

# FROM GERMAN SHEPHERDS TO WET POODLES<sup>1</sup>: THE SEC EXACTS CONCESSIONS FROM DAIMLER-BENZ CONCERNING DISCLOSURE OF ITS HIDDEN RESERVES

## I. FACTUAL BACKGROUND

In October 1993, Daimler-Benz AG (“Daimler”) became the first German corporation to list its shares on the New York Stock Exchange (NYSE).<sup>2</sup> After three years of negotiation with an unyielding Securities and Exchange Commission (SEC), which had insisted that Daimler reconcile its financial statements to U.S. Generally Accepted Accounting Principles (USGAAP), an agreement was struck whereby the company agreed to disclose its “hidden reserves.”<sup>3</sup> Soon after, the SEC, by unanimous vote, granted Daimler and other highly capitalized German corporations wide-ranging exemptions from the trading rules<sup>4</sup> under the Securities Exchange Act of 1934<sup>5</sup> (“Exchange Act”), which aim to restrict the participants in securities distributions from artificially increasing or maintaining a security’s price during the distribution period.<sup>6</sup>

### A. German Efforts to Gain Listings on U.S. Exchanges—an Overview

Since as early as 1990, blue-chip German corporations have sought SEC approval to list their shares on U.S. stock exchanges, principally on the NYSE.<sup>7</sup> Among the perceived advantages of U.S. listing are the ease of

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<sup>1</sup> The reference in the title to wet poodles derives from a statement made by Gerhard Liener, Daimler-Benz’s Chief Financial Officer. See *infra*, text accompanying note 47.

<sup>2</sup> Jim Henry, *Another Benz Pulls onto Wall Street; Daimler Battled for Years to Gain NYSE Listing*, AUTOMOTIVE NEWS, Oct. 11, 1993, at 7.

<sup>3</sup> *Id.* For a discussion of the hidden reserves issue, see *infra* text accompanying note 10.

<sup>4</sup> Rules 10b-6, 10b-7 and 10b-8.

<sup>5</sup> 15 U.S.C. §§ 78a-78ll (1988).

<sup>6</sup> *SEC Gives Exemptions From Trading Rules, Eases Distributions of German Securities*, 25 Sec. Reg. & L. Rep. (BNA) No. 39, at 1336 (Oct. 8, 1993). At its November 3, 1993 meeting, the SEC adopted a Statement of Policy granting class exemptions from the trading rules for foreign issuers generally, subject to “substantially similar principles, terms, and conditions that applied to the exemptions” granted to the Germans. *Rule Exceptions Adopted to Ease Rule 144A Foreign Offerings to QIBs*, 25 Sec. Reg. & L. Rep. (BNA) No. 44, at 1524 (Nov. 12, 1993).

<sup>7</sup> Anita Raghavan & Michael Sesit, *Foreigners Fall in Love with U.S. Financing*, FIN. POST, Oct. 6, 1993, at 9.

access to capital generated by a soaring demand for stock among investors disappointed with low long-term interest rates, the prospect of a higher stock price, and enhanced prestige in the vitally important U.S. market.<sup>8</sup>

From the beginning, the German firms clashed with the SEC (which must approve listings on U.S. exchanges<sup>9</sup>) over the pervasive practice in German corporate accounting of establishing "hidden reserves."<sup>10</sup> This practice, which is not permitted under USGAAP, helps German firms to mitigate the effects of a high corporate tax rate (up to 65% of earnings).<sup>11</sup> In addition, "[w]henver product demand slackens and operating losses develop, these companies tap the reserves, built up from earlier earnings, to offset the loss and show a modest profit."<sup>12</sup>

Concededly, reconciling German companies' financial statements with USGAAP is an expensive and time-consuming proposition. For example, before Espirito Santo Financial Holdings SA, a Portuguese bank and insurance holding company, listed a large number of American Depository Receipts on the NYSE in 1993, it spent nearly a year preparing the financial documents needed to meet the SEC's standards.<sup>13</sup>

