage caused by a

¹⁶⁶ Bloomenthal, Harold and Wolff, Samuel, Securities Law Handbook, 2014, §1 [32].

¹⁶⁷ Soderquist, Larry and Gabaldon, Theresa, Securities Law, 5th Edition, 2014, 140.

¹⁶⁸ *Id.* 140.

failure of a large financial institution.¹⁶⁹ It increased regulation of large banks, increased the authority of the federal reserve, and increased the regulation of derivatives by requiring them to be cleared and traded on an exchange.¹⁷⁰

Jumpstart our Business Startups Act of 2012.

Enacted during the sluggish economic years after the 2008 crisis, the JOBS Act intended to remove some regulatory burdens, many of which had been created by SOX, from emerging growth companies.¹⁷¹

BRIEF OVERVIEW OF STATE LAW

Prior to the Great Depression, each state had its own statutes designed to protect the public from “speculative schemes which have no more basis than so many feet of ‘blue sky.’”¹⁷² As noted above, both of the Acts promulgated in response to the Great Depression substantially increased federal regulation of securities that crossed interstate lines. The US Constitution explicitly dictates that federal laws can preempt those of the states.¹⁷³ Given that Congress has authority to regulate interstate commerce, there is little doubt that the federal government can effectively eliminate the importance of state corporate law. Although state laws regarding fiduciary duty do carry substantial importance since the federal government has not decided to preempt state law on those matters, it seems accepted that this fact is a result of historical tradition and not required by the constitution. For instance, Congress did greatly enhance the SEC’s power to regulate the internal affairs of a corporation with the passing of the Sarbane’s Oxley Act.

That said, considerable importance must be given to state laws regarding the fiduciary duties of corporate directors, most notably those of the laws of Delaware, in which over 60% of publicly traded companies are incorporated.¹⁷⁴ With Respect to securities law specifically, in 1996 the Federal Government explicitly preempted any state laws by passing the National Securities Markets Improvement Act which required state registration of securities that are ‘covered’ under the law, significantly reducing the power of states to affect the behavior of

¹⁶⁹ Skeel, *The New Financial Deal: Understanding Dodd Frank and its (Unintended) Consequences*, 2011, 4.

¹⁷⁰ *Id.*

¹⁷¹ Soderquist, Larry and Gabaldon, Theresa, *Securities Law*, 5th Edition, 2014, 140.

¹⁷² Eisenberg, Melvin and Cox, James, *Business Organizations*, 11th Edition, 2014, 1454 citing *Hall v. Geiger-Jones Co.*, 242 US 539, 550, 37 S.Ct, 220-21.

¹⁷³ Article IV, §2 of US Constitution; Donald, David, *Approaching Comparative Company Law*, 148

¹⁷⁴ Armour, Black, Cheffins, Nolan, *Private Enforcement of Corporate Law: UK and the US*, *Journal of Empirical Legal Studies*, 687, 703.

companies. Since the securities covered under the law include those listed on National Exchanges, securities law for most US companies (or, at least the most important) are dictated by the federal legislation.¹⁷⁵ A full description of the state and federal distinctions between both US corporate law and securities law is beyond the scope of this paper. As such, even though states can effectuate some regulation on securities, the Federal Government preemption of state securities law for companies listed on a national exchange requires that the article primarily focus on the Federal laws and the rules promulgated by the SEC.

FEDERAL SECURITIES REGULATION AND ENFORCEMENT

Rule Making

Each statute confers upon the SEC broad responsibilities. That is, Congress passes a law, such as the Exchange Act, directing the SEC to implement some regulatory plan. As the laws are broadly drafted, The SEC, as an administrative body, has the considerable ability to develop the specific rules that implement the statutory plan, or, as each statute states: “adopt whatever rules and regulations may be necessary to carry out its statutory functions.”

As a process, for an important, complex or controversial issue the SEC will initially begin the rule-making process by issuing a Concept Release. This Concept Release will outline the pertinent issue involved, a number of alternative potential approaches, and elaborate upon the costs and benefits of each approach. The public will have the opportunity to provide comment regarding the issue, and the public’s comments should inform the SEC’s final decision. These comments are then used to inform the SEC’s decision.

After reviewing public feedback from any previously issued “concept Release” the SEC will publish a Rule Proposal for public notice and further comment. Public comments will be accepted generally for 30-60 days. As the name suggests, a Rule proposal is only a proposal as to the precise contours of the final Rule, but it does include discussion regarding the problem that the Rule tries to solve to provide further context on which the public can elaborate. After any amendments or finalizations are made to the Proposal, a final Rule will be proposed to the Commission and, if approved, adopted as an official Rule governing the Securities Industry with the full force of law. In rare circumstances, the Rule can be subject to Congressional review, during which time it may be vetoed if it does not comply with the SEC’s authority under the statute.

¹⁷⁵ Approaching Comparative Company Law, 148; Markham, Jerry, Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in The United States, The United Kingdom, And Japan, 28 Brook. J. Int’l L. 319, 326 (2003).

The SEC will make additional public pronouncements that, though they do not carry the full force of law, provide clarification as to how the laws and regulations ought to be interpreted. Among these non-binding but persuasive pronouncements are interpretive releases, SEC policy Statements, and SEC Staff interpretations.¹⁷⁶ Although these do not have the force of law, they are directed for the benefit of corporate planners and are followed by supervised entities. This fact highlights the SEC's role as an industry standard setter in addition to its legal power as a regulatory body. Additionally, the SEC will, upon request by individuals, entities or attorneys seeking advice on whether a particular course of action is in violation of SEC rules, issue recommendations that the SEC take no enforcement action regarding the conduct. These 'No Action' letters do not technically bind the commission to actually refrain from taking action, but, as a practical matter, the Commission will be extremely hesitant to disregard them.¹⁷⁷ Furthermore, the Commission can respond more precisely to individual requests and issue exemptive orders.

All of the Rules and policy pronouncements may also be amended in the future, as a result of fundamental changes in the capital market situations or as the result of a fundamental philosophical shift of the party that controls the institution on how strict SEC Rules should be.

Duties/Overarching responsibility

As noted above, the bulwarks of US securities laws are the Securities Act and the Exchange Act. The two work in tandem, with the Securities Act designed to regulate the original issuance of securities by a company (the issuer) to the public and the Exchange Act regulating the secondary trading of those securities on the market. As such, most, if not all, large publicly traded companies, and their employees, must abide by the regulations set forth in both Acts, in addition to the Rules promulgated by the SEC pursuant to each.

Securities Act

Federal law requires disclosure in the contexts of securities offerings, takeovers, annual and quarterly reporting, and proxy solicitation for annual meetings of shareholders, as well as fraud related to those activities.¹⁷⁸

The Securities Act regulates the disclosure related to original securities offerings. Its disclosure philosophy is aptly characterized by the SEC website, which indicates that it is called

¹⁷⁶ <http://www.sec.gov/investor/pubs/securitieslaws.htm>

¹⁷⁷ Hazen, *Federal Securities Law*, 2011, 6.

¹⁷⁸ Donald, *Approaching Comparative Company Law*, 147.

the “Truth in Securities Law”, with the two basic goals of requiring that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities.¹⁷⁹

Generally, the securities Act requires that a public issue of securities requires disclosure of information about the issuer, the rights associated with the securities, conditions of the offer, and a comprehensive list of risks associated with the securities.¹⁸⁰ Here, adequate disclosure is the goal, and the SEC’s website notes that the goal is to empower investors, and not government bureaucracy, to make informed financial decisions.¹⁸¹

If the sale in question involves a security, as defined by §2(a)(1), then registration is required unless the transaction falls under one of the explicitly mentioned statutory exemptions or if the SEC utilizes its general exemption powers given under §28.¹⁸²

The registration requirement of §5 of the Securities Act is very broad. Technically, it requires anyone, no matter how small, who sells, offers to sell or buy, a security, no matter how small the transaction is, to register with the SEC. Fortunately, there are significant exemptions.¹⁸³

In 2005, the SEC reformed its offering rules to expedite the registration process, including a relaxation for “Well Known Seasoned Offerors” and a provision allowing issuers to fulfill prospectus delivery requirements by providing investors with a web link to an internet page where the prospectus can be located.¹⁸⁴

The registration process is divided into three periods: the pre-filing period, the waiting period, and the post-filing period.

