Managing Regulatory Arbitrage: An Alternative to Harmonization

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MANAGING REGULATORY ARBITRAGE: An alternative to harmonization


Annelise Riles walks us through a conflict of laws approach to financial regulation.

ARbitRAge: fully anticipated within the core business model. This is because a patchy regulatory landscape is of these institutions, which are beyond the reach of the core business model.

A MERICAN INTERNATIONAL GROUP (AIG), the very name of this company screams out its singular achievements of economic thought. The general art of arbitrage is to spot similarities across what look like differences at first glance: a basket of stocks and an index, the rules of one legal system and those of another. From the perspective of economic theory, the investment strategy behind regulatory arbitrage is exactly the same as in other kinds of arbitrage in which an investment opportunity is created by a discrepancy in the relative price of two investments otherwise deemed similar. So what’s the problem with regulatory arbitrage? For one, it can create a race to the bottom as investors move their transactions to the locality with the most favourable rules.

The prevailing wisdom is that regulatory arbitrage can be countered only if also across allegid systems are harmonized. In other words, regulatory arbitrage opportunities will elude the regulatory cost of transacting in identical capitals. In practice, however, changing national laws is an extremely contentious and slow process. Attempts to universalize the regulation can quickly devolve into regulatory nationalism as domestic political and economic interests clash with international expectations. What is more, the process of harmonization risks creating new regulatory arbitrage opportunities since the pace of enacting legal change will differ across states.

What if international regulatory harmonization at the level of nation-states is an unattainable goal? What non-lawyers may not know is that the law is equipped with sophisticated tools for dealing with persistent regulatory differences – tools like “party autonomy in choice of law”, the rule that says parties get to pick the law that applies to their contracts. However, as discussed in my book Collateral Knowledge (2011), this rule is currently used to favour the financial industry. The industry has worked hard to ensure that judges and academics who make these rules see things its way.

THE TOOL, I’M THINKING OF, is a technical and arcane, but ingeniously invented known as Conflict of Laws within common law, or “private international law” in civil law. Conflict of Laws is the name given to the well-established body of law that determines which law should apply in situations where more than one sovereign state can arguably lay claim to a problem. For example: What law governs a contract between a bank in London and another bank in the Cayman Islands concerning assets in Singapore, and executed over the Internet? The answer is found in the Conflict of Laws.

Unlike the harmonization paradigm which pursues legal uniformity, the “conflicts approach” accepts that regulatory nationalism is a fact of life, and tests for the possibility of achieving coordination among different national regimes. This alternative approach to international regulatory coordination originated to stabilize trade relations after the fall of the Roman Empire and has thus developed over centuries. Under the conflicts approach the point is not to define one set of rules that apply for all, as the esteemed Judge Weinstein, the Federal District Court judge who has handled the Agent Orange litigation as well as numerous other intractable mass tort cases, from breast implants to tobacco lawsuits, once famously said: “I want the parties to settle a dispute I say ‘Hmm … there must be a conflict of laws issue in this question?’ Yet, the very technical quality of the conflicts approach provides a much-needed vocabulary, a register for moving beyond overt politics in the discussion of international financial regulation. I’m interested in what the conflicts approach can do in the sphere of financial regulation precisely because it transforms political questions into technical legal issues that can be managed within the scope of the existing national law.

F OR THE PRESENT, one could think of the conflicts approach as an alternative form of global regulation prior to our achieving the utopian ideal of pure international integration. In an interview with Risk Magazine, Barney Reynolds, a partner at Sherman & Sterling London working in this area has argued: “I don’t think in our lifetimes you’ll get a global insolvency regime, but you might get a global agreement on a ‘conflict of laws and regulation’ rule, so as to determine which country’s insolvency regime takes precedence in different situations.”

My proposition, is there many appealing advantages to this approach over the G20 model of full legal harmonization. From a legal standpoint, paying attention to the laws and processes that should govern the allocation of regulatory authority among overlapping sovereign states is hardly a second best option to eliminating the harm of regulatory arbitrage.

First and foremost, conflict of laws takes an agnostic view of the claim that there is a single overarching “right answer” to what the rules of regulation should be. The doctrines of conflict of laws instruct judges always to be aware of their own perspective is situated and partial, and that a judge in another jurisdiction could and most likely would think of the dispute in different terms. This built-in pluralism contrasts with a significant weakness of the G20’s efforts at global financial regulatory harmonization – its tendency to fall into North Atlantic cliquishness.

Secondly, the conflicts approach is case driven. It builds coordination from the ground up rather than from top down. Cases are presented to courts as they develop, which allows problems to be addressed immediately, rather than wait for long-term harmonization. This has the added benefit of allowing for greater participation in the process of generating consensus, since cases are defined and shaped by the parties themselves, through their established local legal representatives who need not act in an internationally unified manner.

So WHY HASN’T CONFLICT OF LAWS BEEN PURSUED in financial regulation? The explanation is what Gillian Stahl calls “the thinking”, specialists on the conflict of laws have been traditionally confined to cases on inheritance, marriage, land disputes, private contracts and the like because historically those were the problems that courted borders. As people migrated, and emerging European states had to determine which law would govern various aspects of these migrants’ lives. In those days, transnational economic relations were confined to such issues as mercantile agreements (contracts).

This is why conflicts experts are trained to handle problems in private shipping contracts, but they know very little about financial regulation. For their part, financial regulation experts know next to nothing about the conflict of laws, if they are even aware it exists!

PLAYING REGULATORY DIFFERENCES is an important way of generating financial advantage. The technical term for this is ‘regulatory arbitrage’. Financial institution did not to so-called ‘home regulator’. Thinking about conflicts between laws encourages us to more carefully examine how we allocate authority across the existing regulatory regimes. The approach gives us another way of examining, and therefore of challenging, the scope of national, international, and non-state regulation. After all, when regulators or market participants make a claim about the application of one or another body of laws to a given party or transaction, they are effectively making an implicit claim about what the scope of their national law should be.

The technical term for this is ‘regulatory arbitrage’.
APPLICATION

What should determine the extraterritorial reach of US law?

The conflicts approach to transnational regulatory coordination makes regulatory arbitrage far more difficult and expensive, and hence reduces the amount of regulatory arbitrage that will occur. When legal analysis is issue-specific instead of imposed by arbitrary rules, the cost of regulatory arbitrage goes up dramatically because regulatory arbitrageurs cannot simply produce and mass-market one size fits all arbitrage products. Regulatory arbitrage will always be a possibility in some cases, but the additional cost of legal analysis and therefore the cost of prediction will eliminate many opportunities.

This is a medium-sized, but important victory for transnational regulatory cooperation.

Martha Poon, RAR Editor.

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Adapted by Martha Poon, RAR Editor.