Global Comparison of Hedge Fund Regulations

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The regulation of hedge funds has been at the centre of a global policy debate for much of the past decade. Several factors feature in this debate including the magnitude of current global investments in hedge funds and the potential of hedge funds to both generate wealth and destabilise financial markets.

The first part of the thesis describes the nature of hedge funds and locates the work in relation to four elements in existing theory including regulatory competition theory, the concept of differential mobility as identified by Musgrave, Kane’s concept of the regulatory dialectic between regulators and regulatees, and the concept of unique sets of trust and confidence factors that individual jurisdictions convey to the market. It also identifies a series of questions that de-limit the scope of the present work. These include whether there is evidence that regulatory competition occurs in the context of the provision of domicile for hedge funds, what are the factors which account for the current global distribution of hedge fund domicile, what latitude for regulatory competition is available to jurisdictions competing to provide the domicile for hedge funds, how is such latitude shaped by factors intrinsic and extrinsic to the competing jurisdictions, and why do the more powerful onshore jurisdictions competing to provide the domicile for hedge funds not shut down their smaller and weaker competitors?

The second part of the thesis examines the regulatory environment for hedge funds in three so-called offshore jurisdictions, specifically the Cayman Islands, Bermuda and the British Virgin Islands, as well as two onshore jurisdictions, specifically the United Kingdom and the United States.

The final section presents a series of conclusions and their implications for both regulatory competition theory and policy.

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Mr Adrian Pope, Managing partner, Maples & Calder…………………..Grand Cayman, 14 January 2008
Mr Timothy Ridley, Chairman, CIMA…………………………………..Grand Cayman, 29 January 2008
Mr Alasdair Robertson, partner, Maples & Calder…………………… Grand Cayman, 14 January 2008
Mr Langston Sibley, Legal Advisor, CIMA……………………………..Grand Cayman, 22 January 2008
Ms. Heather Smith, Investment and Securities, CIMA…………………..Grand Cayman, 14 January 2008
Mr William Walker, Chairman, Caladonian Holdings Limited……………Grand Cayman, 5 February 2008

United Kingdom

Lord George, former Chairman of the Bank of England…………………………London, 2 December 2004
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<td>Asian Development Bank</td>
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<tr>
<td>AIMA</td>
<td>Alternative Investment Management Association</td>
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<td>AML</td>
<td>Anti Money Laundering</td>
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<td>ATS</td>
<td>Alternative Trading System</td>
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<td>BC 2004</td>
<td>Business Companies Act 2004 (BVI)</td>
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<td>BCC</td>
<td>British Chamber of Commerce</td>
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<td>BIS</td>
<td>Bank for International Settlement</td>
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<td>BMA</td>
<td>Bermuda Monetary Authority</td>
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<td>BVI</td>
<td>British Virgin Islands</td>
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<td>BVI-FSC</td>
<td>British Virgin Islands Financial Services Commission</td>
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<td>BoE</td>
<td>Bank of England</td>
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<td>BSX</td>
<td>Bermuda Stock Exchange</td>
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<tr>
<td>CBA</td>
<td>Cost Benefit Analysis</td>
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<td>CCMR</td>
<td>Committee on Capital Markets Regulation</td>
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<tr>
<td>CDD</td>
<td>Customer Due Diligence</td>
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<tr>
<td>CEBS</td>
<td>Committee of Banking Supervisors</td>
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<td>CEIOPS</td>
<td>Committee of European Insurance and Occupational Pensions Supervisors</td>
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<td>CESR</td>
<td>Committee of European Securities Regulators</td>
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<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
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<td>CFZ</td>
<td>Colon Free Zone</td>
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<td>CIMA</td>
<td>Cayman Islands Monetary Authority</td>
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<td>CIS</td>
<td>Collective Investment Scheme</td>
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<td>CPO</td>
<td>Commodity Pool Operators</td>
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<td>CRD</td>
<td>Capital Requirement Directive</td>
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<td>CRMPG</td>
<td>Counterpart Risk Management Policy Group</td>
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<td>CSE</td>
<td>Consolidated Supervisory Entities</td>
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<td>CSX</td>
<td>Cayman Stock Exchange</td>
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<td>CTA</td>
<td>Commodity Trading Advisor</td>
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<td>DBAG</td>
<td>Deutsche Boerse AG</td>
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<td>DIE</td>
<td>Designated Investment Exchange</td>
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<td>EC</td>
<td>European Community</td>
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<td>ECI</td>
<td>Effectively Connected Income</td>
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<td>ECN</td>
<td>Electronic Communication Networks</td>
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<td>European Union Savings Directive</td>
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<td>EU</td>
<td>European Union</td>
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<td>FATF</td>
<td>Financial Action Task Force</td>
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<td>FCO</td>
<td>Foreign and Commonwealth Office</td>
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<td>FINRA</td>
<td>Financial Industry Regulatory Authority</td>
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<td>FinCEN</td>
<td>Financial Crimes Enforcement Network</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<td>FSA</td>
<td>Financial Services Authority</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
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<td>FINRA</td>
<td>Financial Industry Regulatory Authority</td>
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<td>FRB</td>
<td>The Federal Reserve Board</td>
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<td>Financial Services Commission</td>
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<td>Financial Services Action Plan (EU)</td>
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<td>FSMA</td>
<td>Financial Services Market Act (UK)</td>
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<td>G7/8</td>
<td>Group of Seven/Eight major industrial democracies</td>
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<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>GAO</td>
<td>Government Accountability Office</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>HFWG</td>
<td>Hedge Fund Working Group</td>
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<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
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<td>IBA 2003</td>
<td>Investment Business Act 2003 (Bermuda)</td>
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<td>IBC</td>
<td>International Business Corporation</td>
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<td>ICAAP</td>
<td>Capital Adequacy Assessment Process</td>
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<td>ICG</td>
<td>Internal Capital Guidance</td>
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<td>IET</td>
<td>Interest Equilization Tax</td>
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<td>IFA 2006</td>
<td>Investments Funds Act 2006 (Bermuda)</td>
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<td>IFSL</td>
<td>International Financial Services London</td>
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<td>IOSCO</td>
<td>International Organisation of Security Commission</td>
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<td>ISD</td>
<td>Investment Service Directive</td>
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<td>ITIO</td>
<td>International Tax and Investment Organisation</td>
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<td>LSE</td>
<td>London Stock Exchange</td>
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<td>LTCM</td>
<td>Long Term Capital Management</td>
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<td>MFA</td>
<td>Managed Funds Association</td>
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<td>MiFID</td>
<td>Market in Financial Instruments Directive</td>
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<td>MLAT</td>
<td>Mutual Legal Assistance Treaty</td>
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<td>MoF</td>
<td>Minister of Finance (Bermuda)</td>
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<td>MoU</td>
<td>Memorandum of Understanding</td>
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<td>MPBR</td>
<td>More Principles-Based Regulation</td>
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<td>NAMLC</td>
<td>National Anti-Money Laundering Committee</td>
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<td>NASD</td>
<td>National Association of Securities Dealers</td>
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<tr>
<td>NAV</td>
<td>Net Asset Value</td>
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<tr>
<td>NCCT</td>
<td>Non-Cooperative Countries or Territories</td>
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<td>NURS</td>
<td>Non-UCITS Retail Scheme</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<td>OECD</td>
<td>Organisation of Economic and Cooperative Development</td>
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<td>OFC</td>
<td>Offshore Financial Centres</td>
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<td>PCCL</td>
<td>Proceeds of Criminal Conduct Law</td>
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<td>POCA</td>
<td>The Proceeds of Crime Act 1997 (Bermuda)</td>
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<td>PWG</td>
<td>President Working Group</td>
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<td>QIS</td>
<td>Qualified Investor Scheme</td>
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<td>RIA</td>
<td>Regulatory Impact Assessments</td>
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<td>SAR</td>
<td>Suspicious Activity Report</td>
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<td>SRO</td>
<td>Self Regulating Organisation</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange and Commission</td>
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<td>SIBL</td>
<td>Securities Investment Business Law</td>
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<tr>
<td>SPCR</td>
<td>Segregated Portfolio Company Regulation (BVI)</td>
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<td>STEP</td>
<td>Society of Trust and Estate Practitioners</td>
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<td>SYSC</td>
<td>Senior Management Arrangements, Systems and Controls (UK)</td>
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<tr>
<td>TCI</td>
<td>Children’s Investment Fund Management</td>
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<tr>
<td>UBTI</td>
<td>Unrelated Business Taxable Income</td>
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<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investment in Transferable Securities</td>
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<tr>
<td>UNIDROIT</td>
<td>International Institute for the Unification of Private Law</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>US</td>
<td>United States of America</td>
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<tr>
<td>WFE</td>
<td>World Federation of Exchange</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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CHAPTER 1 – INTRODUCTION

1.0 BACKGROUND

The regulation of hedge funds has been at the centre of a global policy debate for much of the past decade.¹ A significant part of this debate has focused on questions relating to the appropriate regulatory latitude for hedge funds that operate in global financial markets well beyond the borders of the state that provides them with their legal basis for operation. The context for this debate may be seen in part in the magnitude of

current global investments in hedge funds, and their acknowledged capacity to influence, and potentially destabilise, financial markets.

One aspect of the policy debate regarding the regulatory latitude afforded hedge funds focuses on the coordination of national legislation. However, the approaches to hedge fund regulation adopted by individual jurisdictions participating in this debate may be influenced in part by the economic interests of those jurisdictions, interests which may in turn be influenced by the penetration of the hedge fund sector in each jurisdiction. By way of example, the United Kingdom (UK) is the locus of 80% of hedge fund management activity in Europe. The former Chairman of the Financial Services Authority (FSA) noted that the approach to hedge fund regulation adopted by the UK took this into consideration:

…the FSA recognises that it would not be beneficial if regulatory action caused the hedge fund industry to move to more lightly regulated

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5 IFSL (n2). Discussed in section 6.1.
jurisdictions, both from the point of view of the asset management industry and the importance of London as a global financial centre.\(^6\)

The above quotation serves to indicate the tension between prudential regulatory concerns and the competitive interests of individual jurisdictions in relation to hedge funds and sets the stage for the present work.

### 1.1 Location of the Present Research

The principal element in the theoretical foundation for the present research is derived from the regulatory competition model developed by Charles Tiebout.\(^7\) This model, which was based on competition within a single sovereign state federal framework, has been used to analyse the influence of competition between sub-federal units of governance on the efficacy of regulation within such a federal framework.\(^8\) In this context, regulatory competition theory has provided a useful framework with which to analyse the competitive measures deployed by states in the pursuit of the economic activity generated by hedge funds.\(^9\)

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\(^8\) Discussed in section 2.2.8.

The concept of mobility and the recognition that regulatees are able to ‘vote with their feet’ by relocating to a jurisdiction where the regulatory structure matches their needs more closely constitute critical elements within Tiebout’s model.\(^\text{10}\) Within this construct, the threat of exit serves as a discipline on profit-maximising regulators,\(^\text{11}\) with such regulators seeking to keep their residents as well as attract new residents. The threat of exit also influences such regulators to design regulation that is efficient and value-enhancing rather than excessive or value-wasting.\(^\text{12}\)

The second element in locating the theoretical foundation of the present work is the concept of differential mobility as identified by Musgrave:\(^\text{13}\) the observation that all factors of economic production are not equally mobile. Differential mobility in this context may be viewed as an ordering device that may be used to predict which factors are likely to be subject to the greatest degree of competition.\(^\text{14}\) Specifically, more mobile factors may be expected to be subject to greater degrees of competition than less mobile factors. Technological, spatial and geographic considerations that facilitate this mobility are also elements which are taken into account in relation to the effects of differential mobility on regulatory competition.\(^\text{15}\)

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\(^{10}\) In this work the term ‘regulatee’ is used to refer to those persons or institutions to which regulation applies or is intended by the regulator to apply. This term is also used to reflect the transactional nature of the relationship between the parties, as for example in the relationship between payee and payer, mortgagee and mortgagor and lessee and lessor.

\(^{11}\) Profit-maximising is one of the seven assumptions made by Tiebout. Discussed in section 2.2.7.

\(^{12}\) Discussed in section 2.1.1.


\(^{14}\) ibid. By way of example of differential mobility, capital is considered to be more mobile than labour, which in turn, is more mobile than a factory.

\(^{15}\) ibid.
The third element in locating the theoretical foundation of the present work relates to what has been referred to by Kane as the regulatory dialectic between regulators and regulatees,\textsuperscript{16} and in particular that aspect of this dialectic which has been identified by Picciotto as mediated by lawyers operating across jurisdictions.\textsuperscript{17}

The fourth and final element in locating the theoretical foundation of the present work is the concept of trust and confidence related factors that jurisdictions convey to the market which also influence the mobility of capital.\textsuperscript{18} Specifically, capital is more likely to move to jurisdictions that have the trust and confidence of the controllers of such capital. Included among such trust and confidence factors are the independence of the judiciary, political stability and familiarity with the legal framework.\textsuperscript{19}

These four theoretical elements are applied within the present work to examine how so-called Offshore Financial Centres (OFCs),\textsuperscript{20} and their onshore counterparts

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\textsuperscript{18} Discussed in section 4.0.2.b.

\textsuperscript{19} ibid.

\textsuperscript{20} The OFCs of the Cayman Islands, Bermuda and The BVI are discussed in sections 4.1, 5.2 and 5.3 respectively. In this regard it is noteworthy that the OECD defines an OFC as:

Countries or jurisdictions with financial centres that contain financial institutions that deal primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy.

compete to provide the domicile for hedge funds.\textsuperscript{21} This thesis also seeks to extend the analysis of regulatory competition theory to consider the competitive latitude available to geo-politically dominant onshore jurisdictions relative to smaller offshore jurisdictions. It does this by examining three smaller jurisdictions that have OFCs and that host hedge fund activities, specifically the Cayman Islands, Bermuda and the British Virgin Islands (BVI), as well as two onshore jurisdictions that are active in the hedge fund sector, specifically the UK and the US. In so doing it draws on the club-model of governance developed by Keohane and Nye, which argues that geo-politically dominant countries are able to gain competitive advantage through the operation of exclusive supranational rule-setting clubs.\textsuperscript{22}

\subsection*{1.2 Scope of the Research}

The scope of this thesis is defined by a series of four questions:

(1) Is there evidence that regulatory competition occurs in the context of the provision of domicile for hedge funds? If so, what forms does this competition take?

