THE INTERNATIONALIZED SECURITIES MARKET AND INTERNATIONAL LAW – A REPLY TO JOHN M. FEDDERS

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The governor enquired what these boats were doing, and on being told they were surveying the harbor [of Uraga, Japan], he said it was against the Japanese laws to allow of such examinations. He was replied to that though the Japanese laws forbade such surveys, the American laws command them, and that we were as much bound to obey the American as he was the Japanese laws. Here was ... a most important point gained [1].

Mr. Fedders has in his various writings usefully focused attention upon the undesirability of insider trading in securities markets. To an extent he may be preaching to the converted. Few voices may be heard declaring the positive social value of insider trading. Fedders does not, however, reflect a position of international consensus when he goes on to assert, as he implicitly does, that insider trading is so undesirable that the costs, economic and social, of suppressing it are worth bearing. It is possible that a world view to this effect is indeed in the process of formation, although the international efforts of the Division of Enforcement of the Securities and Exchange Commission under Fedders may well be causing sufficient resentment to hamper rather than encourage this process. But it is quite certain that no such world view presently exists. Had Fedders confined himself to exhortation addressed to the community of nations and designed to generate international cooperation in the suppression of insider trading, I would have seen no reason to publish my reactions. The Director of Enforcement of the SEC has, however, further invoked the blessing of law in support of the unilateral measures that he favors taking. In so doing, he has demonstrated a distressing failure to grasp the basic rudiments of that international law whose support he so craves.

To see the nature of the problem, let us begin by reassessing Fedders’ “market fraud hypothetical” [2]. Suppose that ACo plans a tender offer for the shares of BCo. Before the plan becomes public knowledge, X, who has heard of it from private sources in ACo, places an order for the purchase of shares of

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BCo on a stock exchange within the United States through a bank in Ruritania, a secrecy jurisdiction which does not forbid insider trading, X has certainly performed an action in conflict with the nominal terms of Rules 10b-5 and 14e-3 promulgated under sections 10(b) and 14(e), respectively, of the Securities Exchange Act [3], but to say that X has violated that Act implicitly incorporates a determination that the jurisdiction of the United States extends to permit the prescription of rules of law governing X’s conduct. Such a determination has been consistently made by the SEC and the courts of the United States. The United States, however, lacks the power to create international law by unilateral determination, and I strongly doubt whether anything approaching a consensus of the international community in support of the position of the United States could be found. This is particularly so in the case that X is neither a citizen nor resident of the United States and places the purchase order while in Ruritania, and ACo and BCo are not U.S. corporations.

By way of analogy, suppose that Ruritania produces fine alcoholic beverages, but is deeply concerned about alcoholism, especially among young people. It therefore makes it a criminal offense for alcohol to be purchased by or on behalf of any person under thirty years of age. Y, a citizen and resident of the United States, asks her friend B, also a citizen and resident of the United States, who is taking a vacation in Ruritania to bring her back some alcoholic beverages. B is thirty years of age, but Y is younger. May Ruritania, consistently with international law, deem Y to have committed a criminal offense at the moment when B, acting as her agent, purchases the alcohol? Both the Ruritanian alcohol regulation and the U.S. insider trading regulation forbid the purchase of certain commodities by certain persons of a certain status; the status is one of age or of possession of non-public knowledge, respectively. Both nations might reasonably be concerned that their markets in the respective commodities be kept free of what they respectively regard as taint or corruption. But taint and corruption mean different things to different nations. In this example, each nation is untroubled by behavior that the other actively suppresses. Each remains unmoved by the argument of the other that the world would be a better place if it shared the other’s concerns. The two situations are quite closely parallel. Yet if Ruritania asserted jurisdiction over Y, and imposed criminal sanctions, would the United States feel that Ruritania was merely enforcing its regulation within its proper jurisdiction?

Note that the situation would be somewhat different if the transaction were condemned by the laws of both countries. Thus, suppose that B purchased the alcohol during the period when Prohibition was in force in the United States. The act of purchase might then be viewed as in furtherance of an unlawful conspiracy to import alcohol into the United States, and that country would possibly applaud Ruritania’s efforts to compel B to reveal Y’s identity as welcome assistance in the enforcement of U.S. regulations. As illustration, little
international objection was heard to the U.S. antitrust attack on the Quinine Cartel in the 1960s [4], whereas strenuous objection was raised to the attack on the Uranium Cartel in the 1970s [5]. The United States asserted an extra-territorial jurisdictional reach as long in the former case as in the latter. However, in the former case it was perceived as acting as part of an international consensus opposed to the activity in question, whereas in the latter it was perceived as endeavoring to impose its contrary views on other nations within their exclusive jurisdiction [6]. Thus, one might guess that officials of France, which has a strong policy against insider trading, would be more receptive to Fedders’ proposal than those of Switzerland, which is less deeply concerned with the matter [7].

