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MANAGING REGULATORY ARBITRAGE: an alternative to harmonization

Excerpt from a forthcoming research article for Cornell International Law Journal (2014).

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

AMERICAN INTERNATIONAL GROUP (AIG), the very name of this company screams out its US origins. And yet, the traders within the UK subsidiary of this multinational insurance corporation, operating under a French banking licence, were able to engage in risk-taking activities that were largely beyond the reach of US insurance and finance regulators. When AIG's London-based trades fell apart in 2008, the parent institution in the US – and hence the US taxpayers – found themselves on the hook for decisions made in AIG's overseas subsidiary.

In the world of financial regulation, national financial regulators are pit against a globally mobile financial system. Since 2008, regulators have made a concerted effort to address the national regulatory differences that made AIG's trades possible in the first place. New rules hammered out at the G20 that seek to address these challenges apply to banks. How have the markets responded? Financiers have simply found ways of booking their transactions through non-bank institutions, the shadow banks not subject to the G20's rules.

The regulatory challenge posed by both AIG and the shadow banking industry is of paramount importance because the international slipperiness of these institutions, which are beyond the reach of regulators, threatens the sovereignty of nation-states and the well-being of national economies. However, the tension between regulators and financiers is somewhat more complicated than the law makers versus law evaders dichotomy. This is because a patchy regulatory landscape is fully anticipated within the core business model of global finance.

PLAYING REGULATORY DIFFERENCES is an important way of generating financial advantage. The technical term for this is "regulatory arbitrage".

In economic theory 'arbitrage' is considered a significant activity quite distinct from its lesser cousin, 'speculation'. Indeed, arbitrage is one of the great 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 counteracted only if the rules across all legal systems are harmonized. In other words, regulatory arbitrage opportunities will be eliminated if the regulatory cost of transacting is identical in all places. In practice, however, changing national laws is an extremely contentious process. Attempts to universalize substantive 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), the rules we currently use 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 ingenious invention 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 sets for itself the more modest goal 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 is the case in public international law – the law of international organizations such as the UN or the WTO. Rather, it is simply to define under which circumstance should a particular dispute or problem be subject to one state's law or another.

Thinking in terms of 'conflict of laws' changes the debate over global financial regulation because it raises an altogether different set of questions that are largely being ignored. For example: *How far does each regulatory jurisdiction extend, and what should be done when there is overlap? When should so-called host regulators of a global, systemically important*

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financial institution defer to so-called home regulators? 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 highly technical quality of the field of conflicts law makes it quite intimidating to some. 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: "If 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.

FOR 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



of generating consensus, since cases are defined and argued by the litigants themselves, through their established local legal representatives who need not act in an internationally unified manner.

Thirdly, in contrast to substantive financial regulatory standards that must be painstakingly decided, there exists considerable agreement on the formal rules of both private international law and conflict of laws. Some differences of philosophy are present between the American approach through common law and that of civil law. But on the whole, a great deal is already shared.

Last but certainly not least, the switch to thinking in terms of conflict of laws does not require new legislation. Nor does it need new agreements be hammered out at global conferences among regulators. Implementing a conflicts approach requires nothing more forceful than the creative application of laws that are already part of the legal system of all of the nations in which major financial centres are found.

SO WHY HASN'T CONFLICT OF LAWS BEEN PURSUED in financial regulation? The explanation is what Gillian Tett calls "silo 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 crossed 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.

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 certain situations."

In my opinion, there are many appealing advantages to this approach over the G20 model of full legal harmonization. From a legal standpoint, paying attention to the rules and processes that should govern the allocation of regulatory authority among overlapping sovereign states is hardly a second best option for mitigating the harm of regulatory arbitrage.

First and foremost, conflict of laws takes an agonistic 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 that 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





APPLICATION

What should determine the extraterritorial reach of US law?

Let's consider a controversial example to see how a financial regulator might use conflict of laws thinking in determining whether or not a certain transaction or a certain party, should be subject to their regulatory authority.

In Europe and Asia, regulators are concerned with the so-called "extraterritorial reach" of the proposed regulations of the US Commodity Futures Trading Commission (CFTC), which has indisputable authority over the US over-the-counter (OTC) swap markets under the Dodd-Frank Act.

What then should determine the CFTC's extraterritorial reach? The agency has taken an interesting approach that in some way exemplifies the promise and the challenge of the conflict of laws approach. It has proposed that any transactions with US persons shall be subject to US law and regulation. Note the technical legal sophistication of this position; it focuses on particular transactions and particular subjects (persons). This shifts the debate from a political question into a technical one: What is a US person?

On behalf of industry, the International Swaps and Derivatives Association (ISDA) has proposed a highly formalistic rule: A US person should be an institution whose principal place of business is in the US.

This is the old Basel I principle of "home country oversight" according to which US banks, including their foreign branches, are subject to US regulation, while US branches of foreign financial institutions are not. It is formalistic because it piggy-backs on a formal legal definition of territory and place

of incorporation. It is also narrow. In this definition, a free-standing corporation based in the Cayman Islands, all of whose shares are held by a US entity would not qualify as a US institution.

What is most important to the industry is the formal rule-like quality of ISDA's proposal because arbitrage, financial or legal, feeds on clear categories. You can only find arbitrage opportunities when you can see clear differences between assets or regulatory authorities. In other words, it is more important to the industry to be absolutely certain that US law will not apply *somewhere else* – so that transactions can be confidently booked or financial entities established, outside the US.