During the pre-filing period, all offers to sell or purchase the securities are barred.¹⁸⁵ This is to prevent any offeror to precondition the market for the sale before the registration is filed. An offer to sell is any communication reasonably calculated to generate a buying interest.¹⁸⁶

¹⁷⁹ SEC Website, “About”, “Laws That Govern the Securities Industry”, <https://www.sec.gov/about/whatwedo.shtml#laws>.

¹⁸⁰ Gerner-Beuele, Temple International Law Journal, 2009, 317, 326.

¹⁸¹ SEC Website, “About”, “Laws That Govern the Securities Industry,” <https://www.sec.gov/about/whatwedo.shtml#laws>.

¹⁸² §3 covers exemptions for certain types of securities. §4 covers certain transactions that are exempt.

¹⁸³ Eisenberg, Melvin and Cox, James, Business Organizations, 11th Edition, 2014, , 1384

¹⁸⁴ *Id.* 28-29.

¹⁸⁵ §5(c).

¹⁸⁶ Per usual, there are exemptions created by SEC Rules for large public companies (Rule 163) and certain broker-dealer recommendations (Rule 137, 138, 139)

Generally, the definition of ‘offer or sale’ precludes preliminary negotiations with prospective underwriters or underwriters in privity with the issuer. That said, loose communication with underwriters can count as “jumping the gun”.

During the waiting period, the restrictions on offers to sell or purchase the securities are lifted, but the issuer is still restricted from actually selling or taking steps towards the sale or delivery of securities pursuant to a sale (as long as those steps utilize interstate commerce).¹⁸⁷ Moreover, there are restrictions on the means used to solicit offers that remain throughout both the waiting period and the post-effective period.¹⁸⁸

During the post effective period—that is, once the registration becomes effective—sales are permitted. However, restrictions still apply to the conditions of the sale, including that the purchaser actually receives a prospectus.¹⁸⁹

Liability Under the Securities Act

Section 11 of the Securities Act relates to the responsibilities of every signatory to the registration statement, including the issuer, high level executives of the issuer (CEO, CAO, CFO), directors of the issuer, experts (auditors), and the underwriter. It establishes a sliding scale of liability, with the issuer being subject to the most strict version of liability for a misstatement, experts subjected to a reasonability standard, and non-experts merely required to demonstrate that they had “no reasonable grounds” to believe, and did not in fact believe, that the issuer’s statements were misleading¹⁹⁰. Thus, the section implicitly utilizes a ‘gatekeeper’ model of securities regulation, by establishing liability to all of the parties involved, effectively subjecting them to liability if they do not complete their analysis of the company with the standard of care required by their expertise and position. The establishment of liability in proportion to a defendant’s expertise and intimacy with the issuer has led courts to utilize a cost-benefit analysis vis-à-vis a potential defendant, essentially causing them to ask, was the defendant’s conduct reasonable given the circumstances?¹⁹¹

Exchange Act of 1934

As noted above, the Securities Act and the Exchange Act operate in conjunction to produce the regulatory mechanism for securities developed in response to the Great Depression. While the Securities Act covers the sale of securities on the primary market, the Exchange Act covers the sale of securities on the secondary market. As such and consistent with the general

¹⁸⁷ Hazen, 31; §5(a)(1), §5(a)(2).

¹⁸⁸ Hazen, 32.

¹⁸⁹ *Id.*, 34.

¹⁹⁰ Gerner-Beuler, *Temple International Law Journal*, 2009, 317, 334.

¹⁹¹ *Id.*, 335.

philosophy of disclosure, the primary consequence of registration is the requirement to submit periodic reports to the commission.

Moreover, the Exchange Act also regulates the stock exchanges, such as the NYSE, and the exchange's primary SRO, FINRA, and other actors involved in the securities business, like broker-dealers and banks that act as transfer agents.¹⁹²

The primary purpose of the Exchange Act can be found in §3(f), which requires that the SEC, when engaged in rulemaking or review of self-regulatory organizations under the Exchange Act, must consider “whether the action will promote efficiency, competition, and capital formation.”¹⁹³

Exemption powers

First, it is important to note that the SEC does have the authority to exempt any “person security, or transaction, or any class of securities, or transactions” from any provision of the Exchange Act (except for §15C which relates to government securities brokers and dealers) given two conditions.¹⁹⁴ First, that the exemption be necessary or appropriate in the public interest. Second, that it be consistent with the protection of investors.¹⁹⁵

Registration

The presence of either of two conditions will trigger registration requirements by an issuer under the Exchange Act: 1) if the securities will be traded on an exchange¹⁹⁶ or 2) if the issuer is large enough in terms of asset size and number of shareholders.¹⁹⁷ Upon registering, the company becomes a “reporting company” and is thus subject to periodic reporting requirements as well as to the other requirements in the Act.¹⁹⁸

The purpose of disclosure is then effectuated in two ways through the Exchange Act.

¹⁹² Soderquist, Larry and Gabaldon, Theresa, Securities Law, 5th Edition, 2014, 201.

¹⁹³ 15 U.S.C. 78c(f)

¹⁹⁴ Exchange Act § 36.

¹⁹⁶ *Id.*, §12(b).

¹⁹⁷ Total Asset size over \$10,000,000 and b) a class of equity held by either 2,000 people or 500 unaccredited investors. As for many rules, there are some exceptions applicable here: e.g., employee stock and crowdfunding.

¹⁹⁸ Soderquist, Larry and Gabaldon, Theresa, Securities Law, 5th Edition, 2014, 135.

First, the initial registration under the Exchange Act must include certain disclosures. The information disclosed for the registration under this Act and those required under the Securities Act overlap often, although not entirely. However, the main consequence of the registration under the Exchange Act is that it subjects the issuer to the periodic reporting requirements of the Act.

Periodic Reporting Requirements

§13(a) requires registered issuers to comply with rules set forth by the SEC. Regulation 13A, promulgated by the SEC, sets forth the required filings. The most important and common filings are: Form 10-K (Annual Reports); Form 10-Q (Quarterly Reports, financial statements); and Form 8-K: (reporting on materially important events).¹⁹⁹

Technically, companies are required to report on materially significant events that are specified by the statute, which is in contrast to the EU Market Abuse Directive, which requires disclosure of events that may have a significant effect on prices. That said, the enumerated events requiring an 8-K filing in the US law are so broad as to eliminate any practical difference between the US and EU approach. In practice, US 8-K reports will often include every potentially significant press release.²⁰⁰

These requirements are also related to insider trading since information reported through the 8-k ought to be incorporated into the share price of the company, thereby erasing any potential of insider trading.

Both 10-K and 10-Q reports are largely composed of Regulation S-K disclosure requirements. Other sections of the Exchange Act require specific reporting requirements, such as those pertaining to the Foreign Corrupt Practices Act.²⁰¹

Liability Under the Exchange Act

Liability under the Exchange Act is usually predicated on the same rationale as liability under the Securities Act. That is, liability stems from material misstatements or omissions. As with the Securities Act, criminal prosecution can result in either a fine, imprisonment, or both. However, Exchange Act criminal violations are more difficult to prove than violations of the Securities Act because it requires a greater *mens rea* for conviction. The government must prove that the defendant knew that the violated rule existed.

¹⁹⁹ Soderquist, Larry and Gabaldon, Theresa, Securities Law, 5th Edition, 2014, 136.

²⁰⁰ Soderquist, Larry and Gabaldon, Theresa, Securities Law, 5th Edition, 2014.

²⁰¹ *Id.*, 138.

Civil liability can be obtained either through §18 of the Exchange Act or through rule 10b-5 (promulgated pursuant to §10(b) of the Exchange Act).