Needless to say, U.S. and all other foreign companies seeking either listing on an exchange under the Exchange Act<sup>14</sup> or registration of a public offering under the Securities Act of 1933<sup>15</sup> ("Securities Act") must disclose their true financial condition and results of business operations in accordance with USGAAP.<sup>16</sup> Through 1992, however, the German blue chips remained

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<sup>8</sup> *Id.* See also Henry, *supra* note 2, at 7 ("The stock listing plays a symbolic role: it tells the nation that Daimler has a stake here, and it helps strengthen Daimler's reputation as an international company").

<sup>9</sup> Under the Exchange Act, "a foreign company that lists securities on a U.S. exchange or arranges to have its shares quoted on NASDAQ is treated as having entered voluntarily the U.S. markets, and must register under the . . . Act the class of securities to be listed or quoted." 1 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES MARKETS § 2.03 (1992).

<sup>10</sup> See Erik Kirschbaum, *German Shares Want U.S. Listing, But S.E.C. a Hurdle*, Reuters, Feb. 6, 1992, available in LEXIS, News Library, Reuter File.

<sup>11</sup> *Id.*

<sup>12</sup> Raghavan & Sesit, *supra* note 7, at 9.

<sup>13</sup> *Id.*

<sup>14</sup> 15 U.S.C. §§ 78a-78ll (1988).

<sup>15</sup> 15 U.S.C. §§ 77a-77z (1988).

<sup>16</sup> Substantive disclosure requirements for foreign issuers under the Securities Act and the Exchange Act are the same. Adoption of Foreign Issuer Integrated Disclosure System, Securities Act Release No. 6437, 1982 SEC LEXIS 355 (Nov. 19, 1982).

confident that they could convince the SEC to relent.<sup>17</sup> At first, firms such as BASF AG, a chemical company, expressed puzzlement with the SEC's position on hidden reserves, and assumed a confrontational stance. Dietrich Kley, BASF's Chief Financial Officer, lamented the SEC's "oddly rigid standpoint," noting that "[t]o be listed in Germany, U.S. firms don't have to prepare reports according to German standards."<sup>18</sup>

But Richard C. Breeden, the SEC's Chairman from October 1989 to May 1993, would hear nothing of reciprocity: "It is inconceivable that we would have mutual recognition with Germany."<sup>19</sup> Breeden observed that a German company "can adjust its accounts to add to and subtract from reported earnings. The investor has no way to tell what the real level of earnings is."<sup>20</sup>

As late as November 1992, German companies pressed the issue with the SEC, believing that "competitive pressures" resulting from the globalization of world financial markets would force the SEC to relent.<sup>21</sup> Breeden, though, remained adamant. When told in November 1992 of German executives' popular belief that the SEC would be forced to allow German companies to enter the U.S. markets without reconciling their financial statements to USGAAP, Breeden balked:

They can wait forever. We have 500 foreign listed companies in our market from 35 countries and they all have the same standard. They get the same deal American companies get; they don't get a preference. And the German companies are not going to get a preference in raising capital against U.S. companies. . . . There is a touch of arrogance in one country saying they are entitled to a

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<sup>17</sup> *Businesses Urge Retaliation Against SEC's Listing Policy*, Int'l Sec. Reg. Rep. (Buraff) (Oct. 20, 1992).

<sup>18</sup> Kirschbaum, *supra* note 10. Germany, which is only now moving toward the creation of a centralized securities regulatory regime, does not force American firms to conform to German accounting norms. However, this point seems irrelevant—United States accounting principles are simply more stringent than those of Germany, and so Kley's demand for reciprocity rings hollow.

<sup>19</sup> Jonathan Fuerbringer, *World Markets; S.E.C. Says No On German Stocks*, N.Y. TIMES, Apr. 26, 1992, § 3, at 15.