\textsuperscript{21} Hedge fund operations, and factors that influence their domicile decisions, are discussed in sections 3.1 and 3.9.2.

(2) What are the factors that account for the current global distribution of hedge fund domicile, and why is the Cayman Islands the domicile of choice for offshore hedge funds?23

(3) Do all states enjoy the same latitude for regulatory competition in relation to the provision of domicile for hedge funds? If not, how is such latitude shaped by intrinsic and extrinsic factors?

(4) Why do the more powerful onshore jurisdictions competing to provide the domicile for hedge funds not shut down their smaller and weaker competitors?

The approach adopted in identifying the answers to these questions is set out in the following section. No normative claims are made.

1.3 Methodology

The present analysis of the nature of regulatory competition with regard to the provision of hedge fund domicile proceeds from a discussion of the evolution of regulatory competition theory, and in particular that aspect of it that relates to competition for the provision of corporate charters. Thus, Chapter 2 provides an overview of the regulatory competition literature with particular reference to that part of literature that discusses the US state of Delaware and its dominant position for

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23 Discussed in section 3.10.
corporate charters within the US federal model.\textsuperscript{24} It focuses firstly, on the nature of competition among regulators and its effect on both the design of regulation and the distribution of regulated activities, and secondly, on how the design of regulation influences the choice of domicile made by enterprises.\textsuperscript{25}

Chapter 3 provides a definition of hedge funds for the purpose of the present work as well as an outline of the operations of hedge funds and their regulatory requirements. It also provides a description the organisational structures commonly utilised by hedge funds, and a brief overview of their investment activities and the associated risks. It analyses the underlying regulatory requirement that hedge funds consider when selecting their jurisdiction of domicile.

Chapter 4 traces the evolution of the Cayman Islands OFC, and reviews its development in the context of the regulatory dialectic and regulatory adjustments in onshore jurisdictions.\textsuperscript{26} It analyses the extent to which the success of the Cayman Islands in attracting hedge funds may be attributed to specific features in the regulatory environment for hedge funds which operates in the Cayman Islands, and provides some reflection on possibilities for, and limitations of, regulatory emulation and innovation.\textsuperscript{27}

Chapter 4 also provides a detailed description of the general financial services regulatory framework in the Cayman Islands and explores the extent to which

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{24}] The State of Delaware has been highly successful in attracting corporate headquarters for both US and multi-national business organisations and is currently estimated to serve as the domicile of choice for more than 50\% of the companies listed on the New York Stock Exchange. FATF, 'Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism - United States of America (23 June 2006) 231 <http://www.fatf-gafi.org/dataoecd/44/9/37101772.pdf> accessed 1 January 2008.
\item[\textsuperscript{25}] Discussed in section 2.3.
\item[\textsuperscript{26}] Discussed in section 4.2.1.
\item[\textsuperscript{27}] Discussed in sections 4.0.2 and 4.5.
\end{itemize}
\end{footnotesize}
regulation that is not specific to the financial services sector,\textsuperscript{28} together with other factors, are relevant to the development of the hedge fund sector in the Cayman Islands.\textsuperscript{29}

Chapter 5 provides an analysis of the offshore jurisdictions of Bermuda and the BVI and contrasts the evolution of the regulatory environments of these jurisdictions with that of the Cayman Islands in relation to hedge fund domicile.\textsuperscript{30} It also highlights unilateral measures employed by these jurisdictions as competitive mechanisms in order to attract hedge fund activity.\textsuperscript{31}

Chapter 6 provides a comparative analysis of the regulatory structures of the onshore jurisdictions of the UK and the US that are applicable to hedge funds, and analyses the unilateral competitive devices employed by these jurisdictions to compete for the domicile of hedge funds.\textsuperscript{32} Chapter 6 also considers the multilateral dimension of the latitude for regulatory competition that is available to geo-politically dominant countries with membership in the club of exclusive multilateral regulatory and standard-setting organisations.\textsuperscript{33} It considers the extent to which these multilateral organisations are able to set rules and standards that govern the international arena for financial services and provide their geopolitical dominant club members with a

\textsuperscript{28} Discussed in section 4.2.
\textsuperscript{29} As discussed in section 4.2.1, these included immigration policies and the recruitment of ‘branded’ professionals from Magic-Circle law firms and Big-Four accounting firms as well as the development of institutional thickness.
\textsuperscript{30} Bermuda and the BVI are discussed in sections 5.2 and 5.3 respectively.
\textsuperscript{31} Discussed in sections 5.2.14 and 5.3.13.
\textsuperscript{32} UK and US unilateral competition are discussed in sections 6.1.3 and 6.3 respectively.
\textsuperscript{33} Discussed in section 6.5.
competitive advantage.\textsuperscript{34} Chapter 6 also explores the interplay among the diverse array of actors whose contributions shape the financial architecture, influence regulatory competition and give rise to regulatory convergence.\textsuperscript{35}

The final chapter, Chapter 7, provides a series of conclusions drawn from answers to the questions posed in section 1.2. It also provides a discussion of the implications for both theory and policy that arise from these answers.

\textsuperscript{34} ibid.
\textsuperscript{35} Discussed in section 6.4.
CHAPTER 2 – REGULATORY COMPETITION

2.0 INTRODUCTION

Regulatory competition theory encompasses those models or frameworks that seek to explain, and in the theory’s robust form predict, the extent to which regulation in Country A is determined by reference to regulation in a competing jurisdiction, Country B. Regulatory competition theory has also been construed as a model to generate predictions about the effects of competition on institutions involved in regulatory activities.\(^\text{36}\) This chapter charts the evolution of regulatory competition theory from the seminal work of Charles Tiebout to the current scholarly debate focused on the state of Delaware and its position as the jurisdiction of choice for corporate charters of companies listed on the New York Stock Exchange (NYSE).\(^\text{37}\) It extends this discussion to considerations of similarities between Delaware’s dominant position for corporate charters within the US and the Cayman Islands’ position as the jurisdiction of choice for the majority of the world’s offshore hedge funds.\(^\text{38}\)

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\(^{38}\) Discussed in section 3.1.
2.1 Regulatory Competition Defined

Regulatory competition has been defined by Baldwin and Cave as ‘the competitive adjustment of rules, processes or enforcement regimes in order to achieve an advantage’. ³⁹

Barnard and Deakin have provided an alternative definition as follows:

The term regulatory competition refers to a process whereby legal rules are selected (and de-selected) through competition between decentralised rule-making entities. ⁴⁰

Both of these definitions indicate that jurisdictions may design and re-design their regulatory rules in order to gain a competitive advantage. What then is the manifestation or metric of gains achieved through such competition?

Implicit in the concept of regulatory competition is mobility. Such mobility may relate either to regulated or potentially regulated entities, or to factors of economic production they control. Jurisdictions may adjust their regulation in order to attract or retain mobile entities, mobile factors of production, or some combination of these.

Elements of regulatory competition among sovereign states have been linked to regulatory restrictions affecting the movement of capital and other factors of production. Such restrictions may act as tariff and non-tariff-barriers to trans-national

trade, and may in fact stymie cross-border economic flows. Global trends towards the relaxation of border controls have increased the potential for flows of capital, services and labour among jurisdictions and have also increased the opportunity for regulatory competition.

The removal of restrictions on international capital movements has brought regulatory regimes into greater interaction. In one sense it may be said that regulatory competition emerged as a counterbalance to the earlier restrictions on flows of capital, services and labour imposed by regulatory regimes. It also brought differences between national regulatory regimes into focus, giving rise to concerns that market participants would relocate away from more stringent regulatory regimes towards more relaxed regimes with lower regulatory-compliance costs. In response, the concept of regulatory coordination emerged as an approach to limiting opportunities for regulatory competition, as well as avoiding or resolving regulatory conflicts.

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44 Bratton (n41) 12.
46 Discussed in section 2.4.3.
2.1.1 Benefits of Regulatory Competition

There are three benefits commonly cited as flowing from regulatory competition. The first is that regulatory competition provides for the effective matching of legal rules with the preferences of citizen-voters. The reasoning underlying this assertion is based on a micro-argument that regulatory competition allows actors to coordinate in the design of regulatory structures which meet their particular preferences, and that it thereby serves as a force for improving efficiency as perceived from the perspective of the regulator, providing what Tjoing calls intrinsic efficiency.47

The second benefit is that competition between decentralised rule-making bodies seeking to find effective legal solutions promotes diversity, innovation and experimentation. Given the requisite degree of decentralisation, a competitive environment supports the position that only efficient regulation will be developed and all regulation will improve in efficiency over time.48 This macro-argument for regulatory competition advances the proposition that experimentation produces benefits with economies of scope as viewed from the perspective of the regulator, providing what Tjoing calls extrinsic efficiency.49

The third benefit is that regulatory competition provides a medium for the flow of information between consumer-voters and rule-making entities. Consumer-voters are able to express their preferences and rule making entities are able to compare

49 Tjoing (n47) 1.
alternative solutions to the problem of meeting consumer-voter preferences. Given the mobility of the citizen-voter, or the factors of productions that she controls, the imposition of onerous or inefficient regulation in one jurisdiction may benefit a second jurisdiction with more efficient regulation through the migration of such factors or the citizen-voters to the second jurisdiction. This threat of exit may serve as a discipline and affect rule-makers’ incentive to make regulation generally attractive and more effective in order to enhance the wealth of the larger population.

2.2 TIEBOUT’S MODEL

The key concept of mobility in the theory of regulatory competition has developed from the seminal work of Charles Tiebout. As noted by Bratton, Tiebout’s model is widely applied in American federalism discussion to predict the following:

First, that given free mobility of individuals and factors of production, regulators in search of taxpayers will be forced into competition respecting the terms of regulation; and secondly, that regulation thus produced will enhance economic welfare because competitive conditions diminish interest group influence and foster innovation.

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50 Barnard (n40) 199.
52 Bratton (n41) 4.
Tiebout developed his model in response to the work of Samuelson and Musgrave.\footnote{R Musgrave, 'The Voluntary Exchange Theory of Public Economy' (1939) 52 Quarterly Journal of Economics 2, 213; PA Samuelson 'The Pure Theory of Public Expenditure' 36 (XXXVI) (1954) 36 Review of Economics and Statistics 4, 387-89.} Samuelson and Musgrave sought to determine the appropriate incentives, that would allow consumer-voters to voice their public goods preferences and had posited that no ‘market-type solution exist to determine the level of expenditure on public goods’\footnote{ibid.}. Tiebout, whose work was based on a single sovereign state federal model, agreed with Samuelson and Musgrave’s analysis at a federal level of expenditure but disagreed at the local level of expenditure\footnote{Tiebout maintained that ‘at a central level the preferences of the consumers-voter are given, and the government tries to adjust to the pattern of these preferences, whereas at the local level various governments have their revenue and expenditure patterns more or less set.’ C Tiebout, 'A Pure Theory of Local Expenditure' (1956) 64 Journal of Political Economy 5, 418.}.

Tiebout’s analysis was primarily concerned with the administration of local government and the improvement of its effectiveness through the discipline resulting from competition. Tiebout opined that at the local level of expenditure, spatial mobility served to determine the optimum level of collective consumption: the greater the number and varieties of communities to choose from, the more likely the consumers are to identify and select their particular preferences.\footnote{ibid 418, 424.} Tiebout further posited that consumer-voters who are fully mobile will move to that community where their particular preferences patterns are best satisfied; that is, they will ‘vote with their feet’.\footnote{ibid.}
If consumer-voters are fully mobile, the *appropriate* local governments, whose revenue-expenditure patterns are set, are adopted by the consumer voters.\(^{58}\) (emphasis added)

In Tiebout’s model, if residents are mobile and if local governments compete to attract residents, then the basket of public goods and services provided by such governments would be more carefully designed to match the preferences of the residents. Without competition between local governments, there would be no mechanism by which these consumer-voters could express their preferences. By extension, if residents have heterogeneous preferences, then following repeated iterations in which consumers vote with their feet and local governments respond to the preferences of consumer-voters, a greater diversity of communities is likely to emerge, each community tending to maximise the satisfaction of their resident consumer-voters.

Tiebout outlined seven highly restrictive assumptions that need to be satisfied for this theoretical model to work, and acknowledged that the model was; ‘not even a first approximation of reality.’\(^{59}\) However, Tiebout considered the model valid for the analysis of decentralised decision-making on public expenditure, that would ‘yield the same optimal allocation that a private market would’.\(^{60}\) The seven assumptions included requirements firstly, that consumer-voters are fully mobile; secondly, that consumer-voters are assumed to have full knowledge of difference in costs between communities; thirdly, that there is an elastic supply of communities; fourthly, that the mobility of households is costless; fifthly, that there are no inter-jurisdictional

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\(^{58}\) ibid.

\(^{59}\) ibid, 421.

\(^{60}\) ibid.
externalities; sixthly, that there is an optimal size to a community and; seventhly, that communities seek to attract new residents to lower average cost of public service.

2.2.1 Mobility of Consumer-Voters

The assumption of the mobility of the consumer-voter is critical to the Tiebout model. Mobility serves as the market test for ‘willingness to buy’ and is the mechanism through which the consumer demand is registered. Jurisdictions then compete by tailoring their rules and regulation to attract and retain residents. The metric of success in this competition is the relative numbers of residents that each jurisdiction attracts to relocate to their jurisdiction.

2.2.2 Full Knowledge of All Regulatory Costs

In the Tiebout model, consumer-voters are assumed to have perfect knowledge of the differences in costs and public services provided by competing jurisdictions. Hence, the decision as to whether to relocate or not would not afford any personal biases, but rather, would be based exclusively on a rational actor’s response to perfect information. The probability of any consumer-voter actually having perfect information is extremely remote.
2.2.3 Elastic Supply of Jurisdictions

Tiebout’s model assumes that there are large numbers of communities in which consumers may choose to live or, in the language of economists, a perfectly elastic supply of jurisdictions.

2.2.4 No Transaction Cost in Moving

Tiebout’s model assumes that mobility would be costless and further that ‘restriction due to employment opportunities are not considered’.\(^{61}\) Removal of the consideration of employment opportunities, the transaction costs of moving, and other non-regulatory factors from the mobility decision allows the regulation supplied to be considered in isolation, albeit only in a theoretical realm.