§18 of the Exchange Act provides a private liability for losses resulting from misstatements in documents filed with the SEC. However, liability under this section requires the plaintiff to prove the following four facts: 1) she relied on defective filing when she purchased or sold the security in question; 2) that the price was affected by the result of defective filing (causation); 3) Good faith (and without knowledge) defense for D; 4) Courts can require an undertaking and can assign costs to either party.

Over time, courts have imputed a private right of action for plaintiffs under 10-b-5 which requires a lower burden of proof by the defendant.

10b-5 Liability

Both securities fraud and insider trading negatively impact the marketplace by giving an informational advantage to a particular group of people. Fraud can obviously deter investment in capital markets since it undermines investor trust. If investors perceive that insider trading is commonplace, they may require a discount on the price of a security to cover the increased risk that the person on the opposite side of the trade has superior knowledge about the actual value of the security.

Rule 10(b)5, promulgated pursuant to §10(b) of the Exchange Act, is the most prominent fraud claim as it deals with both material misrepresentations and omissions as well as insider trading. The rule prohibits misrepresentations or omissions of material facts and fraudulent behavior in connection with the sale or purchase of any security. Both criminal and civil liabilities may result from its violation. Expectedly, then, most violations are pursued through civil means, which have a lower scienter requirement.

The Court's interpretation of the extent of Private enforcement of 10-b-5 violations has changed over time. Although the statute itself does not contain a provision allowing a private right of action for an individual, and was in fact likely intended to encourage *public* enforcement by the SEC, the courts have clarified that a private right of action does exist for private plaintiffs to bring a class action suit on the basis of a violation of §10(b)²⁰² and SEC Rule 10(b)-5.²⁰³ That

²⁰² *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("Although Sec. 10 does not expressly permit civil suits for violation of this section, violation of a statute is still a wrongful act and tort under the law. The right to sue for a statutory violation is so fundamental and deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly")

²⁰³ Fisch, Jill, *Iowa Law Review*, 2009, 811, 815.

said, due to a fear of the “vexatiousness” of securities litigation (quoting the supreme court), the private right of action for a §10(b)5 violation has been curtailed by both the courts and the Congress.²⁰⁴ The *Blue Chips* decision itself applied a very narrow purchaser-seller requirement, which required a potential plaintiff to have actually been a purchaser or seller of the security in question in order to have standing.²⁰⁵ A plaintiff cannot simply claim that she would have purchased or sold the security in question *but for* the misstatement or omission.²⁰⁶

Out of the professed belief that the US class action system applied to securities litigation made the US stock market anticompetitive relative to foreign counterparts, Congress continued the court’s narrowing of the private right of action under 10-b-5 by adopting the Private Securities Litigation Reform Act of 1995, which required a lead plaintiff, in the hopes that the lead plaintiff would most likely be a financial institution, which could most effectively mitigate the agency costs inherent in the US contingency fee civil litigation culture. It also significantly heightened the pleading requirements and barred any plaintiff request for discovery until all possible motions had been disposed of by the court.²⁰⁷ Additionally, the PLSRA limited the liability in forward looking statements to situations where the defendant knew that the information was false, as long as the statement is accompanied with boilerplate cautionary language. Finally, it codified the “loss causation” requirement for damages, whereby the plaintiff must prove the extent to which her loss resulted from the defendant’s conduct.

Additionally, Congress enacted the Securities Litigation Uniform Standards Act in 1998, which conferred exclusive jurisdiction to federal courts for class actions involving misrepresentations or manipulative acts in the connection of a ‘covered security,’ which includes securities listed on a national exchange as well as those that are privately placed.²⁰⁸ This act significantly curtailed private enforcement of securities laws through state courts.

Damages are awarded on a ‘loss causation’ basis, whereby plaintiffs must demonstrate that they relied on the misstatement or omission and they must separate out the decline (or increase) resulting from the misstatement or omission from that caused by general variations in the stock that would have occurred even without the violation.

²⁰⁴ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

²⁰⁵ Eisenberg, Melvin and Cox, James, *Business Organizations*, 11th Edition, 2014, 866.

²⁰⁶ *Id.*

²⁰⁷ Eisenberg, Melvin and Cox, James, *Business Organizations*, 11th Edition, 2014, 864.

²⁰⁸ Eisenberg, Melvin and Cox, James, *Business Organizations*, 11th Edition, 2014, 865.

Proxy solicitation

The Exchange Act also covers the requisite disclosure in proxy solicitations. During annual or special meetings regarding corporate action, such as board member elections, management or institutional investors often solicit proxy votes by sending information to shareholders regarding the matter at hand.²⁰⁹ Since most shareholders will not attend, most voting occurs through proxies, which effectively grants a shareholder's votes to another. §14(a) of the Exchange Act granted the SEC power to govern private conduct relating to proxy solicitation in order to prevent fraudulent solicitation.²¹⁰

Tender Offers and Takeovers

There is a considerable amount of debate about the economic desirability of takeovers in general and thus, over how ameliorative the law should be towards them. Some free marketers advocate a frictionless transfer of resources to their most valued uses. Others note that takeover battles can be expensive and that corporate raiders can utilize their dispersion to take advantage of the shareholders.

Tender offers, and the acquisition of blocks of shares, are regulated by the Williams Act, which added various sections to the Exchange Act²¹¹.

§13(d) creates a filing requirement for any person amasses more than 5% of a class of equity shares. Within 10 days of crossing that 5% threshold, the individual must file²¹² a disclosure document with the issuer, the SEC, and each exchange on which the stock is traded.^{213,214}

§ 14 (d) is the primary provision relating to tender offers. It places certain restrictions on the types of tender offers that may be made if they will result in the offeror breaching the 5% share ownership threshold and also contains a filing requirement to disclose information about the tender offer as well as information about the bidder.^{215,216} To satisfy the Rule, there is a duration requirement (the bid must be held open for at least 20 days), an "all holders Rule" which requires that the offer be open to all holders of that share of class on the same terms, a

²⁰⁹ Eisenberg, Melvin and Cox, James, *Business Organizations*, 11th Edition, 2014, 350.

²¹⁰ *Id.* 373.

²¹¹ Specifically, it added 13(d),(e); 14(d),(e), (f).

²¹² A Disclosure Document, schedule 13D.

²¹³ *Securities Law*, 5th Edition, 2014, 156.

²¹⁴ The Dodd Frank Act has amended this provision to allow the SEC discretion to shorten the time required for disclosure.

²¹⁵ *Securities Law*, 5th Edition, 2014, 156.

²¹⁶ Schedule TO.

“best price rule,” which requires that the bidder pay the same amount to all those who accept the offer, even if she decides to increase the offer after some have tendered²¹⁷ There are other requirements as well, but they all relate to similar goals.

Interestingly, here we see an instance of the SEC deviating from its usual disclosure prescription in order to interfere with potential contractual arrangements between a potential buyer and seller. This is likely a result of the dramatic asymmetric information and also the strategic position of the raider vis-à-vis the class of shareholders who may succumb to a herd mentality and accept the tender price. First, due to the dispersed nature of shareholder ownership, corporate ‘raiders’ can strategically plan a tender offer in such a way so as to coerce shareholders to accept even if they don’t believe that the transaction as a whole maximizes their ownership rewards. The front loaded merger strategy in Unocal, for instance, was arguably contrived so as to capitalize on a shareholder-herd mentality. If shareholders perceive a likelihood that the raider will acquire a controlling stake through the cash offer, they may rush to accept the cash offer rather than be forced, after the buyer obtains control, to accept arguably less valuable consideration on the back end.

Enforcement Generally

Enforcement can be categorized into three distinct categories: 1) Administrative (preventative and punitive), 2) Civil, and 3) Criminal.

Administrative (preventative)

Investigative Power

The Sec conducts over 1000 investigations per year, including regularly conducted surprise investigations. The Enforcement Division recommends investigations and recommends civil actions in federal court and also prosecutes these cases on behalf of the commission.²¹⁸ If the SEC receives indication that a Rule has been violated, it will generally begin with an informal investigation that can be triggered by investors, whistleblowers from within the company, or the general public. Similarly, an investigation can be triggered if the SEC detects unusual stock price fluctuations that indicate potential insider trading violations. Generally, the SEC will contact the potential violator and will invite them to respond to the Commission in an informal statement.²¹⁹

²¹⁷ This applies even if the offeror attempts to use questionable techniques in order to structure ‘payments’ to recalcitrant shares. See *Field v. Trump*. Eisenberg, Melvin and Cox, James, Business Organizations, 11th Edition, 2014, 1224.