<sup>20</sup> *Id.*

<sup>21</sup> *Chairman Richard Breeden Discusses SEC's International Role*, Int'l Sec. Reg. Rep. (Buraff) (Nov. 17, 1992).

preference that no other country in the world gets, and it's a preference over American companies in their own market.<sup>22</sup>

Breeden proceeded to emphasize the reasons underlying the SEC's position regarding hidden reserves:

What is being argued [by advocates of the German system] is that the management should know what the company really made and the public investor should not be entitled to that information, and they are out there trading against each other. Now that's called inside information. And the assertion of the right to be a public company but put out knowingly false statements of what you actually earned is an assertion of the right to institutionalize insider trading.<sup>23</sup>

And if any doubt remained about his resolve in waiting out the Germans, Breeden added,

In the last three years we have had 149 new foreign companies come to our market. In London and Tokyo, the number has actually declined. . . . If the Germans want to sit on the sidelines while everyone else in the world is financing in the U.S. market, that's their decision. There's no shortage of foreign listings in the United States.

In 1987, we had \$272 billion in public offerings, this year it will be over \$900 billion. We're not suffering from a lack of public offerings. And among the reasons investors are willing to buy \$900 billion instead of \$200 billion is that they have confidence in our system; they get information they want. Investors want to know what a company made. And so, our strategy is to offer the investors the best deal.<sup>24</sup>

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<sup>22</sup> *Id.*

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

<sup>24</sup> *Id.*

Importantly, the hidden reserves issue did not amount solely to a battle along national lines; it must be remembered that the Germans were not without allies in the United States. Most significantly, the New York Stock Exchange through its Chairman, William Donaldson, has for years lobbied the SEC to admit German companies without requiring them to conform to U.S. standards.<sup>25</sup> Donaldson argued that the 2,500 foreign companies (German and otherwise) that could be listed on the NYSE would be a boon to U.S. investors; that Americans who are currently forced to buy foreign stocks abroad receive little protection and pay higher cost; and that the SEC is using "technical rules" to keep out foreign companies.<sup>26</sup>

Not surprisingly, the SEC's Breeden bristled at the dismissive description of the disclosure requirements as "technical rules."<sup>27</sup> To Breeden and to most commentators, the disclosure rules lie at the heart of the American federal securities regulatory regime.<sup>28</sup>

Through 1992, all of the leading German corporations—Daimler, Volkswagen, Deutsche Bank, BASF, Hoechst, Bayer and Siemens—continued to push for listings on NYSE, to no avail. In October 1992, the economics minister of the state of Hesse was dispatched to Washington to do battle with the SEC, and like a string of government officials and private executives before him, he returned to the Continent empty-handed.<sup>29</sup> A conference was convened in Frankfurt to provide an outlet for the Germans' indignation. "It's a disgrace. We must insist on reciprocity from the United States," said a Deutsche Bank director.<sup>30</sup> And from Rutbert Reisch, Volkswagen's Treasurer, came a scathing denouncement of the entire American regulatory regime: "I am anything but impressed with the S.E.C. The performance of the S.E.C. in the 1980s shows it doesn't make much difference whether you have a private or a federal form of market oversight."<sup>31</sup>

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<sup>25</sup> Raghavan & Sesit, *supra* note 7, at 9.

<sup>26</sup> Fuerbringer, *supra* note 19, § 3 at 15.

<sup>27</sup> *Id.*

<sup>28</sup> See generally LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 25-35 (1988 & Supp. 1993) (outlining in some detail the legislative purpose of the federal securities laws). It must be remembered, too, that NYSE's stance is driven by its desire to attract the world's "big players" to its bourse.