2.2.5 No Externalities

Tiebout’s model also assumes that the public services supplied would ‘exhibit no external economies or diseconomies between communities’.\(^{62}\) Tiebout acknowledged that in reality externalities would certainly exist and cited this example:

\(^{61}\) ibid, 419.
\(^{62}\) ibid.
If the neighbouring community fails to provide adequate law enforcement my community is worse off. Similarly if the neighbouring community sprays the trees for Dutch Elm disease, my community may be better off.\textsuperscript{63}

2.2.6 Optimal Size to Communities

Tiebout’s model also carries an assumption that there would be an optimal size to each community, where optimal is determined in terms of the lowest average cost per resident for the basket of public services produced. To guard against the mathematical conclusion of the lowest being infinitesimal, the model implies that certain natural factors in a community, such as the land size or length of the beach, may be fixed and hence serve as restraints to the growth of the community.

2.2.7 Local Governments are Profit-Maximising

This final assumption states that local governments are profit-maximising, and communities below the optimum size will seek to attract new residents to lower average costs per resident, while communities that are above the optimum size will try to reduce their number of residents.\textsuperscript{64} The act of relocating or failing to relocate is essential to the model and represents the mechanism by which the residents register their demand preferences.

\textsuperscript{63} ibid, 423.
\textsuperscript{64} ibid, 420.
The result of iterative relocations produces communities that reflect revenue and expenditure patterns for public goods and service that best match the demand patterns of their residents. Given the model constraints noted above and that residents with homogenous demand preferences will ‘cluster’ together in local communities, then a selection of a sufficiently large number of communities would yield an allocatively-efficient regulatory model that exhibits optimal output-expenditure pattern.

2.2.8 Tiebout’s Model Summarised

Essential to the concept of allocative-efficiency is the recognition that local authorities or decentralised rule-making bodies are operating within a system with at least two levels, the centralised and decentralised.

The centralised level is responsible for a set of rules that applies to the polity as a whole. Similarly the centralised level provides public services such as the military forces, the benefits of which are common to all residents in the system regardless of the local communities they reside in. Further, integration between the centralised and decentralised level of governments may be justified in relation to matters in which the effects of externalities could be significant. By way of example, integration may be justified when local governments are fashioned to provide particular public services. Thus, regulatory jurisdictions may provide a ‘division of suppliers’ similar to the

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economic concept of a ‘division of labour’ offering all residents a selection of ‘jurisdictions of specialisation’ to choose from. By way of example, the US State of Delaware has developed a specialisation in corporate charters and serves as one example of a jurisdiction that has developed an allocatively-efficient regulatory structure attracting a ‘cluster’ of residents with homogeneous demand preferences.

2.3 **The Paradigm of Delaware**

Entities establishing corporations within the US have the freedom to choose from among fifty discrete regulatory environments. Nonetheless, it has been noted that Delaware, a small state with a population of less than 1/3 of 1 percent of the population of the US, has attracted the corporate charters of over half of the so-called ‘Fortune 500’ list of US companies with the greatest revenue and 40% of the companies listed on the NYSE. Commonly referred to as the ‘Delaware Paradigm’, this observation has sparked a body of legal scholarship on regulatory competition seeking to determine

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67 HN Butler, ‘Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges’ (1985) 14 Journal of Legal Studies 129, 156. Butler traced this wide discretion to the supreme court decision of Paul v Virginia (1869) 75 U.S. (8 Wall) 168 which implied that states did not have the power to exclude out-of-state corporations from doing business in their state. Prior to that, incorporation in a state generally meant that the primary place of business of the corporation was also in that state.

68 D Charny, 'Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities' (1991) 32 Harvard International Law Journal 2, 428. Information supplied by Joseph Grundfest, SEC Commissioner, to the Council of the Corporate Law section of the Delaware State Bar Association. Subsequently, the FATF estimated that 50% of the companies listed on the NYSE were registered in Delaware. (n37) 231.
the factors considered by market participants in their decision to incorporate in Delaware even though other US states offered similar regulatory structures.\textsuperscript{69}

The functional policy concern with regard to the adequacy of the laws of Delaware to provide for appropriate prudential oversight of the underlying economic activity has formed a critical part of this discussion. In the specific area of takeover rules, Cary identified that the laws of Delaware provide relatively more protection to the management of companies than they do to its shareholders.\textsuperscript{70} Cary argued that decentralised law-making bodies, such as the state of Delaware, were primarily motivated to attract high levels of corporate charters, and as a result had formulated laws that granted freedom to management to operate with minimum interference from shareholders and thereby had not addressed the public interest concerns of regulation resulting in a ‘race to the bottom’.\textsuperscript{71}

A civilising jurisdiction should import lifting standards; certainly there is no justification for permitting them to deteriorate. The absurdity of this race for the bottom, with Delaware in the lead – tolerated and indeed fostered by corporate counsel – should arrest the conscience of the American bar when its current reputation is in low estate.\textsuperscript{72}


\textsuperscript{71} ibid. This concept of the ‘race to the bottom’ was initially introduced in 1933 by Justice Brandeis who described competition between jurisdictions, that results in corporation moving to the jurisdiction with the least burdensome regulation, as a race ‘not of diligence but of laxity’ - Louis K Liggett Co v. Lee (1933) 288 U.S. 517, 559. (Brandeis J. dissenting). This sentiment may also be attributed to Karl Marx who argued that the spread of capitalism ‘compels all nations, on pain of extinction, to adopt the bourgeois mode of production’. K Marx F Engels and RC Tucker, \textit{The Marx-Engels Reader} (Norton, New York 1978) 338-39.

\textsuperscript{72} ibid.
Cary further argued that there was a need for uniformity between laws to prevent Gresham’s law taking effect and proposed the ‘Federal Corporate Uniformity Act’ as a solution to force uniformity in legislation among US states.\textsuperscript{73}

Countering the ‘race to the bottom’ argument are members of the free-market school who argue that competition between jurisdictions produces efficient law that maximises shareholder’s value and results in a ‘race to the top.’\textsuperscript{74} Adding a crucial element to this debate was Romano who established the concept of ‘law as a product’.\textsuperscript{75} Romano argued that competition between states leads to innovative, responsive and efficient laws.\textsuperscript{76} In this context, Romano identified various benefits offered by Delaware which included; comprehensive case law and statutes; an experienced judiciary which specialises in corporate matters provided by the Chancery courts; the wide range of legal rules and precedents generated by the controversies of the large number of corporations chartered; a commitment to the responsiveness, 

\textsuperscript{73} Cary (n70), 672; Kaplan, ‘Fiduciary Responsibility in the Management of the Corporation’ (1976) 31 Business Lawyer 883, 883. Kaplan explains that Gresham's law ‘alleges that the lax drives out the exacting and commands a race of leniency in corporation act provisions presently being led by Delaware’. Supporting Cary’s position were Bebchuck and Ferrell, who argued that Delaware’s anti-takeover statutes reduce shareholders’ value. LA Bebchuk and Ferrell, 'Federalism and Takeover Law: The Race to Protect Managers from Takeovers' (1999) 99 Columbia Law Review (NBER Working Paper 7232) 1168, 1194. They argue that if competition between states promotes efficient laws and maximizes shareholder value then the legal regime of Delaware should facilitate takeovers and not, given Delaware’s anti-takeover statute, frustrate them. LA Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) 105 Harvard Law Review 7, 1445.

\textsuperscript{74} D Fischel, 'The 'Race to the Bottom' Revisited: Reflections on Recent Development in Delaware Corporation Law' (1982) 76 Northwestern University Law Review 913, 920.

\textsuperscript{75} Romano (n36) 280.

\textsuperscript{76} R Romano, The Genius of American Corporate Law (AEI Press, Washington D.C 1993) 149 Winter also support the concept that regulatory competition leads to innovative and responsive laws and argued that such law could be distinguished by its ability to enhance shareholder welfare. R Winter, 'State Law, Shareholder, Protection, and the Theory of Corporation' (1977) 6 Journal of Legal Studies 2, 251. Further, as argued by Fischel, there was an implied assumption of shareholder irrationality in the 'race to the bottom argument. Fischel questioned why, given an infinite selection of investment options, would shareholders voluntary invest where the managers had no incentive to maximise shareholders’ investment and posits that Delaware’s success as the jurisdiction of choice for corporate charters was due to its permissive corporate laws which maximises shareholders’ welfare. Fischel (n74), 916.
stability and serviceability of its charter structure driven by Delaware’s reliance on incorporation fees.

The central and enduring question in regulatory competition that has emerged from Romano’s ‘law as a product’ is identified by Langille as follows: ‘if competition among producers of widgets is a good thing, why not among producers of regulatory policy?’\textsuperscript{77} Charny concurred and posited that managements’ decisions to incorporate are influenced by jurisdictional factors, which, from their shareholders’ viewpoint, provide the most efficient laws.\textsuperscript{78} Romano observed that there were two components to the appeal of Delaware.\textsuperscript{79} These are, firstly, a direct cost-minimisation aspect focused on the firms activities, and secondly, the minimisation of litigation uncertainty.\textsuperscript{80} Further, Romano argued that jurisdictions that successfully establish themselves as advantageous are likely to remain so.\textsuperscript{81} In the case of Delaware this, in part, may be due to reliance on the revenue produced by the users of its regulation as well as by the investment in human capital and experience made by lawyers and other service providers.\textsuperscript{82} As a result, Delaware’s success may be attributed to its enactment of

\begin{footnotesize}
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\item \textsuperscript{78} Charny (n68) 431-2. Efficient regulation is defined in the context of the Delaware Paradigm i.e. ‘In essence the law are designed to maximize the total value of outstanding shares of Delaware Corporations’.
\item \textsuperscript{79} Romano (n76) 38.
\item \textsuperscript{80} ibid.
\item \textsuperscript{81} ibid.
\item \textsuperscript{82} ibid.
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preferred rules and a ‘market for incorporation’ that produces incentives for states to supply the most efficient law and thereby optimise their revenue.\textsuperscript{83}

Romano’s viewpoint was later supported by empirical evidence that quantified the benefit of Delaware’s corporate charter.\textsuperscript{84} Daines research indicated that, all other things being equal, companies incorporated in Delaware were valued by the market at 2-3 percent higher on average than non-Delaware companies and as much as 5 percent higher in some contexts, giving rise to the term ‘the Delaware Effect’.\textsuperscript{85} Further, Delaware has emerged as the standard-setter for corporate laws, influencing jurisdictions, both within and outside of the United States, to revise their corporate law in order to emulate the corporate laws of the Delaware.\textsuperscript{86} The combination of these factors led Romano to characterise inter-state competition as ‘the genius of American Corporate law’.\textsuperscript{87}

Several lessons may be gleaned from the Delaware Paradigm in the context of Tiebout’s model. Among them is the observation that competition among jurisdictions serves to shape regulatory regimes and that its effects may be observed from the

\begin{footnotesize}
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\item ibid.
\item ibid. Daines used the financial measurement of Tobin’s Q to establish the ‘Delaware Effect’. Earlier support for this viewpoint emerged from the empirical study by Dodd and Leftwich, which showed that corporations experienced abnormally positive returns during the two-year period prior to incorporating in Delaware as a presumed result of their announcement of their forthcoming Delaware incorporation. Subramanian observed that the Delaware effect disappears when examined over a longer time frame. G Subramanian, ‘The Disappearing Delaware Effect’ (2004) 20 The Journal of Law, Economics, and Organisation 1. Dodd and Leftwich, ‘The Market for Corporate Charters: Unhealthy Competition’ versus Federal Regulation’ (1980) 53 Journal of Business 3, 261. Cheffins’s research also suggested that share price movement following the announcement of a re-incorporation in Delaware is typically positive. Consequently he concludes that state-competition for incorporations works for the benefit of shareholders, albeit he does acknowledge that other reasons besides the move to Delaware, which he could not isolate, might exist that could justify the positive price movement. B Cheffins, Company Law: Theory, Structure and Operation (Clarendon Press, Oxford 1997) 446.
\item Winter (n76) 255.
\item Romano (n76) 149.
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‘demand’ and ‘supply’ viewpoints.\textsuperscript{88} Firstly, in exercising their ‘demand’, individuals, firms or factors may select the regulatory structure that best matches their preference from a number of jurisdictions.\textsuperscript{89} Secondly, from the ‘supply’ viewpoint, jurisdictions, either in pursuit of new residents and factors of production or seeking to confer competitive advantages on existing factors, may innovate and enact competitive lawmaking.\textsuperscript{90}

It is generally accepted that the assumptions included in Tiebout’s model are purely theoretical and as such may never be satisfied.\textsuperscript{91} However, two of Tiebout’s assumptions, elasticity of supply of jurisdictions and the mobility of factors, play important roles in the analysis of the Delaware Paradigm.

In the context of mobility, it should be noted that firms and factors within the US have the freedom to choose the State of their corporate charter, regardless of the location of the substance of the corporation.\textsuperscript{92} All fifty US states compete vigorously in the market for corporate charters, creating a relatively elastic supply of jurisdictions for domicile for corporate charters.\textsuperscript{93} Delaware, the second smallest state in the US, has little in the form of natural resources or other internal sources of economic revenue and

\hspace{1em} \textsuperscript{88} \textit{Bratton} (n41) 13.
\hspace{1em} \textsuperscript{89} ibid.
\hspace{1em} \textsuperscript{90} ibid.
\hspace{1em} \textsuperscript{91} JP Trachtman, ‘Regulatory Competition and Regulatory Jurisdiction’ (2000) 3 Journal of International Economic Law 2, 15.
\hspace{1em} \textsuperscript{92} LA Bebchuk, ‘Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments’ (1989) 102 Harvard Law Review 8, 1820; This observation also assumes a certain degree of ‘equivalence’ in the regulatory structures of jurisdictions considered in the jurisdiction of corporate charter decision. As noted by Picciotto ‘Regulatory competition itself generally requires some equivalence between regimes, or some common rules...' Picciotto (n42) 92.
as a result it is obliged to turn to external markets and to the attraction of mobile external factors as sources for its economic revenue stream. This relationship between state revenues generated by the corporate franchise fees and success in obtaining re-incorporations serves to bind Delaware’s lawmakers to supply responsive regulation that closely matches the market demand for corporate charters.