²¹⁸ <http://www.sec.gov/News/Article/Detail/Article/1356125787012>

²¹⁹ Known as “Wells submissions”. Codified in Rule 202.5.

To conduct an investigation, the Commission need only act in good faith—there is no probable cause requirement. Since the investigations are “proceedings” within the meaning of the federal obstruction of justice statute, both obstruction of justice charges and perjury charges can be brought against witnesses. During formal investigations the SEC does have subpoena powers to require witnesses to give testify. They also have the power to require a response from the potential violator.

Often alleged wrongdoers will settle with the SEC, potentially accepting administrative or injunctive remedies to avoid further proceedings. Ninety percent of cases are typically solved in this manner.²²⁰ Although these settlements typically do not require the alleged wrongdoer to admit guilt, they often include provisions that prevent the party from publicly denying the allegations of the complaint.²²¹²²²

If no settlement is made and the SEC determines that further action is warranted, it can choose to implement either an administrative action or a civil action. It can also recommend that the DOJ enact criminal prosecutions.

Administrative

Administrative actions are heard by an administrative law judge, who is independent of the commission.²²³ The judge conducts a hearing, examines the available evidence presented by the Enforcement Division staff as well as evidence from the alleged wrongdoer, will come to a conclusion regarding law and fact, and will recommend the appropriate sanction. Either party can appeal the initial decision to the five commissioners, which can affirm, reverse, or remand for additional hearings.²²⁴ Finally, the target can bring an appeal to a US federal Court of Appeals. All SEC administrative decisions are appealable by the target to the applicable US federal Court of Appeals. Generally, these decisions will be subject to a deferential review, but the amount of deference given to the administrative judge will depend upon the particular issue at hand.

If the issue in the case is a question of the administrative entity’s interpretation of a statute, the administration’s interpretation will be given “*Chevron*” deference. *Chevron* deference,

²²⁰ Fischer, *The SEC an BaFin*, 65.

²²¹ That said, it is unlikely that this clause would ever apply to a testimony in a future court proceeding. *SEC v. Vitese Semiconductor Corp* 771 F.Supp.2d 310 (USDC S.D.NY) (2011). Moreover, the SEC has amended its policy to discontinue to use the clause when there are parallel criminal proceedings.

²²² Hazen, Thomas, *Treatise on the Law of Securities Regulation-the Nature of the Formal Investigative Proceeding*, § 16.28[5].

²²³ <http://www.sec.gov/News/Article/Detail/Article/1356125787012>

²²⁴ <http://www.sec.gov/News/Article/Detail/Article/1356125787012>

which references a 1984 Supreme Court opinion, means that if a section of a statute is ambiguous and Congress has not explicitly addressed the issue, then the court will side with the interpretation of the administrative entity as long as that interpretation is reasonable.²²⁵

If the issue in the case concerns the factual conclusions that the administrative judge made (e.g., the sufficiency of the evidence), the Court of Appeals will still apply deferential review. That said, the precise wording of this standard may vary between the Courts of Appeals. The 9th Circuit, for instance, applies a “substantial evidence” standard, which requires more than a “scintilla of evidence”, but requires less than a “preponderance of the evidence” standard.²²⁶ An SEC decision to begin an investigation is not subject to any judicial review.²²⁷ However, the subject of a cease and desist order is subject to review by the court of appeals.²²⁸

Sanctions

There are a range of potential sanctions that can occur from an administrative proceeding. Sanctions include injunctions (“cease and desist orders”) and other so-called ancillary relief remedies that are based on principles of equity, which include suspension or revocation of registrations necessary to work for public companies (bar), enhanced reporting requirements for the violating company, a required appointment of an independent majority on the board of the company or a specific corporate monitor, and disgorgement of ill-gotten gains, where investors that were harmed can receive at least some compensation.²²⁹

While the SEC has discretion over whether to impose a civil penalty, it may exercise that discretion if it finds that the penalty is in the public interest and: the offender 1) willfully violated the securities act, the investment company act, or the investment advisor act; 2) aided and abetted someone who violated one of those acts; 3) wilfully made a material misstatement/omission in a report or filing; 4) failed to reasonably supervise someone who, under his supervision, violated the act.²³⁰

The non-exhaustive set of factors the SEC is directed to consider when making this decision are: 1) degree of culpability; 2) harm caused to others; 3) the extent to which unjust

²²⁵ *Chevron USA, Inc. v. NRDC*, 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984).

²²⁶ *Vernazza v. SEC*, 327 F.3d 851, 858 (9th Cir. 2003), *amended by* 335 F.3d 1096 (9th Cir. 2003).

²²⁷ Hazen, *Treatise on Securities Law*, §16.2 [7].

²²⁸ Hazen, *Treatise on Securities Law*, §16.2 [12].

²²⁹ Hazen, *Federal Securities Law*, 3rd Edition, 19; Hazen, *Treatise on Securities Law*, §16.2 [4][A]; Fischer, *The SEC an BaFin*, 74.

²³⁰ Hazen, *Treatise on Securities Law*, §16.2 [14]; 15 U.S.C.A. § 78o(b)(4)(E).

enrichment occurred; 4) past violations of securities or corporate laws; 4) the need to deter the conduct in question.²³¹ As with many multiple factor tests given by Congress, the list demonstrates its non-exhaustive or open-ended nature with the last factor: “or other matters as justice may require.”²³²

Civil (public)

With a civil action, the commission files a complaint with the U.S. District Court. Appropriate sanctions can include injunctions, which, in addition to a prohibition of wrongful activity can include mandatory auditing, accounting, or supervisory arrangements.²³³

Philosophy behind Private vs. Public Enforcement of Securities laws.

The SEC was granted civil enforcement powers from the outset of its inception and these powers were greatly increased by the Sarbanes-Oxley Act. Although each Act does provide criminal penalties for violations, the SEC is only authorized to bring civil claims against the potential defendant.

Far more effective is the private enforcement of securities laws, especially through class action lawsuits. The primary benefit of private litigation of securities laws is that it effectively outsources regulatory costs to individual shareholders and lawyers. The primary professed costs of widespread private enforcement come from the nature of the US civil litigation system—most importantly, the contingent fee arrangement, which encourages potential plaintiffs to seek out lawyers who will not receive any fee unless they win, and the American Rule system, which requires each party to bear the costs of the litigation, including discovery costs, as opposed to a ‘loser pays system’, under which losing party faces the costs of the opposing side. The American system may encourage so-called ‘strike suits’, which are brought with no real underlying evidence of misconduct only to force a company to settle in order to avoid the litigation costs and the concomitant public relations costs or to force the company through an expensive and vast discovery proceeding in the hopes of overturning some evidence of misconduct, thereby increasing the potential reward of a settlement.²³⁴

²³¹ Hazen, Treatise on Securities Law, §16.2 [12]; 15 U.S.C.A. § 78u-3(c).

²³² *Id.*; 15 U.S.C.A. § 78u-3(c).

²³³ <http://www.sec.gov/News/Article/Detail/Article/1356125787012>

²³⁴ Eisenberg, Melvin and Cox, James, Business Organizations, 11th Edition, 2014, 867.