<sup>29</sup> *Businesses Urge Retaliation Against SEC's Listing Policy*, *supra* note 17.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

Other conference participants traced the source of the rift to a fundamental difference of philosophies between the U.S. and German systems. Horst Risse of Deutsche Bank Capital Corp. remarked that while investor protection takes precedence in U.S. regulatory philosophy, German regulation places emphasis upon protection of creditors.<sup>32</sup>

Despite the bellicose flavor of the October 1992 Frankfurt conference, some of its participants acknowledged that the German firms were plagued by both a "credibility problem" and a "bad image,"<sup>33</sup> conceding that proposed legislation to create a central regulatory agency and to criminalize insider trading was a step in the right direction.<sup>34</sup>

### *B. The Breakthrough—Daimler's Compromise with the SEC*

In March 1993, Daimler broke ranks with its fellow firms and struck a deal with the SEC.<sup>35</sup> The company agreed to undertake the arduous task of conforming its financial statement to U.S. standards, including the recognition of DM 4 billion (\$2.5 billion) of hidden reserves.<sup>36</sup> In return, Daimler would incur no formal obligation to report quarterly earnings,<sup>37</sup> nor would it have to restate its results for the previous five years, as would normally be required.<sup>38</sup>

Despite a \$592 million first-half loss in 1993 that resulted from revising its accounts (its first loss since World War II<sup>39</sup>), Daimler's leaders were enthusiastic about the firm's imminent listing on the NYSE. Daimler's chairperson, Edzard Reuter, who derided the SEC's disclosure rules before

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<sup>32</sup> *Id.* Just how the practice of concealing earnings jibes with a system solicitous of creditors is unclear. See *infra*, text accompanying note 64 for a discussion of this "what-they-don't-know-won't-hurt-them" theory and its inherent incompatibility with U.S. securities regulation.

<sup>33</sup> *Id.*

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

<sup>35</sup> Erik Kirschbaum, *German Firms Wait for Details on Daimler NYSE Bid*, Reuters, March 25, 1993, available in LEXIS, News Library, Reuter File.

<sup>36</sup> *Daimler-Benz's Gerhard Liener: Accommodating (Partly) U.S. Disclosure Rules*, INSTITUTIONAL INVESTOR, June 1993, at 52.

<sup>37</sup> *Id.*

<sup>38</sup> Henry, *supra* note 2, at 7.

<sup>39</sup> Rhagavan & Sesit, *supra* note 7, at 9.

the deal was struck for "bringing too much attention to short term profits"<sup>40</sup> at the expense of long-term growth, now praised the deal as "a historic moment for our company, and for our country."<sup>41</sup>

Whether Reuter's fellow CEOs agreed that Daimler's listing was a great moment for Germany is unclear. Many executives were reportedly angered at Daimler's defection.<sup>42</sup> BASF representatives balked at the prospect of "having two kinds of accounts, one for international investors and one at home."<sup>43</sup> BMW feared that the cost of reconciling its books to U.S. norms would be prohibitive.<sup>44</sup> Hoechst claimed no interest in a New York listing if the SEC did not recognize the validity of German accounting principles.<sup>45</sup> Siemens, while denying a desire to list in New York, and claiming no need to raise new capital, nevertheless admitted that it is moving toward making its accounts more transparent.<sup>46</sup>

Gerhard Liener, Daimler's Chief Financial Officer, who headed his company's negotiations with the SEC, summarized the evolution of his position: "We wanted to try and overwhelm the SEC with power. . . . We marched in with the flag of German GAAP . . . flying. The U.S. said 'U.S. GAAP was the best thing, and forget about it.' There was no flexibility on either side. We went back to Germany like a wet poodle."<sup>47</sup> Over time, however, a combination of shrinking profits, a growing need for capital and the perception that newly-elected President Bill Clinton would appoint a new SEC chairperson led to Daimler's decision to re-negotiate.<sup>48</sup> In a speech in early October 1993, Liener said to Breeden, whose term as SEC chairperson had not yet expired, "As is so often the case, the two fighters, you and I, we are friends now."<sup>49</sup>

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<sup>40</sup> Henry, *supra* note 2, at 7. According to Henry, Reuter claimed that "American investors would not have allowed him to pursue a long-term strategy, initiated in 1985, that has seen Daimler branch out into aerospace, electronics and financial services." *Id.* In addition, American investors may have demanded a higher dividend had Daimler disclosed its hidden reserves. But is it wrong for a company's owners to make such a demand?