Fedders expends a good deal of effort in persuading us that a party’s entering into a single commercial transaction within the United States constitutes sufficient “minimum contacts” for the United States to exercise its jurisdiction over that party [8]. In this he may well be correct, although for two important reasons the cases he cites are inadequate to support his argument. First, these cases all deal with situations in which the single commercial transaction gave rise either to a continuing contractual relationship, from which a dispute emerged, or to a continuing state of risk of harm, from which a tort action resulted. He cites no case in which a single commercial transaction without a subsequent relationship formed the basis for exercise of jurisdiction. Secondly, it is hardly persuasive to rely wholly upon U.S. cases to establish international law when the whole problem stems from differing views on the part of the United States and other nations as to the content of that law. In any event, the point may freely be conceded without undermining the most severe criticisms of Fedders’ position. His argument is merely one for the existence of in personam jurisdiction. This is certainly present in the case of banks that regularly place orders on U.S. stock exchanges. It may be present, as I concede, in the case of the individual foreign purchaser, although the point is less clear and there remains the further problem of service of process [9]. But, crucially, the fact that these parties may be haled before a court of the United States in no way pre-empts the question whether international law permits the application of U.S. law to their activities.

The United States has consistently taken a broad view of the extent to which jurisdiction to prescribe attaches to, and travels with, a commodity purchased in the United States. Thus, in the gas pipeline controversy of 1981–82, the United States purported to ban the sale to the USSR of commodities purchased by Europeans from the United States. The ban extended to some goods which had already been sold to foreigners and left the territorial jurisdiction of the United States. In the view of many, and possibly all, other nations, the United States was attempting to exceed its lawful jurisdiction. The general view is that while the United States may impose contractual restrictions on the resale of such goods (and here too there may be
problems if the public policy of the nation—in which the resale takes place rejects the restrictions), it may not directly regulate their resale under its own law. But our insider trading illustration is somewhat like this resale transaction. The only party making a purchase in the United States is the bank. Any prior and subsequent arrangements whereby it acts for X, the undisclosed principal, are all made in Ruritania. Does U.S. jurisdiction attach to, and travel with, the stock purchased there [10]? It is no argument at all to say that X is liable for the actions of his agent, for presumably the agency law being applied is that of the United States, and the jurisdictional question must first be answered before it can be determined whether U.S. agency law properly governs X's behavior. If it seems a quibble to focus on the territorial location where the agency relationship was established, observe that from the point of view of Ruritania it may seem equally a quibble to focus on the territorial location where the stock purchase took place—especially if neither ACo nor BCo is a U.S. corporation.

To a great extent Fedders conveys the impression of not according foreign tolerance of insider trading full respect as a separate but equal legal construct. This is a pity. I share Fedders' view that insider trading is undesirable, and would be happy to see him so persuade other nations. Until such time as he has done so, however, due regard must be paid to the right of a nation to protect conduct lawful within its borders and performed there, subject to the limitations imposed by the effects doctrine as it is generally recognized in the community of nations. Foreign laws are not to be dismissed as irritating "impediments" to the universal application of the law of the United States. The process of "internationalization of the securities markets" may itself be perceived by other nations as good reason for U.S. law not to apply throughout those markets. The notion of the SEC as world securities police may have less than universal appeal, however "effective" it might be in ensuring "fair[ness] and honest[y]"—as those terms are understood by the United States.

Foreign nations who perceive an encroachment upon their jurisdiction may, as we have seen in recent years, react adversely. Not surprisingly, they may do their best to obstruct the encroaching power. Indeed, it is remarkably to the credit of the European nations that they have restrained themselves from responding to the United States in kind. On the contrary, they have confined their responses to the same jurisdictional limits within which they have sought to confine the actions of the United States. Thus, the European response to what it perceives as the unacceptable reach of U.S. antitrust jurisdiction has not included criminal actions in domestic courts against U.S. corporations combining under the protection of the Webb–Pomerene Act. In this they have commendably eschewed short-term advantage in favor of the universal long-term benefits of adherence to the international legal order, an approach from which the United States could learn much. In the area of securities regulation, foreign nations have generally confined themselves to non-cooperation in
service of legal process and the enactment and enforcement of blocking laws.