Criminal Liability for Willful Violations

The SEC, in addition to bringing civil lawsuits, can recommend that the Justice Department bring criminal sanctions against an actor who violated securities law, although the *mens rea* required for each offense can vary. There are many distinctions between a finding of liability in a civil case and a finding of criminal wrongdoing. First, and most obviously, are that the penalties associated with criminal liability are much stronger on the guilty individual. However, there are other differences between the two, most notably related to the extent of discovery and the burden of proof. For cases brought by the SEC in a civil action, both the prosecutor and the defendant have the right to access a relatively large amount of information related to the case. In a criminal proceeding, however, the discovery process is much more restricted, both for the prosecutor and the defendant. Consequently, this produces interesting strategic choices for both the SC and the defendant—the defendant, if she believes a criminal prosecution may occur, may actually prefer to have the criminal suit brought first to avoid divulging potentially incriminating evidence during the open civil discovery proceedings. Conversely, a prosecutor may want to wait before she brings forth a criminal case in order for the SEC to uncover more evidence and forward it to her.²³⁵ Finally, and the most important for the purposes of this Paper, is the fact that a finding of criminal wrongdoing requires a much higher burden of proof, which can be particularly difficult to meet in a securities action.

The *mens rea* requirements required for an offense under the Securities Act or the Exchange Act has been the source of a considerable amount of both incoherence and discord, largely due to the fact that both the Securities Act and Exchange Act were written before the Model Penal Code rationalized and standardized *mens rea* concepts.²³⁶ Generally, the requisite ‘guilty mind’ for a criminal conviction is higher than that required for a finding of civil liability, even if the underlying statute is the same.

Thus, requisite states of mind required for conviction—and for each of the individual elements that compose the crime— have run the spectrum from strict liability rules to specific intent.

‘Willfully’ violating the Securities Act or making false or misleading statements about a material fact is sufficient for criminal prosecution. The same is true for willfully violating the

²³⁵ Speech by SEC Staff: The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws, Thomas Newkirk, and Ira Brandriss, 1998 *available at* <https://www.sec.gov/news/speech/speecharchive/1998/spch222.htm>.

²³⁶ *See, e.g.*, Seigel, Michael, Bringing Coherence to the Mens Rea Analysis for Securities-Related Offenses, 1580-1594.

Exchange Act. But for false or misleading statements (or omissions) the required mens rea is ‘willful and knowing.’ Moreover, even a convicted defendant has a partial defense if he can prove that he did not know of the act or rule in question.²³⁷

For securities fraud claims under Rule 10b-5 the criminal mens rea is generally seen as ‘fraudulent intent’, whereas the civil mens rea requirement is ‘scienter.’

²³⁷ *Id.*, 1601.

Join Part

There is no doubt that the securities regulatory apparatus of both the US and Germany share a great deal in common, both in principles and in implementation. In fact, this similarity is somewhat deliberate. As we have seen in section A.I.3., Germany intentionally overhauled their securities law in response to criticism from the SEC and out of a recognition that investors require transparent capital markets with credible regulatory oversight.

Yet, comparative corporate governance should remind us that there is no 'perfect securities law' for all places and at all times. Countries should take into account their own particular context when searching for the 'optimal' regulatory structure. There are significant underlying factors that might explain, and in fact rightly justify, divergences between the two systems.

Most importantly, the two legal systems are built on fundamentally different foundations. Common law legal systems may have strengths and weaknesses not shared by Civil law systems, and vice-versa.

Second, Germany's position within the EU clearly impacts its regulatory approach. While many aspects of the US legal system is certainly complicated by its federalist structure, the preemption of federal government law over state law in matters of interstate commerce allowed it to quickly establish authority and compliance by the important players in the securities market.

However, it seems generally recognized that the German and European system can continue to improve by increasingly modeling their approach with a lens towards emulating US law.

Summary of the similarities and differences.

Guiding Principles

Broadly speaking, there are two distinct interests served by securities law: the public and the private interest. Efficient and functioning capital markets serve the public interest by ensuring businesses easy and cheap access to capital which, in turn, aids overall economic development. Private interests refer to the interests of the individual shareholders currently trading in the market.

Both US and German capital market laws recognize the importance of investor protection as a means of creating sustainable, broad and efficient capital markets. This is demonstrated by the prevalence of disclosure requirements, both for primary issuers and for transactions on the secondary market. Disclosure requirements allow, along with penalties for making misstatements or omissions of material facts, individual investors the confidence that they

can transparently weigh the true financial risks of the company in question. Both jurisdictions require filing for primary issuers as well as periodic disclosures (Ad-Hoc Disclosure requirements in the German context).

That said, in the German context investor protection is considered subordinate to the primary goal of efficient and functioning capital markets, whereas in the US investor protection is considered to be a goal, arguably even independent of its effect on the functioning of capital markets. As a superficial matter, the importance the SEC places on investor protection is demonstrated by the headline of the SEC's 'about us' section in its website, which reads: "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation."²³⁸

This distinction is in part manifested in the relative extents to which monetary damages accruing from civil infractions are apportioned to shareholders.

While both BaFin and the SEC can charge offenders pursuant to an administrative proceeding, the SEC can also bring civil proceedings, pursuant to which it can require the disgorgement of ill-gotten gains which can be placed in a "Fair Fund" for distribution to investors who were victims.^{239, 240}

More telling, however, is the prevalence of the US class action system. This mechanism overcomes the traditional collective action problems facing dispersed shareholders and allows for wronged shareholders to recoup—with the notable exception of attorney's fees and court costs—their provable losses resulting from the wrongdoing.

While arguably this private right of action mechanism enhances the public interest through deterrence and is thus consistent with the German model whereby investor protection is subordinate to the public interest, history belies that claim. As indicated in the brief history of the 10(b)-5 private right of action analysis, the private right of action was not statutorily intended and had its origins in tort principles of loss causation. Moreover, many commentators have criticized the extensive use of private civil litigation as being detrimental to the public interest and Congress itself has intentionally heightened the requirements for prevailing.²⁴¹ This suggests that, at the very least, US common law principles demand the individual right to recuperation from harm as a normative value distinct from any public benefit resulting from increased faith in capital markets integrity.

²³⁸ SEC Website (EDGAR Version), "What We Do", <http://edgar.sec.gov/about/whatwedo.shtml>.
http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2015/fa_bj_1510_bafin_und_sec_en.html
(last seen February 20 2016, 14:28)

²⁴⁰ Pursuant to Sarbanes-Oxley Act of 2002 §308.

²⁴¹ *See generally, e.g.*, William W. Bratton & Michael Wachter, *The Political Economy of Fraud on the Market*, 2011.

How Securities Law is made

Securities law in the US comes ultimately from Congress' power under the Constitution to regulate interstate commerce. Stemming from the Exchange Act, the SEC is granted regulatory powers as an independent regulatory commission with rule making power.²⁴² The latter shall be subject of a comparison to the German approach of rule making under the BaFin.

European Federalism versus United States

Harmonization remains an unattained goal in the EU, as there are significant differences across the various Member States. The more important a difference is the more likely will be an impediment influence from Member States in regard to rule making on the European level. Even though the EU tries to converge with the Anglo-American system, national corporate governance remains heterogeneous among the EU member states. Thus legislation on an European level often – despite the improvements of Lamfalussy – a slow process.²⁴³

Given the constitutional authority of Congress to regulate interstate commerce and its imposition of that authority in the realm of securities law since the Great Depression, heterogeneity among the states does not pose similar obstacles. As such, the rule making process for the US is not nearly as complex as that required by the EU. Hence the primary point of comparison must be at the regulatory institutional level—BaFin and the SEC.

General rule making power

In Germany, as mentioned in A. III., rule making in regard to securities regulation is a multi-level complex due to European and German federalism. The BaFin itself is not entitled to enact ordinances unless specifically mentioned in the WpHG. Thus the BaFin has no general rule making power, but a specific rule making power.

Under the US Constitution it is prohibited to delegate rule making power from Congress to an administrative agency according to the *non delegation doctrine*. Nonetheless legislative agencies draft regulations much like congressionally enacted statutes. The new interpretation of the non delegation doctrine states that there is no forbidden delegation of legislative power if Congress provides for an 'intelligible principle', in other words a guiding principle to administrative agencies.²⁴⁴ Under §§ 10 (a) and (b) of the Exchange Act as well as § 3 (b) of

²⁴² Walla, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, 160.

²⁴³ Ferran, in: Ferran/ Moloney/ Hill/ et. al., Regulatory Aftermath, 2012, 44

²⁴⁴ Watts, Georgetown Law Journal, Vol 103, 1003 (1006) [siehe hierzu entsprechenden Artikel in pdf reader auf ipad]

the Security Act, the SEC has a general rule making power regarding rules and regulations ‘as may be necessary to carry out the provision.’