<sup>41</sup> *Id.*

<sup>42</sup> *Daimler-Benz's Gerhard Liener*, *supra* note 36, at 52.

<sup>43</sup> *European Business: Daimler-Benz Causes Accounting Stir*, DAILY TELEGRAPH, Mar. 29, 1993, at 23.

<sup>44</sup> *Id.*

<sup>45</sup> Kirschbaum, *German Firms Wait for Details on Daimler NYSE Bid*, *supra* note 35.

<sup>46</sup> *European Business*, *supra* note 43, at 23.

<sup>47</sup> Henry, *supra* note 2, at 7.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

### C. *German Blue Chips Granted Exemptions from Exchange Act Trading Rules*

Soon after Daimler's decision to disclose its hidden reserves bore fruit in its listing on NYSE, the SEC voted unanimously on October 6, 1993, to grant the largest German companies (including Daimler) exemption from Rules 10b-6, 10b-7 and 10b-8, the so-called "trading rules."<sup>50</sup> The rules, which generally prohibit trading by a security's issuer or underwriter during the distribution period, are highly complex.<sup>51</sup>

The exemptions apply to distributions of the 30 German issuers whose securities make up the *Deutscher Aktienindex* (the "DAX", Germany's blue chip exchange) and impose several conditions. The conditions include "the disclosure of potential trading activities in Germany, the limitation of certain proprietary trading, notice of reliance upon the exemption and certain recordkeeping and reporting to German authorities."<sup>52</sup>

## II. LEGAL BACKGROUND

### A. *Disclosure Under the 1933 and 1934 Acts*

As previously mentioned,<sup>53</sup> the same sorts of substantive information must be disclosed by companies under both the Securities Act<sup>54</sup> and the Exchange Act.<sup>55</sup> Form 20-F, an Exchange Act form, is the basis for the disclosure mandated by both statutes for foreign companies; the information that must be provided in the form lay at the heart of the dispute between the

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<sup>50</sup> Exemptions From Rules 10b-6, 10b-7 and 10b-8 During Distributions of Certain German Securities, Securities Act Release No. 7021, 1993 SEC LEXIS 2711 (Oct. 6, 1993). See *SEC Gives Exemptions From Trading Rules, Eases Distributions of German Securities*, 25 Sec. Reg. & L. Rep. (BNA) No. 39, at 1336 (Oct. 8, 1993) [hereinafter *SEC Gives Exemptions From Trading Rules*].

<sup>51</sup> See generally LOSS, *supra* note 28, at 862-66.

<sup>52</sup> *SEC Gives Exemptions From Trading Rules*, *supra* note 50, at 1336.

<sup>53</sup> See *supra* note 16.

<sup>54</sup> The Securities Act regulates public offerings. See GREENE ET AL., *supra* note 9, at § 1.02.

<sup>55</sup> The Exchange Act mandates periodic reporting for companies with a class of securities traded on a national securities exchange, and by extension also regulates initial listing on an exchange. See 1 GREENE ET AL., *supra* note 9, at § 1.03.

German firms and the SEC.<sup>56</sup> A necessarily cursory summary of the requirements of Form 20-F is as follows: Part I requires "a detailed description of the company's business by category of activity, its major properties, and any material pending legal proceedings or governmental investigations, the nature of the trading markets outside the United States for the company's securities, and a discussion of exchange controls or other limitations affecting U.S. security holders."<sup>57</sup> In addition, Part I calls for the preparation of a narrative document called "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A"), including a discussion of liquidity, capital resources, and results of operations. This important requirement is intended "to give investors an opportunity to look at the company through the eyes of management."<sup>58</sup>