Romano notes that Delaware’s dependence on corporate law revenues gives rise to what is in effect a pre-commitment to responsiveness that provides Delaware with a first-mover advantage and makes it difficult for other states to compete with Delaware. In essence, other states, not dependent on such revenues, are not viewed as able to pre-commit to a similar faithful course of responsive regulation. Further, Delaware’s pre-commitment engendered significant market cooperation that not only enabled Delaware to establish itself as the dominant jurisdiction, but also gave rise to various economies of scale and security in numbers which allow Delaware to maintain its lead over other jurisdictions. As a result of its commitment to responsiveness and following repeated iterations, Delaware’s regulatory regime for corporate charters emerged as the standard. By maintaining this responsiveness Delaware has remained

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94 R Biswas, *International Tax Competition: Globalisation and Fiscal Sovereignty* (Commonwealth Secretariat, London 2002) 29. Smaller economies that are not economically self-sufficient may be more inclined to compete in external markets for trade in mobile factors. As noted by Harvard Professor Robert J Barro; ‘Small countries, even with populations of as little as a million, can perform well economically, as long as they remain open to international trade. In fact, smallness tends to encourage openness because the alternative really would be a nonviable economy’ RJ Barro, 'Small is Beautiful' *Wall Street Journal* (New York 11 October 1991) A8.

95 *Romano* (n36) 236.

96 ibid. DA Skeel, 'Lockups and Delaware Venue in Corporate Law and Bankruptcy' (2000) 68 University of Cincinnati Law Review 4, 1278. Insight into relationships built on cooperation may be gleaned from studies that indicate that in a relationship of mutual power and without central authority, factors such as the ‘echo effect’ and reciprocity from or ‘tit for tat’ strategy help to build cooperation and deliver successful results, Delaware being the case in point. R Axlerod, 'Effective Choice in the Prisoner's Dilemma' (1980) 24 Journal of Conflict Resolution 1.

97 *Romano* (n36) 235.
the dominant US jurisdiction for the domicile of corporate charters for more than fifty years. 98 This longstanding prominence has also contributed to enduring confidence in the future success of Delaware’s regulatory regime, that is, it contributes to trust in Delaware. 99 As noted by Romano:

The large number of firms already incorporated in Delaware solidifies its commanding position in the market by giving it a first mover advantage. There is safety in numbers - the more firms there are the higher the level of franchise tax paid and the more the state relies on its incorporation business for its revenue which provides an incentive to behave responsively. In addition the large numbers make it more likely that any particular issue will be litigated and decided in Delaware, providing a sound basis for corporate planning. This attracts even more firms for the more responsive a state and the more settled its law, the cheaper it is for a firm to operate under that legal regime. 100

Repeated iterations of attention, adjustment, and first-mover advantage within Delaware’s corporate regime have not only cemented Delaware’s position as the standard-setter in this area, but in Trachtman’s opinion they have largely settled the race to the top/bottom question. 101 In essence, as noted by Bebchuk,

...benefits of state competition are simply a special case of the familiar point that as long as competition operates to reward producers of best product, competition is socially desirable. 102

99 Romano (n36) 280.
100 Romano (n98) 723.
101 Trachtman (n91) 8. Delaware’s regime is better known, and is regarded, as easier to use, more complete and more stable. In this regard, Delaware’s influence as a standard-setter extends beyond the single Federal jurisdiction of the US and has had global influence. By way of example, the Exempted Limited Partnership Law (2003 revision) of the Cayman Islands is largely modelled on Delaware’s Limited Partnership Law. Interview with Mr Adrian Pope, Managing Partner, Maples & Calder, (Grand Cayman 14 January 2008).
102 Bebchuk (n73) 1457.
The success of Delaware shows that competition among regulatory regimes has a qualitative component that extends beyond considerations of regulatory-compliance burdens to encompass the preferences and demands of the market. Accordingly, competition between states is more complex and nuanced than a one-dimensional race to the top or bottom. Rather, competition between states provides a structure that serves to discipline and encourage the development of the qualitative elements of regulation that reflects the preferences of market participants.

2.3.1 The Political Element

Scholarly analysis seldom focuses on the initial competitive strategy adopted by Delaware more than 100 years ago when, as a small state with limited internal economic resources, it sought to diversify its economy by attracting new sources of revenue. In the late 19th century, prior to the ascension of Delaware, New Jersey was recognised as the dominant jurisdiction for corporate charters, having made an early bid to attract the business of corporate charters. Delaware emulated New Jersey’s

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103 Trachtman (n91) 18.
104 ibid, 9.
105 Biswas (n94) discusses small states in a modern context. Barro (n94).
106 In 1875 New Jersey passed the first incorporation law in the US that provided corporate charters to corporations regardless of their residency or the primary place of business. By 1894 a large percentage of companies conducting business in New York had incorporated in New Jersey. Butler 'Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges' (1985) 14 Journal of Legal Studies 129,156-7. It was estimated that the majority of the state budget of New Jersey was funded by fees and taxes derived from these corporate charters. C Barnard, 'Social Dumping and the Race to the Bottom: Some lessons for the European Union from Delaware?' (2000) 25 European Law Review 1, 69. See discussion in note 67.
legal framework, enacting the Delaware Corporation Act 1899, which was largely modelled on New Jersey’s incorporation law.\textsuperscript{107} An additional and complementary element of commercial certainty was brought to Delaware by a ruling of the Chancery Court of Delaware that held that by adopting the language of the New Jersey Statutes the legislature of Delaware had intended the Delaware courts to adopt a construction of statutory interpretation consistent with the case law then established by the New Jersey’s courts.\textsuperscript{108}

Delaware’s emulation of New Jersey met with opportunity when, in 1913, New Jersey passed the so-called ‘Seven Sisters’ amendments to its corporate law, which had the effect of severely restricting the size and powers of corporations and trusts.\textsuperscript{109} However, Delaware’s government recognised the value of the corporate charter business and did not pass similar amendments to its statute\textsuperscript{110} As a result, New Jersey chartered corporations, in search of greater operating flexibility, voted with their feet by re-incorporating in Delaware.\textsuperscript{111} This \textit{en masse} relocation cemented Delaware’s dominant position as the jurisdiction for corporate charters, the revenue from which now contributes almost 20 percent to the annual state budget of Delaware.\textsuperscript{112} Further,

\textsuperscript{108} Wilmington City Ry. Co. v. People’s Ry. Co. 47 A.245 (Del. Ch. 1900) cited in Butler (n67) 162. As a result, the market then perceived Delaware as comparable to New Jersey and hence Delaware was able to ‘free-ride’ on the body of case law developed in New Jersey. Arguably, without the Chancery court’s explicit adoption of New Jersey’s construction, it would likely have taken years for Delaware to develop this element of commercial certainty.
\textsuperscript{109} Cary (n70) 664. Laws of Feb 9, 1913, chs 13-19 [1913] New Jersey Laws.
\textsuperscript{110} ibid.
\textsuperscript{111} ibid.
\textsuperscript{112} Romano (n36) 225, 240.
recent evidence suggests that the vast majority of Delaware corporations are owned by non-residents of Delaware.\footnote{FATF (n37) 231.}

Delaware’s long standing and current dominant position in the market for corporate charters within the US suggests that its state regulators gleaned two important lessons from New Jersey’s experience. Firstly, they observed how quickly a market and its participants can move \textit{en masse} in substituting similar regulatory products. Accordingly, they have endeavoured to maintain a responsive regulatory regime. Secondly, they observed that the market seeks commercial certainty, which requires an element of trust between the regulator and the regulatee.\footnote{The concept of commercial certainty in this thesis is used to include the predictability of regulatory and political policy, as well as the predictability of contractual enforcement. M Guitián, ‘Economic Policy Implications of Global Financial Flows’ (1999) 36 Finance & Development 1 \<http://www.imf.org/external/pubs/ft/fandd/1999/03/guitian.htm> accessed 28 February 2008.} The importance of trust in the context of commercial certainty cannot be underestimated. If trust is undermined, it is foreseeable that a market may migrate to a jurisdiction that provides greater commercial certainty, resulting in any previously acquired position of market dominance being lost. In addition, if the regulatee perceives that the regulatory regime of a particular jurisdiction is one where the rules may change at a moment’s notice and without input from or consultation with the regulatee, then the regulatee may be inclined to move to a jurisdiction where there is a greater element of timely and meaningful communication and trust in the deliberative process,\footnote{Discussed in section 6.2.2 and 6.2.10.} and where the actions of the regulator are more considered.\footnote{B Lange, ‘The Emotional Dimension in Legal regulation in New Directions’ in S Picciotto and D Campbell (eds), \textit{New Directions in Regulatory Theory} (Blackwell, Oxford 2002) 197.}
2.4 Regulatory Competition and the International Setting

Tiebout’s model, which is based on a single federal jurisdiction, may be extended by analogy to an international context.\(^ {117}\) This analogy is, however, limited. By way of example, regulatory competition in an international setting does not have the limit-defining element of a top-level centralised form of governance, the law of which ‘trumps’ that of the lower-level decentralised governments.\(^ {118}\) Further, and fundamental to the concept of regulatory competition in the international setting is the observation that, given the absence of treaty obligations, there are no theoretical legal limits on the extent of a sovereign state’s regulatory authority, at least within its borders, and similarly no limits on regulatory competition measures that it may implement within its borders. Trachtman has observed that even in the context of commitments to the World Trade Organization (WTO) that in one sense may be understood to involve the cession of regulatory authority by signatory states:

…regulatory competition between states appears generally unconstrained by such international regimes as GATT, the Subsidies Code, and U.S. trade law. Therefore, regulatory competition may be a more easily available tool than more overt subsidies and may be the decisive weapon in the international economic warfare of the coming years.\(^ {119}\) (emphasis added)

\(^ {117}\) Tiebout’s model is discussed above in section at 2.2.
\(^ {118}\) M Roe, ‘Delaware Politics’ (2005) 118 Harvard Law Review 8, 5. By way of example, within Tiebout’s single federal-state model, interstate commerce and the limits of regulatory competition between states are circumscribed by rules set at a federal level, whereas intrastate commerce is regulated at state level. Similarly, EU law determines the boundaries of regulatory competition within the EU.
Global competition and the threat of potential loss of business to both developed and developing economies have triggered rapid growth in the ‘network’ of international institutions focused on regulatory convergence and the adoption of limits on regulatory competition.\textsuperscript{120} Developed jurisdictions in particular have tended to respond to what they perceive as the threat of unrestrained regulatory competition by utilising networks of international institutions to influence other jurisdictions to adopt regulatory standards which they favour. That is not to say that all states participating in such networks have the same objectives. Rather, states participating in multilateral organisations may be expected to pursue their own unique interests through influence on the decision-making processes within these organisations.\textsuperscript{121}

Keohane posits that, as a result of such influence within collaborative processes, the outputs may be only dressed in the ‘clothes’ of standardisation, whereas, in effect, such outputs result in a cartel-like response.\textsuperscript{122} In this regard cartels of regulators must be viewed with some concern. Trachtman observes that, ‘from a public interest perspective, “cartelization” among benign regulators is simply benevolent cooperation’.\textsuperscript{123} However, from a public choice perspective, unconstrained

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\begin{itemize}
\item \textsuperscript{120} RO Keohane, ‘International Institutions: Can Interdependence Work?’ (1998) 110 Foreign Policy, Special Edition: Frontiers of Knowledge 82, 94.
\item \textsuperscript{121} Discussed in section 6.5.
\item \textsuperscript{123} Trachtman (n91) 331.
\end{itemize}
self-interest will produce cooperation/cartelization that furthers the interests of the cartel members.\textsuperscript{124} Given a sufficient number of self-interested cartel-like regulatory organisations and a sufficient density of the network of such international organisations, the perception of an umbrella of global governance may arise.

\subsection{2.4.1 Global Governance}

The emergence of a network of trans-regulatory processes may be viewed as the emergence of at least an incipient form of global governance. Giddens notes that the modern geographically-defined state’s ability to assert a ‘monopolistic’ power internally is largely determined by its interaction with the dominant international framework.\textsuperscript{125} In the modern world the G7/8 countries have the dominant roles in most international organisations in the network of global governance.\textsuperscript{126} Gstöhl observed that:

\begin{quote}
...from the point of view of the G8 countries, their weight in the world economy places a particular responsibility on them, when it comes to governing globalization.\textsuperscript{127}
\end{quote}

\begin{flushright}
\textsuperscript{124} ibid.
\textsuperscript{125} A Giddens, \textit{A Contemporary Critique of Historical Materialism} (Polity Press, Cambridge 1985) ch. 10.
\textsuperscript{126} Since its initial summit in 1975, the G7 has consistently indicated that it intends to utilise existing international organisations. De Guttry, Andrea (1994) in S Gstöhl, 'The G7/G8's network governance arrangement with international organisations' workshop "The Governance of Global Issues: Effectiveness, Accountability, and Constitutionalization" at the ECPR Joint Sessions in Edinburgh, March 28 - April 2, 2003, 1
\textsuperscript{127} ibid, 1.
\end{flushright}
Gstöhl further opines that although the G7/8 may not be the only decision makers within an international organisation, they do have great potential influence.  

Barry summarised the influence of the G7/8 thus:

By virtue of its combined economic, military, and diplomatic power and influence, the G8/G7 can exercise tremendous influence over the multilateral institutions of global governance. This power gives the G8/G7 great influence on the policies, programs, and decisions of the UN Security Council, World Trade Organization (WTO), International Monetary Fund (IMF), World Bank, and Organization for Economic Cooperation and Development (OECD). This is the case despite the fact that, unlike these institutions, the G8/G7 has no permanent staff, no headquarters, no set of rules governing its operations, and no formal or legal powers.

If we accept that the G7/8 do indeed attempt to provide a form of global governance, and given that their intrinsic self-interests may not be aligned with those of other states with which they are in competition, then that element within Tiebouts’s model that operates as an ‘unbiased’ centralised level of governance may be absent in an international context.  

Borrowing from historical lessons, it is foreseeable that

128 ibid.
130 That is, ‘unbiased’ in relation to the components of the decentralised level. In this regard, it is noteworthy that William Riker observed that true federalism has two distinct characteristics: firstly, both levels of government rule ‘the same land and people’, and secondly, each of the levels has a clearly defined and autonomous authority and operates within its own sphere of political authority. J Macey, ‘Regulatory Competition in the US Federal System: Banking and Financial Service’ in DC Esty and D Geradin, Regulatory Competition and Economic Integration: Comparative Perspectives (Oxford University Press, Oxford 2001) 95.
131 The history of The Unequal Treaties and Colonisation serves as examples. The Unequal Treaties, signed after the Opium Wars of 1839-42, generally involved unilateral concession from the Chinese in favour of the European powers. TW Wallbank and AM Taylor Civilization-Past and Present (Scott Foresman Chicago 1944) ch. 29. Biases in favour of dominant jurisdictions have also been observed during the colonial era in the 17th century, which saw the establishment of colonies, by European nations.
any rules of regulatory competition established in multilateral organisations, but influenced by these conflicted dominant nations, may be biased to give these dominant nations a competitive advantage.