As shown above, both the BaFin and the SEC have rule making power, but the nature of that power is significantly different between the two. Administrative agencies in the US, like the SEC, must receive their regulatory authority from Congress but do have a relatively large amount of flexibility to interpret congressional statutes and to craft rules according to the specific environment. The BaFin, on the other hand, must strictly comply with the wording of the legislative delegation from the Department of Treasury and therefore lacks an equivalent degree of interpretive flexibility. Moreover, the judicial analysis of regulatory interpretations requires only that the regulatory agency applies a rational interpretation of the implementing statute. The SEC has a rule making power that is delegated and only bound to a principle that may be rather broad such as ‘public interest’.

The substantive distinction between the two legal regimes then, is that the US common law system allows for a greater degree of institutional flexibility. This can have both positive and negative effects. The primary benefit of flexibility is that it allows the SEC to quickly adapt as it receives feedback from practitioners or as the economic or financial environment has changed. However, there are drawbacks to the US approach. In the German system, regulators operate much more like machines, with a defined set of rules regarding how to approach any particular issue. The US system grants regulators with significant discretionary authority over whether or not to enforce the rules or to interpret the rules in a narrow or broad manner. Discretion is power, and this power creates two potential problems. First, that of regulatory capture, whereby regulators consciously apply favorable approaches to companies in the tacit expectation of gainful employment in the future. Second, the focus and strength of the SEC can wax and wane depending upon the economic philosophies held by the President, who appoints the commissioners. Although the system attempts to ensure bipartisan representation, the aggressiveness of the SEC can vary greatly depending on the party in power. This conclusion is underlined by the fact that the US law scholars have been discussing the danger of an agency capture meaning that rule making participation of the subjects that are in the scope of the agencies oversight is extended to an unhealthy degree due to lobbying.²⁴⁵

²⁴⁵ Walla, Die Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, S. 198

Informal acts of administration

Rule making in Germany does not only include rules, regulations and ordinances as shown in section A.III. 1.b) bb) (b) but also administrative informal acts. The SEC likewise utilizes its ‘soft power’ to take advantage of its position as an industry standard setter through the release interpretive releases, SEC policy Statements, and SEC Staff interpretations.²⁴⁶ ‘No Action letters’ are particularly relied upon by the requesting companies although they too do not carry the force of law.²⁴⁷

Obvious is that in both jurisdictions the attractiveness of rule making by using informal means that have considerable consequences for market participants is high.

Given the discrepancies in the relative rule making power of both there must be some intrinsic benefit to informal rule making that explains its use by both regimes. One possible explanation is that the informal rule making approach affords a greater flexibility than either regulatory regime has with its formal rule making process. Although the SEC rule making process is, as explained above, more dynamic than BaFin’s, rule making still takes time and there can be legal hurdles involved, even in the US system. If true, the extent of BaFin’s influence as an industry standard setter through informal means may mitigate the limitations imposed upon it by its relatively handcuffed position within the German legal apparatus by enabling the agency to respond, albeit informally, in a dynamic fashion to rapidly changing market conditions and upon the uncovering of new information and experience. The same would, of course, be true for the SEC, but given its relatively flexible ability to amend regulations the marginal beneficial effects of increased adaptability and case-by-case tailoring resulting from the use of informal means may be smaller than those associated with the corresponding ability of the BaFin.

Another benefit of the use of informal methods of regulation is transparency. By publishing internal documentation, both agencies can explain their attitudes regarding the implementation of a particular regulation ex-ante, and can also justify their actions ex-post, each of which safeguards the agency’s reputation in the community it seeks to regulate and enhances legal certainty.

Single Regulatory Authority (BaFin) vs. SEC

²⁴⁶ *Hazen*, Securities Regulation, 2011, 12, 40

²⁴⁷ *Halpap*, Kapitalmarktaufsicht, S. 129

Perhaps the biggest distinction between the agencies, aside from their different legal contexts, is their respective degrees of institutional concentration.²⁴⁸

BaFin is based on the model of a “Universal Supervisor,” unifying securities, banking, and insurance supervision under one roof and the supervision is organized on the basis of business functions, not supervisory functions²⁴⁹, as is the case, for example, in the UK.²⁵⁰ (To be clear, organizing on the basis of business functions means that the specific regulatory groups are assigned to oversee the entire regulatory and supervisory process of certain types of businesses). In the US these same responsibilities are shared between the SEC, the Fed, Treasury, the FDIC, and others. As noted above, overall this amounts to over ten regulatory bodies at the federal, state, and industry level.²⁵¹ Even in the realm of securities law, the CFTC and the SEC separately regulate, but in parallel, swaps and derivatives.²⁵² Further complicating the matter is the overlapping regulatory role that individual states play in all of these areas. In fact, insurance regulation is left entirely to the states to regulate.²⁵³ Moreover, the US “two-tiered structure” of its securities regulatory approach combines jointly the regulatory and supervisory powers of the SEC with voluntary regulation by FINRA, ceding a degree of control by the SEC (although, as noted above, the SEC does have significant control over FINRA). On the other hand, this approach arguably enhances the flexibility of responses and the communication between the public and private spheres, further enhancing the SEC’s effectiveness.

Two factors that justified this aggregation of regulatory power under BaFin were the emergence of universal banking in Germany and the consolidation of banks and insurance companies into financial conglomerates²⁵⁴—the government wanted the regulatory agency to mirror the size and scope of the conglomerates.²⁵⁵

²⁴⁸http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2015/fa_bj_1510_bafin_und_sec_en.html

²⁴⁹ Lastra, Rosa, *The Governance Structure for Financial Supervision and Regulation in Europe*, 10 *Colum. J. Eur. L.* 49 (2004) 49, 51.

²⁵¹ Schumer, *supra* note 1.

²⁵² Dodd Frank specified that the CFTC regulates ‘non-security based derivatives while the SEC will regulate ‘security based derivatives.’ However, the category ‘non-security based derivatives’ includes items that are associated with ‘securities’ in the common vernacular and that can also have significant impacts on the securities markets, such as interest rate swaps and credit default swaps. Skeel, *The New Financial Deal*, 68.

²⁵³ *Id.*, 54.

²⁵⁴ Kenneth K Mwenda, *Legal Consequences of Unified Financial Services Supervision in Germany*, *German Law Journal*, 1009, 1019.

²⁵⁵ La Rosa, *The Governance Structure for Financial Regulation and Supervision in Europe*, 51.

There are additional arguments concerning the costs and benefits of concentrated regulatory powers under BaFin. First, a consolidated entity can take advantages of economies of both scale and scope by efficiently utilizing a central resource allocation mechanism (the benefits of synergy).²⁵⁶ Second, centralized planning systems, can increase the allocational efficiency of regulatory resources. Third, an individual entity can more effectively harmonize cultural and supervisory approaches and thus ensure the consistent treatment of regulated entities.²⁵⁷

Some commentators fear that unifying so much responsibility in a single bureaucratic entity can lead to the abuse of power, especially as members of the entity vie for greater control.²⁵⁸ This is arguably less likely to occur in a segregated regulatory market place, since the sharing of responsibilities necessitates communication and cooperation, both between regulatory apparatuses themselves (as in the relationship between the SEC and the DOJ) and between regulatory bodies and private sector leaders (as in the relationship between SEC and FINRA). Even in the absence of cooperation between regulatory authorities, the US approach arguably decreases the possibility of bureaucratic contagion, since overlapping regulatory spheres ensures somewhat of a redundant regulatory system—that is, if one agency is incompetent there are other agencies that may still be able to spot potential infractions. However, this redundancy obviously also represents increased costs in the form of—well, redundancies. It is a matter up for debate as to whether or not the benefits of the duplicative scheme outweigh the costs.