Part II of Form 20-F requires a detailed description of the securities being registered.<sup>59</sup> Part III calls for a discussion of any recent default on indebtedness of either the corporation or any of its major subsidiaries.<sup>60</sup> Part IV, which most rankled the German firms, sets out the requirement that the financial statements must be prepared in accordance with, or reconciled to, USGAAP.<sup>61</sup>

Clearly, foreign companies seeking access to the U.S. market face no less exacting disclosure requirements than those faced by domestic companies. But why such an emphasis on "disclosure, again disclosure, and still more disclosure?"<sup>62</sup> The answer lies in the unquestioned intent of Congress. When drafting the federal securities laws during the depths of the Depression, Congress sought to erect a regulatory scheme that focuses not on the merits of particular investments (as do many of the state securities laws—the "blue sky" laws), but rather on allowing investors to make informed choices.

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<sup>56</sup> Forms F-1, F-2 and F-3 are the Securities Act forms that foreign companies must complete; Form F-1 refers to Form 20-F, and both forms incorporate parts of Regulation S-K. *Id.* at § 2.03[1][a][i].

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at § 2.06[2][a]. The MD&A is also required for U.S. issuers. See Securities Act Release No. 6835, 1989 SEC LEXIS 1011 (May 18, 1989), discussing the importance of the MD&A, and identifying certain types of disclosure to be included in the statement. See also Caterpillar, Inc., Exchange Act Release No. 30,532, 1992 SEC LEXIS 786 (Mar. 31, 1992).

<sup>59</sup> 1 GREENE ET AL., *supra* note 9, at § 2.03 [1][a][i].

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* The MD&A, discussed at note 58 and accompanying text, *supra*, would also be affected by use of USGAAP.

<sup>62</sup> LOSS, *supra* note 28, at 7.

As Representative Sam Rayburn explained during the House debate of the bill that became the 1933 Act, "The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporation, and to place the buyer on the same plane so far as available information is concerned, with the seller."<sup>63</sup>

If the emphasis on disclosure evinced by the federal securities laws seems a bit overwrought in the 1990s, today's jaded observer must keep in mind the evils that were routinely countenanced in the days before securities were regulated. *Caveat emptor* ruled the day, and countless investors were bilked. The Supreme Court, in a leading case, reaffirmed the principles animating the securities statutes: "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."<sup>64</sup>

Louis Loss traces this notion of Salvation Through Disclosure to Louis D. Brandeis, who spoke of openness as the remedy for many of the evils of the corporate age: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>65</sup>

In deciding to eschew regulation of the merits of investment securities, and instead to compel exhaustive disclosure, "Congress did not take away from the citizen 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him."<sup>66</sup>

Of course, comprehensive disclosure had, and has, its critics, who charge that compliance is most difficult for reputable, long-established firms with many concrete operations, and easiest for the most speculative ventures of dubious merit. In addition, they claim that exhaustive disclosure of raw financial data does little to enable the layman to fairly assess the propriety of an investment.<sup>67</sup>

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<sup>63</sup> 77 CONG. REC. 2,918 (1933).

<sup>64</sup> S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

<sup>65</sup> LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 92 (Frederick Stokes Co. 1914), quoted in LOSS, *supra* note 28, at 32. Loss adds somewhat cheekily, "The length and complexity of some SEC prospectuses make one wish that Brandeis had recognized that excessive sunlight can cause skin cancer."

<sup>66</sup> LOSS, *supra* note 28, at 32-33.

<sup>67</sup> See *id.* at 25-35. While requirements such as the MD&A required in Form 20-F (see *supra*, text accompanying note 58) go a long way toward enabling investors to assess a company's prospects, nowhere are projections or forward-looking information required. Instead, only known trends must be discussed. See Securities Act Release No. 6835, *supra*

For better or worse, the course of U.S. securities regulation was fixed long ago. And that is why the German companies seeking NYSE listing encountered a storm of opposition from the SEC on the hidden reserves issue.