The potential for conflicts of interest and biased policies within the network of global governance clearly warrants some scrutiny. However, unlike the availability of full information that operates in Tiebout’s model, the activities of G7/8 are non-transparent. In this regard and given that the G7/8 are essentially informal institutions of politicians that engage in ‘fireside chats’, the relevant actors are under no obligation to provide transparency in relation to their decision-making processes. As a result their influence on global governance has attracted some criticism. Gstöhl observed that the G8 had:

…often been decried as a powerful, elitist and secretive club of rich countries lacking any legitimacy ‘to act on behalf of the world’, as the world’s self-appointed ‘management board’ or group hegemon. Some critics claim that given its power, the G8 was by far not doing enough to solve global problems, others maintain that given its lack of representativeness, it was already doing too much.

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in the Americas and the Caribbean. Notwithstanding the Westphalia agreement to respect the borders of nation-states, and as with Africa, the European colonialist powers ascribed the indigenous people of their new colonies as ‘uncivilised’ and therefore not deserving of the equal status provided for in Westphalia. GW Gong, The Standard of "Civilization" in International Society (Clarendon Press, Oxford 1984) 97. The important and relevance of these historical occurrences lies in the observation that biases and tactics that existed in the treatment of less developed countries by more developed countries is still of concern today. Keohane (n122) 6. Further, the Unequal Treaties and colonialism are arguably a manifestation of an underlying assumption, which, still exists today, that it is ‘acceptable’ for more developed countries to impose unilateral burdens on less developed countries.

132 Tiebout’s model has the assumptions that ‘there would be full knowledge of regulatory cost’. Discussed above in section 2.2.2.

133 Gstöhl (n126) 1.

134 ibid. Gstöhl, further observed that the G7/8 represents approximately two thirds of the global gross domestic product (GDP), but only represents a tenth of the world’s population.
Gstöhl further notes that the policies of the G7/8 countries have generally been reactive and selective. The G7/8 does not act against the vital interests of its members or its own collective interests. Koehane and Nye termed this dominant influence of the rich countries the club-model of governance and opined that ‘the club model was very convenient for officials negotiating agreements within issue-areas since in two ways it kept outsiders out’.\textsuperscript{135} Specifically, it uses exclusion and non-transparency

Under the club model \textit{a lack of transparency to functional outsiders} was a key to political efficacy. Protected by this lack of transparency, ministers could make package deals that were difficult to disaggregate or even sometimes to understand.\textsuperscript{136} (emphasis added)

Keohane indicates that institutionalised cooperation provides several benefits to self-interested states and consequently international economic institutions will continue to have a role in the international setting even without hegemonic clubs.\textsuperscript{137} Keohane concludes that as a result, states will continue to cooperate and support the international institutions and share the benefits they bring as well as the burden of their cost.\textsuperscript{138} Breton posits that one of the benefits of a hegemonic power is the provision of stability to the market place as a result of its undertaking to prevent an unstable

\begin{itemize}
  \item \textsuperscript{135} \textit{Keohane} (n122) 3.
  \item \textsuperscript{136} ibid.
  \item \textsuperscript{137} RO Keohane, \textit{After Hegemony: Cooperation and Discord in the World Political Economy} (Princeton University Press, Princeton 2005) 135.
  \item \textsuperscript{138} ibid.
\end{itemize}
competitive process from degenerating into a debacle.\textsuperscript{139} This stabilising force may take many forms, as observed by Trachtman;

The difference between centralization and hegemony as regards stability may be too subtle for some of us, but there appears to be no reason in theory why this hegemonic power must be a state; we have seen the European Union emerge as just such a power in Europe, and it might be argued that the WTO or functional organizations such as IOSCO may play such a role. Alternatively, perhaps the U.S. or EU exercises hegemony through these organizations. Perhaps a dynamic governance structure along the lines of ‘cooperative federalism’ may provide a kind of ‘contingent centralization’ that can maintain stability.\textsuperscript{140}

The geo-politically dominant national governments have chosen issue-specific multilateral organisations as their never wholly independent arbiters, with the result that the authority of these organisations has grown.\textsuperscript{141}

2.4.2 Regulatory Arbitrage and the International Setting

A regulatory arbitrage opportunity may be said to exist when regulated or potentially regulated entities are able to obtain a risk-free advantage in making choices between or among regulatory environments.\textsuperscript{142} Regulatory arbitrage opportunities may be seen as a


\textsuperscript{140} Trachtman (n91) 17.

\textsuperscript{141} Keohane (n122) 5. The emergence of cooperative networks is discussed below at 2.4.3, while specific organisations, including the FATF, FSF and OECD, are discussed in section 6.5.2.

function of mobility. The differential mobility among factors of economic production may be viewed as an ordering device that determines which factor is subject to the highest degree of competition. By way of example, capital is considered to be more mobile than labour, while labour is generally more mobile than a factory. As a result, there will be greater competitive pressures to attract the more mobile factors, such as capital. In this regard, technological developments and the advancement of telecommunications have played a pivotal role in facilitation of the mobility of capital and, in turn, the development of globalisation of financial services. Seen from the perspective of suppliers of mobile factors, the mobility that facilitates competition between jurisdictions also allows the implementation of strategies involving regulatory arbitrage.

The existence of spatial and geographic factors are fundamental to the mobility of capital. In this regard, the evolution of the financial services sector in the Cayman Islands, which will be fully discussed in Chapter 4 of this work, provides an example of the critical nature of communications. It is worth noting for present purposes that the early phases of the development of Cayman Islands in 1960s may be linked in part to its access to reliable telecommunication which facilitated wire transfers and the

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143 Differential mobility is discussed in section 4.2.1.
145 ibid.
147 That is, market participants are able to make ‘risk free’ choices between regulatory environments in order to obtain competitive advantage.
booking of financial transactions, thus facilitating the growth of its banking sector.\textsuperscript{148}

Without this accessibility, other factors contributing to this development including the Cayman Islands tax-free status and the enactment of relevant legislation by the Cayman Islands, may have had limited impact.

There is another element that is critical to regulatory arbitrage in the international setting. This element is the interconnectedness of onshore and offshore. It is evident by the observation that the private-sector actors in offshore jurisdictions are closely linked to, and in some cases identical to those in the onshore jurisdictions. In this regard, lawyers in onshore jurisdictions acting in a manner consistent with the regulatory dialectic,\textsuperscript{149} were pivotal in the identification of opportunities for regulatory symbiosis and the emergence of OFCs.\textsuperscript{150} They were also instrumental in the development of the legal frameworks required to provide an operational ‘coupling’ of onshore and offshore regulatory jurisdictions in order to facilitate regulatory arbitrage and the mobility of capital.\textsuperscript{151} The role played by these private sector actors extended to

\begin{flushleft}
\textsuperscript{148}Picciotto (n42) 108. In this regard, in 1966 the Cayman Islands became famous for having the most telex machines per capita in the world. Cayman Islands Department of Tourism ‘Communications’ \url{http://canada.caymanislands.ky/services/communication.asp} accessed 21 February 2008; M Craton and Cayman Islands. New History Committee, \textit{Founded Upon the Seas: A History of the Cayman Islands and their People} (I. Randle Publishers, Kingston Jamaica 2003) 355.

\textsuperscript{149}The regulatory dialectic refers to the tension between the regulator and the regulatee and is discussed in section 4.0.2.a

\textsuperscript{150}The concept of regulatory symbiosis is used to describe a collaborative relationship between the regulator and the regulatee in which such collaboration provides greater benefits for each than could be achieved without such collaboration. The Cayman Islands as an example of regulatory symbiosis is discussed in section 4.4. \textit{Picciotto} (n42) 121.

\textsuperscript{151}YM Dezalay and G Bryant, ‘Law, Lawyers, and Empire: From the Foreign Policy Establishment to Technical Legal Hegemony’ (2006) \url{http://ssrn.com/abstract=947633} accessed 28 January 2008; EJ Kane, ‘How Offshore Financial Competition Disciplines Exit Resistance by Incentive-Conflicted Bank-Regulators’ 16 (1999) 16 Journal of Financial Services Research 2, 275. The dialectic model of competitive de-regulation states that as regulations become burdensome, financial institutions will be tempted to circumvent the regulation by innovation. In response, the regulator will then change the regulation to best achieve the regulator’s initial objectives.
\end{flushleft}
drafting legislation, as well as to persuading the rule-makers to enact the laws which would form the legal framework for offshore financial activity which in turn brought benefits to the relevant OFC economy as well as to the lawyers. This is consistent with Tiebout’s premise that local governments are profit-maximising. In addition, the role of the lawyers may be viewed as providing improved, if not ‘full knowledge of regulatory costs’, which also resonates with Tiebout’s model. As noted by Picciotto:

…the type of transnational legal practice developed by such lawyer-diplomats essentially involved devising legal forms for business which could accommodate the interaction of regulatory jurisdictions, and negotiating the limits of acceptability of such forms with relevant state officials.

Thus, the advice of unpaid legal advisors guided the Cayman Islands to enact its Bank and Trust Law in 1966 that, history has shown, played a key role in the development of the Eurodollar market in London.

There is another context in which regulatory competition in the international setting may be viewed. That involves competitive de-regulation. The removal by onshore jurisdictions of regulatory barriers such as exchange controls, tariffs and quotas during the 1970s and 1980s gave rise to a more open international economy

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152 The role of lawyers in the evolution of the Cayman Islands as an OFC in discussed in section 4.2.1 in text around note 507.
153 Discussed in section 4.2.1.
154 Discussed in section 2.2.7.
155 Discussed in section 2.2.2.
156 Picciotto (n42) 106.
facilitating capital mobility and greater interaction between regulatory regimes.\textsuperscript{158} This in turn facilitated increased mobility of business and a related increase in the use of OFCs by business.\textsuperscript{159}

### 2.4.3 To Cooperate or to Compete?

The absence of regulatory coordination among jurisdictions gives rise to regulatory arbitrage and, perhaps inevitably, to the migration of business activity away from some states. The potential for such loss of business resulting from arbitrage has compelled the re-evaluation of national regulatory regimes even among jurisdictions with well-established regulatory structures.\textsuperscript{160}

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It is noteworthy in this context that the mobility of a factor may be determined not only by its physical attributes, but also by the rules which govern it. That is, in certain contexts functional mobility may only exist if jurisdictional outcomes are capable of being manipulated through changes in legal domicile or notional location.\textsuperscript{161} Seen from this perspective, regulatory competition may be viewed as ‘the competition of the immobile factor for the mobile factor’.\textsuperscript{162}
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\textsuperscript{158} B Eichengreen, ‘Taming Capital Flows’ (2000) 28 World Development 6, 1108. The evolution of the Cayman Island OFC and BVI OFC is discussed in section 4.2.1 and section 5.3.1 respectively.
\textsuperscript{159} Bratton (n41) 2.
\textsuperscript{160} Easterbrook (n51) 2.
\textsuperscript{161} Musgrave (n144) 61, 64.
…the arbitrage of consumers and firms will clearly reveal which national regulatory system is best in the eyes of the consumer or the producer: national regulation has to pass a litmus test of private agents voting with their purses and with their feet. Accordingly, there will be pressure on national regulations to adjust over time.\(^\text{163}\)

Jurisdictions may choose to adopt a centralised approach and cooperate in seeking to ameliorate regulatory conflicts. Alternatively, jurisdictions may choose to adopt the decentralised approach advocated by Tiebout and engage in regulatory competition. The debate in the literature has similarly become polarised between advocates of regulatory competition and those of regulatory cooperation. One camp proposes that regulatory harmonisation will facilitate more open markets that minimise ‘non-tariff barriers’ between jurisdictions and mitigate against competitive, welfare-reducing under-regulation.\(^\text{164}\) A second camp argues that competition between jurisdictions produces welfare gains and leads to regulatory standards of varying stringency that match the needs and desires of each jurisdiction.\(^\text{165}\) The central questions for profit-maximising jurisdictions in determining the appropriate course of action in this two-option model may be viewed as: will regulatory competition produce enhanced value and widespread gains? Alternatively, will cooperation give rise to the harmonisation of standards and produce better results than regulatory competition?

More recently, a third option has emerged which posits that in an international setting neither absolute regulatory competition nor absolute regulatory harmonisation

\(^{163}\) ibid.
\(^{164}\) Discussed in the context of the Delaware Paradigm in section 2.3.
are viable in the context of regulatory conflicts.\textsuperscript{166} Rather, given that regulatory arbitrage reflects the activity of actors outside the jurisdiction, then some degree of coordination and cooperation is desirable. However, such cooperation should allow for some degree of heterogeneity between regulatory policies.\textsuperscript{167}

Termed ‘regulatory co-opetition’ by Esty and Geradin, this approach encompasses the dynamics of interactions among governments at all levels in the context of competition and cooperation.\textsuperscript{168} Lomas suggests that given the existence of cross-border externalities, the need for some level of regulatory collaboration at an overarching level is not disputed among academics.\textsuperscript{169} Rather, it is the pervasiveness and scale of such collaboration that is not agreed.\textsuperscript{170} Sykes indicates that the essential question should be, ‘to what extent should regulators cooperate with regulators in other

\textsuperscript{166} A Sykes, 'Regulatory Competition or Regulatory Harmonization? A Silly Question?' (2000) 3 Journal of International economic law 2, 257. Further, the desirability of regulatory competition does not preclude the desirability of regulatory cooperation. By way of example, in the context of the single jurisdiction of the US, federal environmental programmes rely on implementation at the state level.

\textsuperscript{167} ibid. By way of example, regulators may agree principles of deference or covenant relevant to specific transactions or actors in that they may agree to be subject to the laws of a particular jurisdiction or convention.