An important observation needs to be made regarding the service of process issuing from a U.S. court to a party outside the United States. Fedders cites the *Saint Gobain* case [11] for the principle "that subpoenas cannot be served outside the United States without approval by officials of the nation involved", but, implicitly, that service of a summons or a complaint is less intrusive since it merely "provide[s] a defendant with notice that a legal action has been commenced" [12]. It cannot be too strongly stressed that, whatever hierarchy of levels of intrusiveness one may desire to establish, *neither* procedure is permissible without the consent, express or implied, of the foreign nation. It is disingenuous to view service of process as merely informative in nature, since service not only provides notice that an action has been commenced but also has the legal effect of permitting it to proceed to a judicial hearing and judgment. Furthermore, a summons demands a response, *requiring* an answer on pain of suffering a default judgment [13]. It thus "seeks to compel specific acts" just as does a subpoena. The acts compelled, and the sanction machinery employed, may be different, but the principle remains unchanged. While many nations do permit service of process by mail from abroad, if a nation decides, for whatever reason, not to do so (and is not party to a treaty requiring it to do so) it is violative of international law to proceed counter to its wishes [14].

Fedders' main attack is reserved for blocking statutes designed to enforce secrecy laws. It is important to observe what the foreign nation is blocking and what it is not. In our hypothetical example, if information as to X's identity is physically within the United States then that nation does not lack power to compel its production. The difficulty arises only when the SEC wishes to examine documents physically located within Ruritania, and Ruritanian law insists that those documents not be revealed. Once again, the United States stands virtually alone in refusing to acknowledge that the law of the country where documents are situated governs their disposition. This principle, evidenced by the widespread reaction in the form of blocking statutes to U.S. attempts to discover foreign documents [15], is much older and broader than the present controversy [16]. The principle is of general application to property within the territorial jurisdiction of a state, as indubitably would have been demonstrated had the extraterritorial application of U.S. regulations freezing Iranian assets proceeded to litigation in European courts.

Parallel illustrations, in which the United States would vehemently support the principle here enunciated, may readily be offered. Suppose that D attempted to defraud a Ruritanian bank, and a prosecution in Ruritania results. D sent letters from San Francisco as part of her scheme, and subsequently consulted a California attorney to determine whether she was in danger of being prosecuted in the United States. The Ruritanian authorities now demand discovery of the attorney's record of the interview with D. Would the record be released over D's protestation that California's attorney-client privilege pro-
tects her secrecy interest in it? A nation whose various jurisdictions grant the
 privilege of secrecy in varying degrees to communications with spouses,
 physicians, psychotherapists, priests, social workers and even accountants
 cannot reasonably balk at respecting another nation’s privilege in favor of
 communications with bankers.

 Fedders, however, claims that nations are unlawfully giving their secrecy
 laws “extraterritorial effect to cloak transactions that occur in the United
 States” [17]. It is hard to suppress a wry smile at the notion of an official of the
 U.S. Government complaining about the extraterritorial application of the
 laws of other nations. On a substantive plane, a threefold response may be
 made. First, our illustration in the context of the attorney-client privilege
demonstrates clearly enough that the United States would engage in similar
 conduct in like circumstances. Secondly, in our example of insider trading, is
 Ruritania not entitled under the U.S. view of the effects doctrine to apply its law
 universally in order to protect itself against the likely and intended adverse
 effect upon its domestic policy of protecting secrecy in communication?
 Thirdly, Ruritania is prescribing law only with regard to conduct within its
 territory. To dub this extraterritorial is to indulge in Orwellian Newspeak, and
 hardly merits a serious response. Is Fedders defining as extraterritorial any
 foreign law that does not maximize the capacity of the United States to enforce
 its laws up to, and even beyond, the limits of its extraterritorial jurisdiction?

 The “waiver by conduct” argument, upon which Fedders places so much
 reliance [18], may also be dismissed in a few words. Any unilateral declaration
 by the United States that “the act of trading securities in the United States
 constitutes a waiver of any otherwise applicable secrecy or blocking laws that a
 financial institution, a customer or an agent might claim” [19] is, like any other
 law of the United States, effective only within the limits of the jurisdiction of
 the United States to prescribe rules of law. A new law of waiver can reach no
 further than could the substantive rules on insider trading. The United States
 cannot enlarge its jurisdiction under international law by unilateral declara-
tion. Of course the United States might persuade other nations to adopt the
 “waiver by conduct” rationale [20], but doing this will depend upon first
 persuading them to share U.S. views on insider trading itself. They are hardly
 likely to embrace the legal doctrine of waiver without paying heed to the
 consequences of so doing. In short, the “waiver by conduct” argument is
 devoid of substantive legal or policy content.