### *B. The Trading Rules*

The regulation of trading during distributions embodied in Rules 10b-6, 10b-7, and 10b-8 is analytically distinct from the basic disclosure requirements mandated by the statutes. Rule 10b-6, the focus of the trading rules, makes it unlawful for distribution participants to bid for or purchase a security during the distribution period, subject to enumerated exceptions.<sup>68</sup> Promulgated in 1955, 10b-6 was an elaboration by the SEC of earlier case law holding that open market purchases by issuers and underwriters made during distributions were unlawful. Presumably, these purchases were made to prop up demand (and prices) for the security being distributed.<sup>69</sup> Rules 10b-7 and 10b-8 are closely related provisions, the former specifying the terms on which distribution participants may stabilize a security's price, and the latter announcing the terms by which "standby underwriters" may participate in rights offerings. 10b-7 and 10b-8 are essentially exceptions to Rule 10b-6.

By closely regulating the practice of indirect manipulation of security prices during distributions, the trading rules seek "to protect the integrity of the secondary trading market as an independent pricing mechanism and thereby enhance investor confidence in the marketplace."<sup>70</sup> However, unlike the basic disclosure mandated by the securities statutes, the highly complex trading rules from which the German blue chips received exemption cannot be said to derive from a specific demand of Congress. Rather, the trading rules represent a series of administrative judgments by an expert agency, made in a fact-intensive context. In fact, the SEC has during recent

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note 58.

<sup>68</sup> LOSS, *supra* note 28, at 863.

<sup>69</sup> *E.g.*, Halsey, Stuart & Co., 30 S.E.C. 106 (1949); Barrett & Co., 9 S.E.C. 319 (1941); Thompson Ross Sec. Co., 6 S.E.C. 1111 (1940); Canusa Gold Mines, Ltd., 2 S.E.C. 548 (1937). *See also* Exchange Act Release No. 5040, 1954 SEC LEXIS 257 (May 18, 1954) (describing the trading rules as codifying "principles which historically have applied in considering questions relating to manipulative activity and stabilization in connection with a distribution").

<sup>70</sup> LOSS, *supra* note 28, at 863.

years taken cognizance of the special problems attending application of the trading rules to foreign securities.<sup>71</sup>

### III. ANALYSIS

The flurry of dealmaking between the SEC and large German companies during 1993 raises questions about the SEC's proper role in regulating the securities markets in the United States. That the Commission's far-reaching exemption of German issuers from the trading rules followed so closely Daimler's monumental concession on hidden reserves at least seems to suggest a *quid pro quo*. Observers might wonder whether the SEC acted properly in easing trading restrictions on an entire class of issuers, especially when that class has been notoriously hostile to SEC regulation in the first place. Indeed, is it fair to grant German companies special treatment, when other nations' firms have embraced SEC regulation for years?<sup>72</sup> And what about U.S. investors? Has the SEC strayed from its regulatory mandate by weakening the protections afforded to the public at large?

On the contrary, the SEC's decisions concerning German companies represent a principled response to the growing globalization of the financial markets and an adherence to its Congressionally-delegated mission of protecting the investing public. In insisting that Daimler disclose its hidden reserves, the Commission stalwartly refused to dilute the disclosure requirements that were central to the 1933 and 1934 Acts. The statutes' legislative histories<sup>73</sup> left no room for compromise—to weaken the disclosure requirements is to thwart the purpose of the entire regulatory scheme.

At the same time, given the genesis of the trading rules as an attempt to proscribe very specific conduct in order to preserve the integrity of market

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<sup>71</sup> See, e.g., Review of Antimanipulation Regulation of Securities Offerings, Exchange Act Release No. 33,924 (Apr. 19, 1994) (“[A] global marketplace has unfolded, characterized by a proliferation of multinational securities offerings. Many foreign issuers now conduct concurrent offerings of their securities in the United States and abroad as well as solely in the United States. This rise in the supply of, and demand for, multinational offerings has required careful coordination of the interaction of the Trading Practice Rules with foreign distribution practices and regulatory requirements”).