Alternatively, the fragmented nature of US financial regulatory scheme can lead to competition among the various US regulatory agencies that encourages each to become the fiercest regulatory agency and therefore to have a tendency to overregulate, which can harm the formation of capital markets by incentivizing managers and directors to expend resources to avoid corporate or even personal liability.²⁵⁹

²⁵⁶ Kenneth K Mwenda, Legal Consequences of Unified Financial Services Supervision in Germany, *German Law Journal* *Id.*, 1010; Lastra, *supra* note 107, 66.

²⁵⁷ *Id.*

²⁵⁸ *Id.* 1017

²⁵⁹ Silvia, Joseph, Efficiency and Effectiveness in Securities Regulation: Comparative Analysis of the United States's Competitive Regulatory Structure and the United Kingdom's Single-Regulator Model, 6 *DePaul Bus. & Comm. L.J.* (2008), 247, 251.

Other concerns with the BaFin organizational structure have been the potential blurring of the distinctions between financial institutions, cultural conflict within the entity since employees have different specialties and different goals, and diseconomies of scale.²⁶⁰

Another potential advantage of having fragmented regulatory agencies is that they may each compete for regulatory authority over new industries or financial products. If the system functions rationally, the agency that is most capable and efficient should be given the jurisdiction.²⁶¹ However, as noted above, this competition could create a tendency towards over regulation, both on the level of the individual regulator and in the sense that multiple agencies will try to assert jurisdictional authority over the matter.

Overall, it is unclear which system is superior. And, as with nearly every other aspect of this comparative analysis, the ideal organizational structure may be different for each country given their legal and historical context. It is certainly clear that the US system imposes significant burdens on companies—estimated in 2006 to be 15 times higher than the regulatory burdens on British companies.²⁶² But these differences in regulatory burdens may have more to do with prevailing cultural attitudes among the regulators (i.e., whether they intellectually favor a ‘hands off’ approach or a more aggressive regulatory stance) than with whether or not the regulatory apparatus is fragmented or consolidated.

Enforcement of securities law

The US relies heavily on a deterrence approach towards capital markets regulation and securities enforcement,²⁶³ as indicated by the SEC’s characterization as the “tough Cop on Wall Street”.²⁶⁴ As shown in section B. VII. the US approach is based upon a wide variety of sanctions as well as high enforcement intensity in order to achieve the deterrence. Enforcement intensity can be measured by calculating the input of resources dedicated to enforcement relative to a quantifiable output.²⁶⁵ Theoretically, the enforcement output should correlate with enforcement

²⁶⁰ *Id.*, 1017

²⁶¹ Silvia, Joseph, Efficiency and Effectiveness in Securities Regulation: Comparative Analysis of the United States's Competitive Regulatory Structure and the United Kingdom's Single-Regulator Model, 6 DePaul Bus. & Comm. L.J. (2008), 247, 251.

²⁶² Schumer, *supra* note 1.

²⁶³ Coffee, CLEWP, 2007, 4 f.

²⁶⁴ *Jennings./ Marsh/ Coffee/ Seligman*, Securities Regulation – Cases and Materials, 100.

²⁶⁵ *Moloney*, EC Securities Regulation, 1104 f.; Walla, Konzeption der Kapitalmarktaufsicht in Deutschland, 2012, 185

input—that is, expending a greater amount of resources towards enforcement ought to yield more results. Regulatory costs in the US outnumber costs for regulation in Germany by far. While the BaFin has a budget of approximately 262 million Euro in 2016, the SEC spends approximately 1.722 billion US-Dollar (or 1.553 billion Euro). In 2012 the costs of regulatory agencies compared to the market capitalization of the individual national stock markets were 52 % higher in the US than it was in Germany.²⁶⁶ Moreover, since BaFin serves as the regulatory authority for banks and insurance companies as well as securities whereas the SEC only regulates securities, the ratio US to German spending would be much higher if spending on securities were isolated in the German budget. Data from 2002 and 2003 suggests that Germany spent \$3.914 per billion of Gross Domestic Product versus \$131.731 the US towards security regulation.

Administrative Enforcement

The SEC may initiate an Administrative Proceeding, an internal proceeding based on the Securities Enforcement Remedies and Penny Stock Act 1990. In this case the SEC may issue a variety of orders. The Cease and Desist Orders target individuals in charge of a breach of securities law. Additional methods of administrative enforcement include monetary penalties, disgorgement of illegal profits, temporary or final exclusion from the stock market trade, and the so called stop order or refusal order, and may also issue officer and director bars.²⁶⁷ Functionally, German equivalents exist for all sanctions mentioned above. However, officer and director bars though only exist for financial institutions in Germany.

Another sanction common to both jurisdictions is public censure. According to the market manipulation guideline, the BaFin may make breaches of securities law public once they are incontestable; the sanction nonetheless is subject to harsh preconditions such as the consideration of the constitutional right of informational self-determination.²⁶⁸ Additionally, BaFin relies heavily on the practice of ‘corporate shaming.’

²⁶⁶ SEC, <https://www.sec.gov/about/secfy12congbudgjust.pdf> (as from 18th Feb 2016 14:44); BaFin http://www.bafin.de/SharedDocs/Downloads/DE/Bericht/Haushalt/Haushaltsrechnungen/dl_jahresrechnung_2012_gesamt.pdf?__blob=publicationFile&v=1 (as from 18th Feb 2016, 14:44); Quandl, <https://www.quandl.com/collections/economics/stock-market-capitalization-by-country> (as from 18 Feb 2016)

[aufnehmen in Lit Verveichnis]

²⁶⁷ Bockmann, 2012, 116

²⁶⁸ Halpap, 219

The SEC may obtain a court order to restructure the board of managers or to appoint an external authorized individual (a so called corporate monitor).²⁶⁹ A comparable institution may only be found in the KWG and exclusively regarding financial institutions und the laws of the KWG.

That the German armory is not as fierce also indicates the lack of certain powers such as the power to seize evidence or to the power to freeze assets.²⁷⁰

The SEC conducts inspections and investigations. Inspections are not conducted by the SEC branch in charge of enforcement thus inspection is considered a part of supervision.²⁷¹ Formal investigations under the SEC include the subpoena power, which can compel the production of evidence and can compel individuals to appear at a hearing.²⁷² Moreover, obstruction of justice charges and perjury charges can be brought against witnesses.

An important part of enforcement are intervention rights and the right to sanction, as mentioned before in sections A III b) and B VII. While the US on this field have a two-tier system of civil and administrative proceedings, the German securities regulator relies on a one-tier system of administrative enforcement. The regulatory administration in the US may submit a case to court while the SEC itself conducts administrative hearings. In Germany on the other hand only the regulatory administration may sanction and intervene on the field of securities regulation. The administrative court serves as a level of jurisdiction to grant legal protection against unlawful sanctions and interventions.

As mentioned in section B VII 2 most cases that are under investigation of the SEC are settled. Such a “Deal” or settlement as mentioned in section A III 3 b) does not exist in the German securities regulation enforcement system of the BaFin.

Criminal Proceeding

Neither the SEC nor BaFin is able to conduct criminal proceedings on its own, but must rely on the Department of Justice.²⁷³ Under the US Sarbanes/Oxley Act individuals face in a case in which they are finally convicted a five-million-dollar penalty and a maximum of 25 years of imprisonment.²⁷⁴

Reflecting the fragmented nature of the US administrative system, the SEC has discretion over whether or not they will recommend a case to the DOJ for prosecution. A crucial difference

²⁶⁹ *Bockmann*, 2012, 117.

²⁷⁰ *Fischer*, The SEC an BaFin, 176

²⁷¹ *Halfpap*, 213

²⁷² *Halfpap*, 213 f.

²⁷³ *Bockmann*, , 116 f.

²⁷⁴ *Bockmann*, 2012, 117.

to the BaFin is the discretion of the SEC whether they forward a case in which there are suspicious facts. This contradicts a real separation of powers between the different agencies on the field of Criminal prosecution. The SEC has full discretion to forward evidence in ‘case’ to the DOJ, which also has discretion as to whether or not they will bring a criminal prosecution. Institutionally the DOJ is an entirely separate entity that brings criminal o prosecutions in a variety of fields that are subject to regulatory supervision (e.g., Food and Drug violations). It can also investigate in tandem with the SEC investigation.