 My analysis so far has been based upon the assumptions of the insider
 trading hypothetical, in which Ruritania both tolerated insider trading and
 refused to acknowledge that X had violated U.S. law by trading through a
 Ruritanian bank. It is of crucial importance to the smooth running of the
 international system to understand that these assumptions are inessential. We
 may considerably weaken both of them without in any way changing our
 conclusions as to what the United States may reasonably expect of Ruritania
 in cooperating in the prosecution of X.
Again, an illustration will be helpful. Suppose that in a cinema in the state of Xanadu, patrons become aware of the presence of tobacco smoke. Smoking in a public place is a felony in Xanadu, carrying a maximum penalty of a fine of $10,000 and/or two years imprisonment. The culprit, aware of discovery, absconds and avoids arrest by driving off into the neighboring state of Ruritania. Ruritania also bans smoking in public places, which it treats as a misdemeanor carrying a maximum fine of $1,000. The Xanadu authorities promptly telephone the Ruritanian authorities, urging them to set up roadblocks in an attempt to find the felon, as would be the procedure in Xanadu. The Ruritanians demur.

First [they say] while we regard smoking as harmful, and officially proscribe it, unlike you we do not consider it worth extravagant efforts to root it out entirely. Our policy is to expend limited resources in keeping the level down. Secondly, we have a strong policy against mass searches [presumably Fedders would deprecate this extraterritorial application of Ruritanian policy], and even if public smoking were a felony here we would not countenance the procedures you employ. Thirdly, you are in effect trying to get us to pay the cost of implementing your policy with regard to a crime committed in your territory. This cost should be borne by you. Thus we might be willing to discuss setting up roadblocks in such cases if you are willing to discuss making payments at an agreed level to any of our citizens who are stopped and who are innocent, to compensate them for the intrusion.

The parallels are obvious. Why should Ruritania allow the SEC to delve into the private financial affairs of great numbers of its citizens in order to identify the few who may have committed an offense under U.S. law? Why should these citizens have to bear the costs of conforming with the peculiarly onerous discovery requirements of the United States? Why should the United States not itself pay the entire cost of enforcing its own law? Note well that the United States could readily deal with the problem of insider trading from abroad, by requiring U.S. brokers to obtain advance assurances from foreign purchasers that they would name any beneficial owner on demand from the SEC. This requirement was contained in an amendment, proposed in 1976 but never adopted, to Rule 17a-3(a)(9) [21]. If it is feared that such assurances would be empty, there could be a requirement that the names of beneficial owners be transmitted (with a statutory guarantee of secrecy) at the time of the purchase order. But this would impose costs on U.S. brokers, and might lead foreign investors to trade on non-U.S. exchanges [22] unless the United States offered adequate compensation for the burdens imposed. Doubtless the United States would prefer not to bear such costs. They are, however, the costs of enforcement of its own policies, and other nations are unlikely to welcome any attempted externalization of those costs. It is no answer to say that other nations ought to shoulder some of the costs since they partake of the benefits. Nations that do not share the United States' strong views on insider trading would be paying a cost higher than the value to them of what they receive.
It is vitally important to maintain a clear distinction between the benign end of preventing, or at least limiting, insider trading, and the means appropriate to achieving that end. The recent agreements negotiated with the Swiss Government [23] and the Swiss Bankers’ Association [24] epitomize the appropriate means. If those agreements do not grant the SEC all it wants [25], presumably they grant all that Switzerland is presently prepared to yield. It is a cost of living in an international community adhering to the rule of law that even powerful nations may occasionally fail to fulfill all their desires. It is unacceptable for Fedders to dismiss as “unrealistic... that the SEC can negotiate separate disclosure agreements with each nation that has secrecy or blocking statutes” [26]. Is the SEC rather to ride roughshod over the sovereignties of fifteen or more nation-states [27]? We prefer to conclude, with Fedders, that “while the way to cooperation may be difficult, the advantages far outweigh the difficulties” [28].
Notes

[3] Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumental-ity of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 14e-3 provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

1. The offering person,
2. The issuer of the securities sought or to be sought by such tender offer, or
3. Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise....

[6] Id.
[7] See generally the various replies to Fedders in this issue.
[10] Possibly the stock certificate may remain in the United States. But different nations may take different views as to whether this is a crucial or a trivial point.
It follows that application of Federal Rule of Civil Procedure 4(i)(1), except under 4(i)(1)(B), will in such cases place the United States in breach of international law.


Fedders, supra note 1, at 25.

Id. at 25-28.

Id. at 27-28.

Id. at 25-27.

The proposed amendment required:

A record in respect of each cash and margin account with such member, broker, dealer or municipal securities dealer containing the name and address of the beneficial owner of such account and, in the case of a margin account, the signature of such owner: Provided, that, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account, and in the case of a municipal securities dealer which is a bank or a separately identifiable department or division of a bank such records need not be maintained with respect to margin accounts.


See Fedders, supra note 1, at 14-15.

Id. at 10-11.

Id. at 11-12.

Id. at 15-25.

Id.

See id. at 3 (or number of jurisdictions with secrecy and/or blocking laws).

Id. at 29-30.

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