\textsuperscript{169} O Lomas, 'Environmental Protection, Economic Conflict and the European Community' (1988) 33 McGill Law Journal 506, 515; Britain did not regulate the sulphur emission level of its power plants as the effects of such emissions were primarily felt in Scandinavia until cooperative agreements regulating emission levels were concluded. In a similar vein, Lawrence Summers, past US Secretary of the Treasury who was then at the World Bank issued an internal memorandum indicating that it was economically efficient to allow the migration of ‘dirty’ industries to less developed countries. Esty (n168) 10.

\textsuperscript{170} ibid.
jurisdictions? Similarly, Trachtman has noted that in the context of international regulatory competition:

Competition and coordination are not mutually exclusive: fiscal competition needs rules of the game that can only be established through cooperation. Cooperation in the form of market facilitating regulation at an international level is necessary to achieve the benefits of competition.  

The benefits of cooperation between governments are many. Alexander Schaub, then Director-General for Competition in the EU identified some of these benefits:

A multilateral (for instance within the WTO) or bilateral arbitration mechanism (and to a greater degree a global antitrust authority), which would allow us to resolve case related conflicts and go beyond the limitations imposed by the necessity for each competition authority to implement its own legal rules and to take primarily account of the specific market conditions and the consumer interests in the territory it polices, is inconceivable under current circumstances. We must therefore admit that we can profitably co-operate with our partners in the majority of cases and accept that there will exist infrequent situations where our approaches may diverge.

Nonetheless, it should be noted that, at least at the extremes, cooperation limits the scope for regulatory competition and thereby may reduce the potential benefits

\[171\] Sykes, (n166) 257.
available from such competition.\textsuperscript{174} Optimising the mix of cooperation and competition continues to present a challenge.

### 2.4.4 The Emergence of Cooperative Networks

The perceived threat posed by global mobility has prompted regulators to develop new modes of international coordination.\textsuperscript{175} The empirical evidence indicates that jurisdictions generally resort to cooperation as a means to obviate and to resolve regulatory conflict. As noted by Picciotto,

> Concerns about regulatory conflict are generally linked to consideration of the desirability of coordination by central intervention in a federal system or by regulatory harmonization through regional or international institutions.\textsuperscript{176}

The processes of diffusion of regulatory conflict are strongly influenced by complex social and political considerations. States seeking to neutralise the effects of regulatory arbitrage while retaining as much of their individual regulatory characteristics as possible will be inclined to consider the approach to regulatory coordination that generates symbiotic benefits but that does not necessarily replace

\begin{footnotesize}
\textsuperscript{174} Benefits are discussed in section 2.1.1.
\textsuperscript{175} Bratton (n41) 9.
\end{footnotesize}
competition. In some contexts, this has resulted in the formation of institutions focused on issues of regulatory coordination. Indeed, with the growing influence of the forces of globalisation, the mandates and presumed competencies of certain multilateral organisations have expanded to include areas that were generally considered to be the legislative responsibility of national governments. Correspondingly, the profiles of these multilateral organizations, such as the WTO, the IMF and the Basle Committee, have been increased. Although, this thesis has hedge funds as its principal preoccupation, the broader questions of governance are readily detected in the narrative and analysis.

The increase in density of these networks has given rise to the perception of the world as a global market place for mobile financial flows and for opportunistic positioning within the multilateral networks. In an international context, institutional ‘networks’ are generally coordinated at a national-level through semi-formal arrangements that provide connections to various regulatory communities. In this regard, and as noted above, these networks of coordination have not replaced competition between states but have provided, to some degree, an additional dimension for the dynamics of competition. In this realm where there is ‘competition among

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178 Stein (n122) 63; Picciotto (n42) 92. Two examples of these institutions of coordination are the OECD and the IOSCO.
179 Keohane (n122) 3.
180 Gstöhl (n126) 4.
182 ibid.
183 ibid.
rules’, the question of who determines the rules for competition becomes an important focus.184

2.4.5 The Dynamic Process of Regulation in the Context of International Networks

Interaction between jurisdictions has facilitated innovative transnational regulatory practices developed for individuals in the context of private banking.185 The success of these practices, in turn gave rise to the more common usage of techniques and devices that identify and utilise selected regulatory structures in order to deliver what the relevant actors view as the best value at the lowest cost.186

The intensification of processes applied by private-sector actors for identifying regulatory conflicts and overlaps employed by market participants resulted in systematic regulatory arbitrage.187 As observed by Picciotto,

...tailor-made devices such as the Vesteys’ trust/corporate structures of the 1920s became transformed into standardized formats such as off-

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185 P Knightley, The Rise and Fall of the House of Vestey: The True Story of How Britain’s Richest Family Beat the Taxman - and Came to Grief (Warner, London 1993); S Picciotto, International Business Taxation: a Study in the Internationalization of Business Regulation (Weidenfeld and Nicolson, London 1992), 100-102; Picciotto (n42) 109. The Vestey brothers, whose businesses were based on distribution of beef from Argentina using cold storage, developed an elaborate family trust and corporate structure that allowed them to avoid double taxation.
186 ibid, 110. By way of example, the use of trust/corporate structure used by Vestey brothers became more routine as the use of off-the-peg offshore corporate vehicles to conduct Eurobond transactions became common practice.
187 ibid.
the-peg offshore corporate ‘vehicle’ for Eurobond flotation, involving large-scale production processed for major operations such as an international M & A (merger and acquisition) deal. Access to the special facilities of ‘haven’ jurisdictions was no longer only for the privileged few, but became available to anyone with the price of a ticket to Geneva or the Cayman Islands.\(^{188}\)

In response to the mounting pressure and complexity of increasing arbitrage activity, and in the hope of mitigating further regulatory arbitrage, regulators with specified functional responsibility developed cross-border contacts with their regulatory counterparts in other jurisdictions.\(^{189}\) In this regard, regulation may be viewed as a communicative process where the conversations among those involved in the regulatory process play an important role in the evolution and operation of the unfolding regulation.\(^{190}\) Accordingly, ‘discourse analysis’ is a critical element in understanding the evolution of regulation in the international setting.\(^{191}\) As observed by Black, ‘understanding such regulatory conversations is thus central to understanding the “inner life” of that process’.\(^{192}\)

Picciotto notes that the points of contact and links developed by regulators expand most rapidly between ‘power-nodes’ which consequently generates ‘groupings’ that have been shaped by the perceived need.\(^{193}\) These points of contacts and links

\(^{188}\) ibid.
\(^{189}\) ibid, 112. The consequence of this contact at the horizontal level was to effectively by-pass the need for coordination at the national level of government and also bypass the need for the use of the mediation skills of their diplomats.
\(^{191}\) ibid.
\(^{192}\) ibid.
\(^{193}\) Picciotto (n42) 113. As an example of a ‘power-node’, Picciotto notes that the formally structured BIS ‘hosted’ monthly meetings of a ‘grouping’ of representatives of central banks from the Group of 10 countries. This became the power-node which in 1974, following the \textit{cause célèbre} of the Herstatt Bank
evolved into networks of knowledge-based technical regulatory specialists, termed ‘epistemic communities’ by Haas, that in turn created forums or international organisations that are able to influence and constrain fellow regulators. Thus, based on their claim of credibility and authority over particular areas of technical knowledge, these epistemic communities are able to influence policy makers.

Networks provide the fora for the establishment of international organisations that are generally loosely and informally structured. Conventional legal instruments such as treaties are not often utilised. Rather, many of these international organisations are founded on ‘gentleman’s agreements, which are non-transparent. More recently, faced with mounting pressure to formalise their structure, these organisations have shown a preference for less formal formats such as ‘administrative arrangement’ and Memorandum of Understanding (MoU).

National governments seeking to maximise the well-being of their citizens may supply public services up to the point where the marginal costs outweigh the marginal benefits, at least in theory. However, regulatory beliefs about the composition of factors that will maximise the well being of citizens may be influence by subjective collapse, gave rise to the formation of the informally structured Basel Committee on Banking Regulation and Supervisory Practices.

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194 PM Haas, 'Introduction: Epistemic Communities and International Policy Coordination' (1992) 46 International Organization 1, 2. In this context these forums also serve a useful function in countering unilateral assertions.
195 I Maher, ‘Competition Law in the International Domain: Networks as a New Form of Governance’ in S Picciotto and D Campbell, New Directions in Regulatory Theory (Blackwell, Oxford 2002), 120.
196 An exception to this is IOSCO, which utilises a multilateral memorandum of understanding (MMOU) in relation to cooperation among regulators.
197 Picciotto (n42) 112.
198 ibid. Administrative arrangements or MoU implies an intention to not be legally-binding. Examples of these ‘arrangements’ include the Capital Adequacy principles and the Concordat agreed by the Basel Committee, which have no formal legal status but are considered, at least in honour, to be binding.
199 Oates (n65) 378.
regulatory beliefs.\textsuperscript{200} In the context of multilateral organisations, the interactions of subjective beliefs held by diverse regulators may produce competing as well as complementary influences on the market adaptation processes.\textsuperscript{201} Similarly, the absence of regulators representing less powerful jurisdictions in such interactions may influence such processes. There is therefore some concern that the governance of these exclusive regulatory organisations may be institutionally underdeveloped and may produce conflicts of interest or result in a lack of representation from the democratic base.\textsuperscript{202} Indeed, the current international order has been described as having the following attributes: ‘a process of deal-making among sovereign governments and that citizens have next to no place in the system’.\textsuperscript{203} As observed by Picciotto:

\begin{quote}
These networks are seen as the technical specialist as a necessary functional response to both the increased complexity of regulatory problems and their international scope; but their creation outside the established institutional structures of the national state involves new problems of legitimacy. Although the coordinating rules and standards may, with difficulty, be agreed between functional specialists, they are often hard to reconcile with nationally-developed norms and expectations growing out of a denser cultural background and the broader framework of accountability supplied by the national state.\textsuperscript{204}
\end{quote}

\begin{flushright}
\textsuperscript{200} Picciotto (n42) 116.  \\
\textsuperscript{201} ibid.  \\
\textsuperscript{204} Picciotto (n42), 112.
\end{flushright}
The potential for opportunistic and self-interested participants in the networks to take advantage of existing institutions by using them as their points of attachment in forming side links to the benefit of a limited subset of participants, all without regard for formal memberships and organisational structures, also exists.\textsuperscript{205} By way of example, although financial regulators have utilised formal points of contact, as in the case of the Bank for International Settlement (BIS), the primary functional activities notionally within the remit of the BIS are conducted through more informal groupings, such as the G10 Central Bank Governors and Ministers.\textsuperscript{206} In addition, the dominant actors within these already exclusive groupings are able to influence and control negotiated agreements, as was observed in the context of the Capital Adequacy Agreement (CAA).\textsuperscript{207} In that regard, Kapstein observed that the impetus for the CAA came from Paul Volker, the Chairman of the Federal Reserve, who approached Governor Leigh-Pemberton of the Bank of England (BoE) directly, by-passing Peter Cooke who was the then representative for the BoE on the Basle Committee.\textsuperscript{208} The potential effect of this bilateral arrangement between the US and the UK was perceived as a threat by Japan, France and Germany, which would have been relegated to the ‘zone of exclusion’ had they not accepted the joint US-UK proposal. As a result of this perceived threat, these ‘captured’ jurisdictions accepted the CAA.\textsuperscript{209} This indicates

\begin{itemize}
\item \textsuperscript{205} ibid.
\item \textsuperscript{206} ibid. The Basel Committee on Banking Regulation and Supervisory Practices involves banking supervisory agents from the G10, Luxembourg, and Switzerland, as well as senior officials from central banks. In this regard, the internal working of the Basle Committee has been secretive, although its output is published, with notable examples including the Concordat of Principles and the Capital Adequacy Agreement.
\item \textsuperscript{208} ibid.
\item \textsuperscript{209} ibid.
\end{itemize}
that, within the context of multi-lateral arrangements, the range of regulatory options available to national regulators may be limited at the outset by institutional constraints or factors giving rise to bargaining strengths and weaknesses. As observed by Strange:

The *dynamic* character of the ‘who-gets-what’ of the international economy, moreover, is more likely to be captured by looking *not* at the regime that emerges on the surface but underneath, at the bargains on which it is based. By no means all of these key bargains will be between states. For besides those between states and corporate enterprises, or between corporations and banks, there will be others between corporations and labor unions, or between political groups seeking a common platform on which to achieve political power. Having analyzed the factors contributing to change in bargaining strength or weakness, it will be easier then to proceed to look at the outcome with less egocentric and value-biased eyes.  

Informal organisations may also ‘grow’ more formal institutions as well as links with the technically versed professional sector. A notable example that emerged from the collapse of barriers between the banks and the ‘non-banks’ and related capital adequacy concerns is the grouping of financial market regulators that formed the more visible and formally structured International Organisation of Securities Commissions (IOSCO). In turn, given that securities markets’ disclosure requirements are related to accountancy standards, IOSCO’s technical committee formed strong links with the International Accounting Standard Committee (IASC), a grouping of professional bodies in more than 80 countries, to produce acceptable

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211 Picciotto (n42) 115.
212 ibid. IOSCO was initially started as an inter-American group in 1976 and became global in 1983. The role of IOSCO in OFCs is discussed in sections 4.1, 5.2 and 5.3.
accounting standards. Similarly, the less formally structured Basel Committee as well as various EU bodies have used their interaction with IOSCO to achieve compatibility in capital adequacy rules. Further, IOSCO’s endorsement of a proposal is generally perceived as a useful negotiating tool in navigating cross-border tensions. Other organisations have also evolved influence.

The Organisation of Economic and Developing Countries (OECD) takes a role in monitoring international capital markets and, by so doing, provides another point of linkage. Concern over the use of the banking system for money laundering among OECD members was the cause célèbre that became the impetus for the formation of Financial Action Task Force (FATF), a body with a membership that overlaps that of the OECD. The FATF in turn developed a series of ‘recommendations’ that are now applied beyond the G7 countries, specifically they are applied in OFCs. However, the FATF utilised controversial strategies such as ‘naming and shaming’ and ‘black listing’ to overcome resistance from non-member vested interests and achieve its objectives.