<sup>72</sup> British, Canadian, and—to a lesser extent—Japanese firms have all proved willing to work with the SEC. Indeed, the United States and Canada now have a reciprocal disclosure agreement (the Multijurisdictional Disclosure Agreement), developed in 1987. See 1993 Supp. to LOSS, *supra* note 28, at 16-19.

<sup>73</sup> See *supra*, text accompanying note 64.

prices, the SEC acted within its authority when it granted relief from the rules to the German firms. The trading rules do not represent a direct command from Congress.<sup>74</sup>

In addition, one might argue that the SEC lacks the authority to apply the trading rules extraterritorially. Of course, deliberate manipulation of the U.S. market by a foreign company issuing securities in the United States must be subject to regulation. But where the impact to U.S. investors is at most tenuous, general rules forbidding foreign issuers from trading in their own markets may well be beyond the scope of the SEC's authority.

The growing internationalization of world financial markets also militates toward flexibility in applying the highly technical trading rules to foreign companies. When such rules are applied by rote to foreign companies seeking access to the U.S. market, they seem less like regulation and more like a protective tariff.<sup>75</sup> And that is certainly undesirable—we *want* foreign companies to list here. So long as U.S. investors have access to the information that really matters, they are well-served by the influx of foreign companies' securities. There is some merit to the admittedly parochial view of the NYSE's chairperson that it is better for American investors to have foreign firms list in the United States than in London or Tokyo. The world's capital markets are becoming increasingly competitive, and some compromise with foreign companies is probably necessary.

The SEC's strategy in all this has been to facilitate the globalization of markets without compromising the regulation of disclosure. Indeed, in order for the German companies to exploit the exemption from the trading rules, the SEC has required them to disclose any trades they make during distributions.<sup>76</sup> Investors are therefore in a position to assess the impact on the public offering price of such trading. This reliance on disclosure in the context of the trading rule exemptions represents a return to core principles.

And finally, the grant of relief from the trading rules to German companies should not be seen as an aberration. A month after the exemption was granted, an SEC Statement of Policy extended it to "distributions in the United States of actively traded securities of highly capitalized foreign

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<sup>74</sup> See *supra*, text accompanying note 69.

<sup>75</sup> The analogy is imperfect, as the trading rules also apply to domestic issuers and underwriters. However, because financial structures abroad differ fundamentally from the U.S. model (*e.g.* interlocks between finance and manufacturing companies in Germany), the trading rules present more of a barrier to foreign companies than to domestic firms.

<sup>76</sup> See *supra*, text accompanying note 50.

issuers" generally.<sup>77</sup> And so it appears that the German companies are not the beneficiaries of special treatment or unwarranted leniency.

#### IV. CONCLUSION

The SEC's firm stance toward German companies' unprecedented wish to gain NYSE listing without conforming their financial statements to U.S. norms represented a principled defense of the values implicit in the Securities Act and the Exchange Act. The "what-they-don't-know-won't-hurt-them" concept of corporate management espoused by German companies that conceal earnings in hidden reserves cannot be reconciled with the U.S. federal securities statutes. The SEC's insistence that Daimler recognize its hidden reserves before listing its shares on NYSE was appropriate.

At the same time, the SEC knew where to draw the line in its application of the highly complex trading rules to foreign companies. The exemption from the rules granted to the German blue chip companies, and soon extended to highly capitalized foreign companies generally, showed no disrespect for the values animating the federal securities laws. In addition, the Commission's flexibility evinced a recognition that the swift movement toward internationalization of the world capital markets necessitates some compromise on the application of the trading rules to foreign companies.

*Andrew H. Walcoff*

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<sup>77</sup> Exchange Act Release No. 33,137, 1993 SEC LEXIS 2,999 (Nov. 3, 1993). *See Rule Exceptions Adopted To Ease Rule 144A Offerings to QIBs*, 25 Sec. Reg & L. Rep. (BNA) No. 44, at 1524 (Nov. 12, 1993).