In contrast, public advocacy groups such as Americans for Financial Reform have proposed a highly functional definition of a US institution. In their view, a US institution is any institution whose failure would substantially impact the US economy. The functional approach of advocacy groups strikes fear in the heart of foreign regulators because of its breadth and hence the potential for overlap between US and foreign regulatory authority.

To date, the CFTC has responded in a highly technocratic way. According to one prong of the CFTC's complex proposal, a foreign branch of a US financial institution will qualify as a US institution, but a foreign subsidiary of a US financial institution will not. Note that industry can live with this distinction since it is often possible, using sophisticated legal technologies, to reproduce many of the functions of a foreign branch in the form of a foreign subsidiary.

But there is another piece to the CFTC proposal which is more innovative and controversial. The CFTC has further proposed that foreign institutions that transact with such "US persons" can apply, on an individual, institution by institution basis, for exemption from US regulation based on the fact that they are already in compliance with a body of foreign regulation that is functionally analogous to US law. This is called "substituted compliance".

What is new about the CFTC proposal is that substituted compliance will be determined, firm by firm, rather than by country. Thus, one Japanese bank may qualify while another may not. This has ruffled the feathers of foreign regulators who see the legal test as an infringement on their national sovereignty. If Japanese regulators have determined that two of their banks are in compliance with Japanese regulation, who is the CFTC to judge them differently?

But the creative insight of the conflicts approach is precisely that of handling problems case by case. In fact, the conflicts perspective would take the matter one important step further. The question of whether a financial institution is or is not a US person or of whether a foreign institution should or should not be entitled to substituted compliance depends not solely upon the status of the person, but upon the legal issue at stake in the case.

The conflicts approach asks: "What turns on this legal distinction?" Are we determining, for example, whether the parties need to post a certain size margin? Or whether US anti-fraud provisions of Dodd-Frank should apply?

This is obviously very different from the formalist approach to the scope of national law. What is perhaps less obvious is how the conflicts approach also differs from the functional test for determining which entities will be subject to US regulation, proposed by public advocacy groups.

In order to see how it is different, let's make our hypothetical example even more specific. Imagine a simple swap transaction between a subsidiary of a US institution located in a foreign country and an institution in that country. Is the subsidiary a US person for purposes of margin rules? There are many technical steps that the conflicts approach would go through to answer this question, but we only need to work through one to have the gist of a conflicts analysis.

Take the step called "interest analysis". As the name suggests this is a technical approach to the question, "What is really at stake in this choice? What interests are involved?" In the case of our swap transaction, the conflicts doctrine directs the regulator to ask, "What are the purposes behind this margin rule?" As it turns out, the Commodity Exchange Act as revised by Dodd-Frank is quite clear on this point. The purpose of the rule is to avoid future taxpayer bailouts by ensuring that financial institutions bear the cost of their risky behaviour.

The conflicts approach would then query, "What is the relevant contact that would determine whether this interest legitimately comes into play in this case?" Here again, a clear answer emerges. The relevant contact is the potential for US taxpayer liability.

The third step is for the regulator to ask, "Is there potential for US taxpayer liability such that the US has an interest in applying its law?" The answer again is clearly, 'Yes'. If this subsidiary of a US institution gets into financial trouble, the liability will flow back to the US and ultimately to US taxpayers.

But that is only the first prong of the analysis. The conflicts approach would then direct the regulator to go through the same thought process with respect to the other jurisdiction that might apply its law. Instead of resorting to a functional decision about whether US law applies, it recognizes the existence of other regulatory authorities. It acknowledges that defining the scope of extraterritorial authority is really a question of how to share authority with another regulator.

In our example, the other possible regulatory authority would be the foreign jurisdiction where the subsidiary and the foreign financial institution were located and where the transaction is taking place. Now let's imagine the foreign jurisdiction has its own margin rule with largely the same purpose. The US regulator could determine there is no substantial conflict between US and foreign law. Hence the US can and should go ahead and apply its law.

But let's change the facts just a little bit: imagine that the foreign regulatory authority has no comparable margin rule, but the transaction is booked in a third jurisdiction. In this case, the regulator should ask, "Why did this foreign jurisdiction choose not to have a margin rule like ours?" After some comparative investigation he or she might determine that policy-makers in the foreign jurisdiction were more concerned about attracting business than they were about protecting national taxpayers. But since the transaction in question is actually occurring in a third jurisdiction and is arguably not bringing business to the foreign jurisdiction we can conclude the foreign jurisdiction has no legitimate interest in applying its law. By this reasoning, the US regulator should proceed with the determination that the transaction involves a "US person" and hence is subject to US margin rules.

Now try a third fact pattern: let's imagine there is no regulation comparable to the Dodd-Frank Act in the foreign jurisdiction where the transaction occurs. If both jurisdictions are legitimately interested, the regulator will have to resort to some tie-breaking principles. It could perhaps negotiate with foreign counterparties.

We have walked through only one small piece of a proper conflicts analysis. Nevertheless, this extreme simplification is enough to highlight the key advantage of such an approach: it transforms a highly political determination into a technical legal one. In so doing it forces a serious, albeit technical inquiry, into the relative interests of each jurisdiction whose laws may apply in a given case. This strikes me as a viable alternative means of coordinating and reaching compromise between international regulatory authorities.

Most importantly, a 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.



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Adapted by **Martha Poon**, R&R Editor.