The increasing density in the network of transnational regulatory arrangements has created a ‘global arena’ for the debate of regulatory issues, the formulation of

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213 B Steil, *International Financial Market Regulation* (Wiley, Chichester 1994), 222-4; Standard-setters are discussed in sections 6.1.1, 6.2.1, 6.2.2 and 6.5.1
214 ibid.
215 ibid.
216 The OECD was established in 1961 and has a membership of 30 countries. Goodhart, ‘Discussion’ in J Fingleton and D Schoenmaker, *The Internationalisation of Capital Markets and the Regulatory Response* (Graham & Trotman, London 1992) 104; Goodhart notes that specialists prefer the less political and more formal forum of IOSCO.
218 ibid.
international principles, and the negotiation of enforcement. However, the actors in this arena remain influenced by the interests of their national regulatory systems. As a result, efforts to coordinate national regulatory systems are, effectively, battles between national interests, groupings, and alliances. Political resonance becomes a key part in this competition and the involvement of politicians may be used to give a specific issue a more serious imprimatur, as was demonstrated by the use of the G7 for the money laundering issues.

Nonetheless, despite the success of multilateral coordination as evidenced by the growth in the network of international organisations and the significant influence they have in the international setting, national regulation remains dominant. National regulation also remains a key factor in corporate strategies and this is particularly so in the area of financial services. Further, and as observed by Kapstein, regulatory agreements made at the multilateral level continue to rely on national regulators to implement them, suggesting that ‘home-country rule’ will become the global norm.

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219 Picciotto (n42) 120.
220 ibid.
221 ibid.
222 That is, at least for the dominant states.
224 Kapstein (n207) 118. This observation is also consistent with the EU where there has been a trend toward mutual recognition of national regulations rather than full harmonisation. ‘Home country rules’ in the context of the EU Saving Directive (EUSD) is discussed in section 4.3.6.a.
2.4.6 Competitive Devices in a Multi-Lateral Setting

Trachtman views competition for the allocation of regulatory authority as a core issue within the international setting.\(^225\) In this context, recognition diminishes barriers to trade and is essentially a choice of which laws prevail in regulating the underlying transactions.\(^226\) By way of example, provisions for harmonisation and mutual recognition of regulation in international agreements may be viewed as rules establishing regulatory authority.\(^227\) In this regard, competitive advantage in the allocation of regulatory authority may be obtained through competitive devices such as ‘negative integration rules’.\(^228\)

Other devices, such as exclusion and non-transparency, may be utilised to gain competitive advantage within the dynamics of multilateral/international organisations.\(^229\) These include the use of global dramas or *causes célèbres* to dramatise a threat and gain political support for measures that may be in the interest of national regulators or the states they represent.\(^230\) In this regard, Picciotto noted that the interconnectedness of the global markets and news media have essentially created a

\(^{226}\) ibid, 5. Trachtman noted that, ‘Recognition is a selection by importing (or host) states of the rule of the home or exporting state, to the exclusion of the rule of the importing state. Pure recognition regimes diminish barriers to trade, by dismantling importing country regulatory barriers.’
\(^{227}\) ibid.
\(^{228}\) ibid; Examples of ‘negative integration rules’ include national treatment or ‘home country’ rules.
\(^{229}\) Keohane (n122) 3. States may be excluded from the negotiations and the negation process may be non-transparent. Keohane opined that maintaining the confidentiality of the negotiations resulted in a domestic policy that was easier to manage and was in the collective best interest of the negotiators. In this regard Michael Zürn observed that under such conditions ‘the opportunity of strategic manipulation of information is wide open to decision-makers’. M Zürn, ‘Multilevel Governance: On the State and Democracy in Europe’ in M Albert, L Brock and KL Wolf (eds), *Civilizing World Politics: Society and Community Beyond the State* (Rowman & Littlefield Publishers, Lanham MD 2000) 164.
\(^{230}\) Picciotto (n42) 117. Emotionally resonant words such as *Harmful Tax Initiative, Unfair Tax practices, anti-money laundering* are also used to intensify the global dramas or *causes célèbres*. 
‘global stage’ for these dramas and that national regulators, motivated to put their own concerns on the international agenda, can use deliberate moves to heighten their issue of concern.\textsuperscript{231} As noted above in the instance of the Capital Adequacy Agreement, other devices to gain agreement may include the threat of exclusion or, in the instance of the FATF, the threat of black-listing.\textsuperscript{232} Other more-nuanced devices may include white listing or non-white listing, recognition or non-recognition, the establishment of principles or standards that give the dominant jurisdiction a competitive advantage, and the imposition of different time scales for the compliance with newly designed standards.\textsuperscript{233} The mosaic formed by the usage of these devices paints a fairly clear scene which supports the conclusion that the opportunities for regulatory competition within cooperative multilateral organisations are many. In Chapters 4, 5 and 6 of this work, the manner in which such opportunities may be exploited is illustrated.

\textsuperscript{231} ibid.
\textsuperscript{232} Discussed further in section 6.5.2.
\textsuperscript{233} The designation of equivalence of anti-money laundering among EU member states may be viewed as an example of white listing. HM Treasury, ‘JMLSG Money Laundering Guidance Notes for the Financial Sector Equivalence Status of Other Countries’ <http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2000/press__131_00guid.cfm> accessed 12 February 2008. IOSCO also imposed a shorter timeline for compliance with its multilateral MoU and adoption of standards on the BVI and the Cayman Islands than that imposed on OECD countries. Interview with Mr Langston Sibley, Legal Advisor to CIMA and Ms Heather Smith, Deputy Head Investment and Securities Division of CIMA, (Grand Cayman 22 January 2008). The exclusion of small and developing countries from double tax agreements is noted in C Stoll-Davey, \textit{Assessing the Playing Field: International Cooperation in Tax Information Exchange} (Commonwealth Secretariat London 2007) 26.
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CHAPTER 7 – CONCLUSIONS AND THEIR IMPLICATIONS FOR THEORY AND POLICY

7.0 INTRODUCTION

This chapter summarises the answers to the questions which were identified in chapter 1, as well as the implications for both theory and policy flowing from these answers. These questions included the following:

1. Is there evidence that regulatory competition occurs in the context of the provision of domicile for hedge funds? If so, what forms does this competition take?
2. What are the factors that account for the current global distribution of hedge fund domicile, and why is the Cayman Islands the domicile of choice for offshore hedge funds?
3. Do all states enjoy the same latitude for regulatory competition in relation to the provision of domicile for hedge funds? If not, how is such latitude shaped by intrinsic and extrinsic factors?
4. Why do the more powerful onshore jurisdictions competing to provide the domicile for hedge funds not shut down their smaller and weaker competitors?

7.1 THE NATURE OF REGULATORY COMPETITION IN RELATION TO THE DOMICILE OF HEDGE FUNDS

Integral to the concept of regulatory competition as used by Tiebout, Romano, and others, is the recognition that mobility and the threat of exit serves as a discipline in the
context of a regulatory environment in which there are at least two levels, a centralised level and a decentralised level.\footnote{1309} In this context, the centralised level is considered to contribute an element of stability and confidence by guaranteeing key elements such as the freedom of movement between jurisdictions at the decentralised level, while also serving as an arbiter in disputes.\footnote{1310} Regulatory competition may also be viewed in terms of opportunities for regulatory arbitrage which in turn may be viewed as a function of mobility, with differential mobility among factors of economic production serving as an ordering metric that determines which factors are subjected to the greatest degree of competition.\footnote{1311} Accordingly, hedge funds as collective investment schemes, capital aggregation mechanisms, and conduits for highly mobile capital, attract intense competition.\footnote{1312}

Regulatory competition for the provision of domicile for hedge funds that operates at the international level does not adopt the same forms generally associated with regulatory competition as described by Tiebout, Romano and others in the context of single federal states.\footnote{1313} Nevertheless, regulatory competition theory does provide a valuable framework with which to address the dynamic tensions that exist in the context of competition for hedge fund activity at the international level.

\footnote{1310} Discussed in section 2.4.
\footnote{1312} ibid.
\footnote{1313} Tiebout (n1309): R Romano 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 Journal of Law, Economics & Organization 2; Discussed in section 2.3.
In an international context, that is, outside of a single-state federal model, states have greater latitude to restrict or free the movement of potentially mobile factors by a variety of means, specifically because there is no strong central level guaranteeing freedom of factor movement. Thus, borders may be opened or closed by degree with respect to potentially mobile factors, including capital, as well as natural and legal persons.

Historically, this may be seen in the imposition and subsequent relaxation of capital controls by the US and Western European governments.\textsuperscript{1314} It is on the basis of relaxed controls in relation to such capital movements that capital tends to be viewed in the first decade of the 21\textsuperscript{st} century as among the most mobile of factors at least in relation to the states of Western Europe and North America. Put another way, it is on the basis of relative non-regulation that capital attracts intense competition.\textsuperscript{1315}

\section*{7.2 Evidence of Regulatory Competition in Relation to the Domicile of Hedge Funds}

The evidence examined in relation to the first question asked in the present work indicates that regulatory competition does exist in regard to the provision of domicile

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for hedge funds. As noted in Chapters 4, 5 and 6, such competition may take on a number of forms including, innovation\textsuperscript{1316} the emulation of other jurisdictions regulatory environments,\textsuperscript{1317} recognition or non-recognition of other jurisdictions,\textsuperscript{1318} and the systematic undermining of other competitors’ positions utilising techniques, such as black-listing or non-white listing that contribute to the relative regulatory advantages of competitors.\textsuperscript{1319}

It is also the case that the utilisation of legal and economic constructs, such as onshore and offshore hedge funds as vehicles for the application of mobile capital, is also the result of a particular regulatory stance relating to the recognition of such constructs.\textsuperscript{1320} In that sense, international competition for hedge fund activity in a multi-state model is a function of the latitude given to the recognition of foreign hedge fund structures.\textsuperscript{1321} This is particularly the case in relation to the activities of institutional investors including pension funds, which in one sense are bound to the jurisdiction in which the economic activity giving rise to the underlying pensions occurs and from which they derive their legal personality, yet such investors are

\textsuperscript{1316} Regulatory innovation is discussed in section 2.1.2.
\textsuperscript{1317} By way of example, the Cayman Island’s emulation of Delaware’s corporate legislation and the Bahamas banking legislation is discussed in sections 4.0.2.
\textsuperscript{1318} Discussed in section 2.4.5.
\textsuperscript{1319} The three-pronged initiative serves as an example and is discussed in section 6.5.2.
\textsuperscript{1320} That is, in the international context the mobility of a factor may be viewed as a function of jurisdictional rules in that a factor is only functionally mobile if jurisdictional outcomes are capable of being manipulated through changes in legal home or notional location. Musgrave (n1311). Jurisdiction rules as a factor of mobility are discussed in section 2.4.3.
\textsuperscript{1321} ibid. In this context, as observed by Kapstein, national rules continue to dominate the regulatory dynamics. Discussed in section in text to note224. EB Kapstein, Governing the Global Economy: International Finance and the State (Harvard University Press, Mass 1994) 145.
granted extensive latitude in selecting the domicile of entities in which they choose to invest.\textsuperscript{1322}

The mobility of factors of economic production, including capital and the vehicles of capital deployment including hedge funds, as well as other factors including natural and legal persons, may also be a function of the application of specialist knowledge and skills.\textsuperscript{1323} Thus, integral to the execution of regulatory arbitrage in relation to the movement of capital, as well as arbitrage related to the vehicles used by capital and other mobile elements, is the role of lawyers. Individual lawyers, as well as networks of lawyers, serve in this context as the medium for information flows including such flows as relate to the identification of opportunities for regulatory symbiosis.\textsuperscript{1324}

The roles of lawyers and other experts in relation to the competition for hedge fund activity are not restricted to interpretation and advice based on existing regulation. Rather, these actors frequently assist with the design and the development of the legal frameworks required to facilitate mobility and provide for an effective ‘coupling’ between regulatory jurisdictions and potentially mobile factors of production.\textsuperscript{1325}

\begin{itemize}
\item \textsuperscript{1322} ibid.
\item \textsuperscript{1323} This is consistent with Tiebout’s assumption of ‘full knowledge of regulatory cost’ as discussed in section 2.2.2.
\item \textsuperscript{1324} Regulatory symbiosis is discussed in section 2.4.2 at note 150 and section 4.4. Regulatory arbitrage is also discussed in section 2.4.2.
\end{itemize}
7.3 Factors Accounting for Global Distribution of Hedge Funds

Hedge funds pursue absolute returns and accordingly employ dynamic investment strategies rather than static trading strategies. This contrasts with more traditional collective investment schemes that pursue relative returns. The wide variety of transactions from which hedge funds seek to extract profit requires them to adopt legal structures with comparable latitude and suitability with respect to the transactions in which they engage. These structures include corporate vehicles, partnerships, and trusts. Hedge fund organisers therefore seek out jurisdictions that have laws that make these forms available.

The global diversity of hedge funds investors presents unique regulatory challenges for hedge funds in implementing legal structures that are able to deliver the benefits of economies of scale while meeting the collective investment objectives of diverse investors with equally diverse regulatory and tax requirements. Accordingly, some of the key factors that hedge funds consider in selecting a jurisdiction, and that jurisdictions, in turn, consider in relation to attracting hedge funds, include spatial or geographic factors as well as trust or confidence factors.

1326 ‘Dynamic strategies’, ‘relative returns’, and ‘absolute returns’ are discussed in section 3.1. However it should be noted that there appears to be some recent evidence of convergence between the risk profiles as traditional collective investing schemes have taken on more risk and hedge funds have undertaken less risk. This change may be as a result of improvements in risk management systems, coupled with greater transparency in the industry that provide more information and facilitates better analysis. D-L Kao, ‘Battle for Alphas: Hedge Funds versus Long-Only Portfolios’ (2002) 58 Financial Analysts Journal 2. Discussed in section 3.1.

1327 ‘Qualified investors’ is discussed in sections 3.5.1, 4.3.2.d, 5.2.10.a, 5.3.9.b 6.1.3, 6.1.4.c.i, 6.2.2, and 6.4.of this work. RS Zarin and WP Zimmerman, ‘Overview of Hedge Fund Tax Structures’ (2006) 7 Journal of Investment Compliance 1.
Spatial or geographic factors include, the convenience of the location, acceptable technological and communication infrastructure, and the availability of the skilled professionals necessary to carry out the required functions.\textsuperscript{1328} Trust or confidence factors include, traditions of fiscal neutrality, and the availability of flexible regulatory and legal structures that best match the needs of the investors as well as the needs of the investment portfolio.\textsuperscript{1329}

There are other related trust and confidence factors, the effects of which are less clear and less direct, but that nevertheless appear to be considered by hedge fund promoters when analysing jurisdictional risk.\textsuperscript{1330} These include factors such as the extent to which the laws and regulations of a jurisdiction provide for commercial certainty over the expected life of the hedge fund, and the extent to which there is trust in the stability of the jurisdiction largely determined by the quality and independence of the judiciary.\textsuperscript{1331}

However, merely providing the legal and commercial framework required by hedge funds is not sufficient to allow a jurisdiction to successfully compete for hedge fund business. Just as the possession of eggs, sugar and chocolate does not make a soufflé, so the factors which combine to create an environment in which hedge funds would choose to operate must be delicately balanced and blended. How then has the Cayman Islands come to be the domicile of choice for hedge funds?