The BaFin on the other hand has no discretion at all and must forward any suspicious evidence to the criminal prosecutor that then decides with to bring a charge against the regulation violator. This difference may be explained by a different principle of separation of powers and different agency cultures in the different legal systems. Mergers of administrative, judicial and legislative powers are considered to be a key factor for regulative excellence nonetheless but are not, or only to a certain degree, compatible with constitutional law.²⁷⁵ From a comparative perspective it is opined that the US enforce their criminal law more systematically.²⁷⁶

Private Enforcement

The SEC may initiate a Civil Injunctive Proceeding in addition or alternatively to its administrative proceeding. Sanctions are very much comparable to the latter. Administrative Enforcement in the US is also supplemented by a “hyperactive” system of private enforcement. In fact, the private system appears to exact a greater annual aggregate sanctions. The system relies on both class actions as well as entrepreneurial plaintiff’s bar motivated contingent fees and has as such no functional counterpart in Germany.²⁷⁷

An approach to install a system to class action as explained in section A.III. 3. c), the so called KapMuG, has not proven its efficiency to substantially supplement securities regulation enforcement. Due to the explained ‘rational apathy’ a law suit under KapMuG is unattractive and the lack of real a collective redress. In the US on the other hand victimized consumers respectively investors with only small damages more often file a law suit collectively. The opportunity of attorney fee shifting makes legal action more attractive to investors and serves as an incentive to file a class action.²⁷⁸ Civil liability claims in the US on the other hand are more often pursued. They again serve as preventive action for capital market fraud. Such claims

²⁷⁵ Niemeyer, 36.

²⁷⁶ Coffee, CLEWP, 18.

²⁷⁷ Coffee, CLEWP, 17 f.

²⁷⁸ Waller/ Brady/ Acosta/ Fair, EJCL, 21 f.

do not appeal to possible plaintiffs or courts which reduces their frequency and hence their repressive or preventive power.²⁷⁹

Punitive damages again do not exist in the German enforcement system and thus reduce the deterrent effect of private enforcement and the attendance towards regulation compliance. The same is true in regard to pre-trial discovery.

In section B II 4 self-regulatory organizations have been introduced. Aside from the Stock market no self-regulatory organization exists in Germany. An institution such as the FINRA has no analogue in Germany. To install such an agency is not debated. Especially on the field of investor protection private investors remain self-responsible as for example Secretary of Treasury Wolfgang Schäuble stated in 2014: 'The mature citizen remains a mature citizen.' Nonetheless BaFins powers may be extended in regard to collective consumer protection in the near future.²⁸⁰

Public versus private enforcement from a cost benefit perspective

There has been a substantial amount of literature focusing on a cost-benefit analysis of private litigation and public enforcement, with often mixed conclusions. Such mixed conclusions are certainly understandable given the difficulty of cross country comparisons in general alongside the difficulties in articulating the various legal and cultural nuances that affect the actual application of seemingly similar laws in different jurisdictions.

Philosophically, there are two arguments in favoring public enforcement over private enforcement.

First, whereas private enforcement focuses only on compensating the costs to the plaintiff(s), public enforcement can consider the social costs of fraudulent activity, which is primarily the inefficient allocation of capital caused both by the malinvestment in the offending company and also by the decreased faith in the entire market system. Thus, public enforcement penalties can be predicated on the principle that the private gains to be made from fraud should be made less than the expected costs to a potential defendant. That is, public enforcement can attempt to make the expected benefit from fraud less than the expected costs of fraud: personal monetary and other punitive costs multiplied by the probability of punishment, requiring self-interested actors to refrain from fraudulent behavior.

²⁷⁹ Fischer, *The SEC and BaFin*, 178.

²⁸⁰ *Gala*, <http://www.zeit.de/wirtschaft/2014-05/aktionsplan-verbraucherschutz> (as from Feb 19 2016 15:11)

Second, public enforcers have greater resources and greater investigative powers to utilize in the detection and prosecution of fraudulent activity. Thus, public enforcement can take better advantages of both economies of scale and scope in the deterrence of fraudulent behavior.²⁸¹

Third, in a private-enforced civil litigation context, most jurisdictions, including the US, require that the victim actually traded on the misleading information involved. This limits the compensation disproportionately to investors who actively trade in the market. While this factor also increases the discrepancy between private compensation and public welfare, as mentioned in the first paragraph of this section, it also gives disproportionate gains to short-term traders and thereby exacerbates any social costs associated with ‘short-termism’.

Fourth, if rational investors are adequately diversified, then there may be a decreased incentive for investors to be concerned with fraud since their risk of fraud is dispersed among many different investments. Since widely dispersed shareholders bear a relatively small amount of the gains from litigation and bear a large portion of the costs, they may will be inadequately incentivized to litigate.

Fifth, the ultimate defender is usually the corporation itself, and private actors within the firm may be shielded from any personal liability in a civil context. In turn, it is the shareholders, not the bad actors, who suffer from the fraudulent activity. Moreover, D&O insurance often will indemnify corporate actors who engage in liability that brings forth civil action (although D&O insurance normally precludes reimbursement from suits arising from intentionally criminal activity).

However, there are arguments that question the validity of these arguments.

First, it is, as a practical matter, impossible to assess either the true social costs of fraudulent activity since that measurement would need to calculate the monetary damages associated with a general chilling effects on markets, often from the result of a single case of bad behavior. Such costs are too difficult to calculate precisely, making any society wide cost-benefit analysis untenable at best. Likewise, it is impossible to calculate the cost-benefit analysis from the defendant’s perspective, and thus the appropriate punishment for effective deterrence of a rational trader, since the overall level of bad behavior is unknown. That is, it is impossible to calculate the likelihood of detection.

Second, although public agencies may appear to have greater resources, the accumulation of the experiences and the information of the large numbers of private actors dwarfs the information that public bodies can access. This is particularly true when public enforcers are

²⁸¹ Guido Ferrarini, 43.

responsible for the actions of a wide swath of companies. Moreover, public enforcers, although they have a greater absolute amount of resources to implement a single case, do not have the relative amount of resources to pursue all potential cases with the same level of rigor²⁸².

Third, individuals involved in public enforcement are as susceptible to the same agency costs as others who serve in a gatekeeper capacity through the ‘revolving door’ between public agencies and private companies. That is, that public enforcers are incentivized to overlook potential violations in companies for whom they may wish to work in the future.²⁸³ Additionally, political pressure from important companies could also be a source that deters effective enforcement from public actors.

However, the use of class action has received substantial criticism in the United States for promoting the use of frivolous lawsuits. Although they solve the collective action problem inherent in single-individual private enforcement cases (that a single individual with a small stake must bear all of the costs of litigation and share a small portion of the benefits), the process in the US is largely lawyer driven. This can create two problems. First, that lawyers will be likely to settle quickly even if a settlement is not in the interest of their class of clients. Second, that lawyers, understanding the financial and reputational costs borne by companies facing prolonged litigation, will seek to create illegitimate lawsuits in order to force a quick settlement by the company.²⁸⁴

Conclusion

In conclusion it may be said that the US enforcement is administered by more actors especially on the field of private enforcement. Sanctions available to the SEC as well as criminal prosecutors are more deterrent focused. On the field of private enforcement self-regulatory organizations such as FINRA guard the enforcement system as an independent private agency with both preventive and repressive means. Criminal proceedings are conducted more systematically in the US. On an administrative level enforcement shows considerable parallels regarding intervention rights but eventually the SEC has more extensive powers on this field as well.

In the end, much of the distinction between the two regulatory regimes is predicated on historical accident. Although Germany, as well as much of the Eurozone, has attempted to emulate the US regulatory model there are political and institutional reasons for why it cannot, and should not, do so fully. Most importantly is Germany’s position within the EU and its legal

²⁸² Ferrarini, 44.

²⁸³ Id. 44.

²⁸⁴ Id. 46.

infrastructure based on civil, not common law, which alters every regulatory approach the government can make.