Exhausting Regulatory Arbitrage

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Annelise Riles, *Managing Regulatory Arbitrage: A Conflict of Laws Approach*, 47 **Cornell Int'l. L.J.** 63 (2014).

A recent gathering of regulators opened with a round of congratulations: bailouts were history, bail-ins were on the march, and victory was in sight, just as long as the assembled continued to speak with one voice and kept their bankers well-clear of the public trough. Moments later, it became clear that delegates from continental Europe were marching in different directions, while delegates from certain Nordic and African countries wanted no part of the march. The U.S. and the U.K. held the line, and the meeting closed on a cheerful note, with renewed pledges of regulatory unity.

It is fashionable to criticize regulatory harmonization as hopeless, pointless and potentially harmful. Yet harmonization continues to dominate regulation of international finance in good part because it feels like the obvious answer to two problems: regulatory competition and regulatory arbitrage. Scholarly criticism of harmonization tends to focus on competition. Annelise Riles' liberating article shows why harmonization loses to arbitrage, and offers an intriguing alternative.

At the outset she revisits definitions. Regulatory arbitrage is a strategy for managing legal difference: by "locating" an activity in one corner of the market rather than another, the arbitrageur gets the same economic result at a lower regulatory cost. Arbitrage is a problem for the regulator when it puts the activity beyond his reach, but leaves him stuck with its effects.[1] The fix seems obvious: ending difference ends arbitrage. Enter regulatory harmonization.

For Riles, harmonization and arbitrage are analogs and competitors, since both try to overcome difference. Harmonization starts the race at a big disadvantage because it requires coordination at home and abroad (a regulators' cartel), and must contend with local politics. The arbitrageur is better off alone; borrowing a phrase from another part of the article, she is working "bottom-up."

Governments too can fight difference alone—hegemony can displace harmonization—but they are too cheap, too weak, or too squeamish to do it. This follows from Riles' discussion of harmonization as North Atlantic law-making, a formal convergence subverted in local practice. Inept harmonization is better than hegemony, but it is haphazard and undemocratic. When states commit to harmonize, they give up a "vocabulary" of difference that should be used to articulate local and functional aspirations. Differences "worth fighting for" become unspeakable. Here too, the arbitrageur is unburdened by the public's constraint: while regulators profess harmony, she is free to exploit difference.

While harmonization fumbles, national courts treat global finance as a local law problem—and feed regulatory arbitrage. They describe financial activity as in-or-out, onshore or offshore, regulated or shadow. In Riles' example, *Morrison v. Nat'l Austl. Bank*, U.S. courts apply U.S. law to block regulation by the United States, but also to preempt regulation altogether—they project power to create a regulatory vacuum.[2] The field is clear for the arbitrageur.

Riles' contribution addresses the combined failure of the regulators and the courts. The former paper over national differences; the latter ignore them. She would restore the vocabulary of difference using weedy, elaborate Conflict of Laws doctrines. The result would be a mode of authoritative decision-making that is transnational from the start, but also both structured and dynamic.

Knowing nothing about Conflicts, I found two arguments most startling for contemporary regulation. First, there is no vacuum. Problems of "regulatory perimeter" and shadow finance give way to problems of competing authority and competing laws. There is no offshore, just iterating choices among multiple onshores, with the burden of proving applicable law on the party resisting regulation. This goes against the textbook presumption that governments should stay out of the market, echoes Katharina Pistor's vision of constructed markets, and adds technique.

Second, I was drawn to the capacity for slicing and iteration in Riles' description of Conflicts reasoning. In the last part of the article, she unpacks a barely-hypothetical transaction involving a U.S. investor and a French employee at a London branch of a U.S. firm, under an English-law contract. The investor claims fraud in New York. For every aspect of the dispute, the court can (must) engage in thick contextual analysis to determine the scope of its own authority and, separately, applicable law, based on competing interests of different jurisdictions. No single factor—not "location," not nationality, not party autonomy embedded in contractual choice of law—forecloses inquiry into compelling values.

The result is a problem for regulatory arbitrage, because the law applicable to the activity emerges in a thick substantive inquiry designed to go behind formal attributes and test the multiple values and interests at stake. This feels immensely unsettling to a transactional lawyer, but that may well be the point. Designing around regulation becomes expensive and exhausting, more trouble than it's worth.

This is an exciting and hopeful insight, which could take many different paths in future work. The analysis is expressly meant to go beyond judicial reasoning, although examples in this article focus on the courts. Regulatory applications, to be explored in a promised sequel, could recast debates about home-host tensions, substituted compliance, and cross-border resolution. Perhaps more importantly, the erstwhile harmonizers would recover a platform for asserting difference without projecting distrust or defeat. A different project could spin out transactional implications: how should contract drafters and deal designers work in a radically dynamic regulatory regime implied by Riles' argument?

Part of me wishes the article would invest less in sounding pragmatic. Conflict of Laws has deep roots in multiple jurisdictions, but this is an ambitious way of thinking Conflicts in a new context. Deploying Conflicts reasoning against arbitrage would not require new statutes or compacts, but it would require courts, legislators, and regulators committed to formal stability to embrace disruption—and a lot more work. The U.S. Supreme Court's choice of nineteenth-century Conflicts reasoning in *Morrison* is not by default. I am also less sanguine about the "bottom-up" inclusive potential of Conflicts. The rules would let small states, people, groups and firms argue about competing values directly, but the voices most likely to percolate from the bottom up are already well-heard in global finance. Meaningful participation would take more institutional work—perhaps for another sequel.

Riles offers a rich frame for talking about difference in global finance. It opens a research agenda, and feels "doable" at multiple levels of ambition. Thinking of conflict as a mode of regulatory cooperation is a relief. Let the arbitrageur worry about harmony.

1. It also distorts capital allocation and diverts revenues. [?]
2. Consider similarities with recent prosecutions of French and Swiss banks for U.S. sanctions running and helping U.S. tax evasion. Here too, one country's law occupies the field to the exclusion of others. Pending harmonization, U.S., French and Swiss authorities negotiate competing interests behind the scenes. [?]

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