\textsuperscript{1328} Discussed in section 3.9.2 and 4.4.
\textsuperscript{1329} Discussed in section 3.1.
\textsuperscript{1330} The key factors hedge funds consider is discussed in section 3.9.2.
\textsuperscript{1331} ibid.
7.4 THE CAYMAN ISLANDS AS THE DOMINANT CHOICE FOR HEDGE FUND DOMICILE

The Cayman Islands has emerged as the dominant choice for the domicile of offshore hedge funds.\textsuperscript{1332} The emergence of a hedge fund sector in the Cayman Islands is undoubtedly attributable to the much earlier evolution of a diversified OFC in the Cayman Islands.\textsuperscript{1333} In that sense, the initial seed of demand for hedge fund structures may be viewed as having fallen on fertile ground in the Cayman Islands.

The regulatory structure that exists in the Cayman Islands was in part shaped by the regulatory dialectic between regulators and regulatees in onshore jurisdictions that gave impetus to the migration of economic factors of production,\textsuperscript{1334} and facilitated the evolution of the Cayman Islands OFC.\textsuperscript{1335} In effect, the evolution of the Cayman Islands OFC may be linked to elements of serendipity and the prescience of those within the Cayman Islands,\textsuperscript{1336} combined with a conflation of spatial or geographic factors with trust and confidence factors made widely recognised by networks of professionals.\textsuperscript{1337}

If it is assumed that the selection of Cayman Islands domicile by so many hedge funds reflects an efficient market for hedge fund domicile, in which numerous

\begin{itemize}
\item \textsuperscript{1332} Discussed in 4.3.6.
\item \textsuperscript{1333} Discussed in 4.0.2.
\item \textsuperscript{1334} Discussed in 4.0.2.a.
\item \textsuperscript{1335} Discussed in section 4.1.
\item \textsuperscript{1336} Discussed in section 4.2.1 in text near note 149.
\item \textsuperscript{1337} Discussed in section 4.2.1.
\end{itemize}
rational hedge fund operators have made independent informed choices, then questions of whether the choice of the Cayman Islands indicates an arbitrage opportunity and how the Cayman Islands best mitigates the risks faced by hedge funds arise.

The analysis set out in this thesis indicates that there are four core reasons why the Cayman Islands dominates the market of hedge fund domicile. These are, firstly, the benefits of ‘path dependence’ and ‘early mover advantage’ in the offshore hedge fund domicile market;\textsuperscript{1338} secondly, the fiscal/tax-neutral status of the Cayman Islands;\textsuperscript{1339} thirdly, the ‘institutional thickness’ and the body of professional experience and its reputation for excellence;\textsuperscript{1340} and fourthly, the pre-commitment of the Cayman Islands’ regulator to responsive regulation as well as the alignment of the regulator’s interest with that of the regulatee’s regulatory preferences and the resulting will to deflect and resist competitive pressures in order to maintain commercial certainty.\textsuperscript{1341}

OFCs have been the objects of some negative comments by their onshore competitors and the multilateral instruments of such competitors in the forms of various international organisation.\textsuperscript{1342} In this context it is particularly interesting to note the use of the Cayman Islands structures as conduits for the efficient deployment of capital by various onshore governmental agencies and global governance bodies including the World Bank and its contributor OECD countries.\textsuperscript{1343} This observation would appear to undercut their rhetoric.

\textsuperscript{1338} First-mover advantage is discussed in section 2.3 and 4.1.2.
\textsuperscript{1339} Discussed 4.4.4.
\textsuperscript{1340} Discussed in section 4.4.2.
\textsuperscript{1341} Commercial certainty is discussed in section 4.4.3 and trust and confidence factors in section 3.9.2.b.
\textsuperscript{1342} Discussed in the context of the three-pronged initiative in section 6.5.2.
\textsuperscript{1343} Discussed in section 6.5.5.
7.5 The Available Latitude for Regulatory Competition

Regulatory competition is in one sense a function of the degree of regulatory porosity of borders and mobility of factors of economic production. That being said, for any given degrees of relevant porosity and mobility, all states do not enjoy the same latitude for regulatory competition in the hedge fund sector. In some jurisdictions there are unique practical internal constraints. Other jurisdictions face constraints imposed by foreign states. Specifically, certain jurisdictions coordinate their activities to restrict the competitive latitude available to other jurisdictions.

Latitude for regulatory competition may also be seen as a proxy for the degrees of flexibility, in relation to structuring, that are available to the operators of hedge funds. A demand for latitude extends to the options that hedge fund operators have in relation to hedge fund domicile. Jurisdictional stability, and its correlate commercial certainty related to regulatory environment, may also be viewed as functional constraints on latitude. That is, it is latitude in practice rather than in theory that is relevant to the operators of hedge funds.

1344 Discussed in sections 2.2 and 4.0.2.c.
1345 By way of example, it is unlikely that either the US or the UK, could as a matter of practical politics, eliminate their direct tax structures in order to emulate the Cayman Islands.
1346 Capital Adequacy Agreement (CAA) is discussed in section 2.4.5 and the three-pronged initiative in section 6.5.2.
1347 Discussed in section 3.10.3.
1348 ibid. Discussed also in section 2.3.1 at note 114.
Small jurisdictions are generally excluded from the exclusive clubs which seek to act in a role functionally analogous to centralised regulatory governance in matters affecting international regulatory competition.\textsuperscript{1349} Thus in an international context, small offshore jurisdictions may be viewed as having their role access restricted to positions analogous to those at the lower or decentralised level as described by Tiebout in a single federal state. In that regard, small jurisdictions may be seen as competing at least in part, utilising the constrained latitude which they are given by more powerful jurisdictions operating within cartels or clubs at the analog of the centralised level. In that context, small jurisdictions are constrained to design their laws for regulating commerce while operating under the umbrella of the de facto centralised ‘soft-governance’ rules established by the multi-lateral organisations which are controlled by conflicted competitors.\textsuperscript{1350}

 Nonetheless, it is noteworthy that offshore jurisdictions, as smaller and, at least potentially, less politically complex jurisdictions relative to their onshore counterparts, are perceived as more nimble and more able to respond to changes that may be required in their regulatory environments in order to deliver enhanced value.\textsuperscript{1351} In this regard, the dynamics of the relationship of mutual power of profit-maximising hedge funds and the profit-maximising governments of OFCs such as that of the Cayman Islands, helps to build cooperation that generates successful results.\textsuperscript{1352} Romano observes that this mutual dependency gives rise to what may be viewed as a bilateral

\textsuperscript{1349} Discussed in section 2.4.2.
\textsuperscript{1350} Discussed in section 2.4.4.
\textsuperscript{1351} Small jurisdictions’ pre-commitment to a faithful course of responsive regulation is discussed in section 2.3 at note 60 and section 4.4.
pre-commitment to remain faithful to the needs of hedge funds and governance, which makes it difficult for other states to compete.\textsuperscript{1353} That is not to say that the consequences of defection are proportionate for the two sets of actors sharing mutual power. Hedge funds may have a relatively easy time relocating to other jurisdictions while small jurisdictions that provide domicile for hedge funds may have relatively few options in relation to replacing revenue streams associated with hedge fund activities.

The position of larger, economically diversified and more complex onshore jurisdictions differs from that of small OFCs. While such jurisdictions may be in a position to attempt to dictate standards for the use of hedge funds, they are unlikely to have the same latitude in their responsiveness to hedge fund demands. How then are the latitudes available to onshore and offshore jurisdictions reflected in their practices?

7.5.1 Regulatory Competition Measures Employed by Offshore Jurisdiction

The theoretical latitude for legislation and regulation available to sovereign states is in one sense functionally irrelevant in relation to identifying which measures are likely to be employed by small offshore jurisdictions competing for the domicile of hedge funds. This is so for at least three reasons.

The first is empiric. The most successful competitors in this area are non-sovereign jurisdictions.1354

The second is that regulatory competition, which is effective in the sense of attracting and retaining economic activity, may be said to be a function of arbitrage for which the metric is economic, rather than sovereign capacity. That is, assuming that economic actors act in a self-interested and rational manner, then mobile factors of economic production may be expected to move in response to regulatory differentials if such a movement is perceived as offering a greater risk-adjusted rate of return. It may therefore be expected that any regulatory measures adopted by offshore jurisdictions on the basis of rational analysis and intended to attract hedge fund activity, may relate either to perceived costs or risks identified within particular other jurisdictions, or such costs or risks identified in relation to moving capital between or among jurisdictions.

Financial markets function in part as mechanisms for the allocation of capital and risk to capital.1355 Innovations that allow such mechanisms to operate more efficiently are perceived as producing global benefits,1356 and as observed by Bratton,

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1354 By way of example, the Cayman Islands, Bermuda and the BVI are British Overseas Territories and are not sovereign states. Discussed in sections 4.2.2, 5.2.2 and 5.3.2 respectively.
1356 ibid.
as enhancing economic welfare. Efficiency in this regard may be thought of as applying to the distribution of capital as well as to the application of capital.

Small jurisdictions typically have relatively limited capacity to absorb hedge fund investment capital directly. Rather, such jurisdictions tend to be used in order to create structures that may be used for the aggregation of capital and as conduits for the efficient movement of capital between and among jurisdictions. By way of example, the fiscal/tax-neutrality, which is identified as one feature that is attractive to hedge funds, provides for efficiencies, such as a reduction in the wasted cost of tax-compliance (as opposed to the total tax paid), that would then be available to be passed on to investors or other stakeholders. In this context, the interposition of an offshore hedge fund may be said to be allocatively efficient.

The third reason is that noted in section 7.1. Specifically, the practical latitude for competitive measures is a function of the porosity permitted by other jurisdictions, and in particular those jurisdictions that are the sources of capital and the destinations at which capital will be applied in production. Competitive measures that have no interface with ‘pores’ in the jurisdiction of capital origin and the jurisdiction of

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1358 Fiscal neutrality as one of the regulatory requirements of hedge funds is discussed in section 3.9.2.
1359 The efficient allocation of capital, and its benefits that are potentially available to the average consumer, may ultimately help to stimulate economic growth and generate economic stability.
1360 Calomiris (n1355). Allocative efficiency in Tiebout’s model is discussed in section 2.2.7.
1361 The mobility of factors of production is a function of the porosity of national boundaries. As observed by Mayer-Schönberger, ‘In an age in which the application of various anti-discrimination rules has made national boundaries much more porous, the resulting mobility of goods, services, and factors of production necessitates national regulators to respond to the challenges posed by the régimes of their neighbours.’ V Mayer-Schönberger and A Somek, ‘Governing Regulatory Interaction: the Normative Question’ (2006) 12 European Law Journal 4.
efficient capital application are futile. This is consistent with the conduit nature of hedge funds domiciled in OFCs.

7.5.2 The Indirect Dimension of Regulatory Competition – The Provision of Specialist Workforces

Regulatory competition for hedge fund activity also has an indirect dimension relating to attracting, developing and retaining the specialist workforces needed to service this economic sector. Thus, as noted in Chapter 4, when political unrest in the Bahamas created concerns among the specialist financial services workers in that jurisdiction, the Cayman Islands welcomed them. Similarly, Cayman Islands law firms have adopted a deliberate strategy of recruiting ‘brand’ professionals from Magic-Circle firms in London. The Cayman Islands also has a history of recruiting regulatory expertise from onshore regulators.  

Seen from this perspective, the actors in both onshore and offshore jurisdictions are not only very similar and frequently part of a larger network, but may be the same persons. A natural person who is a regulator, lawyer or banker in London one day may be a regulator, lawyer or banker in the Cayman Islands the next. Multinational financial services firms operate across borders in order to serve the demands of institutional investors that operate both offshore and onshore, and frequently straddle multiple

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1362 Discussed in section 4.2.1.
jurisdictions. These actors may also be viewed as being the same in onshore and offshore spaces.

National regulatory institutions are however generally defined by the political and geographical spaces in which they operate. In that sense they are immobile and not the same onshore and offshore. This may not remain the case however. The advent of standard-setting organisations, and mechanisms providing for regulatory recognition, as discussed in section 6.1.4 in relation to the EU, may ultimately serve to allow regulatory spaces to follow commercial activity into foreign political spaces, further blurring the divide between offshore and onshore.

One result of successful regulatory competition aimed at financial services professionals is that practitioners working in the Cayman Islands and other leading OFCs have come to be seen as global specialists whose skills are mobile between OFCs. In effect, these OFCs act as knowledge clusters for the specialist financial markets, and provide a medium for the flow of information between the actors in this sector. It is useful to note that these knowledge clusters do not automatically or efficiently disseminate information throughout a region. Further, the existence of strong knowledge clusters in some jurisdictions and not others that may offer similar legislative frameworks, suggests that local institutional practices and arrangements may do much to help or hinder the growth of such knowledge clusters. Professional companies operating within OFCs strive to develop their own competitive edge by

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1363 Discusses in section 2.4.2.
guarding their operations’ proprietary information and by holding on to key personnel.1364

It is possible that large diversified economies, with divergent and competing constituent interests such as typically exist in onshore financial services jurisdictions, may be unable to maintain a regulatory environment that is, over time, uniquely attractive to a global pool of specialist labour such as that involved in the hedge fund sector.1365 By way of recent example, it may be that, whatever their merits, recent proposals for removing incentives attractive to the financial services sector in the UK may have ignored potential consequences for the hedge fund sector in the UK.1366

7.5.3 Opportunistic Regulatory Competition

Regulatory frameworks are not static. Regulatory competition utilised by offshore jurisdictions involves the monitoring and analysis of the activities of competing jurisdictions, both onshore and offshore. By way of example, in the event that a competing jurisdiction makes a significant regulatory or political error that generates the potential for an en masse relocation, other jurisdictions are likely to attempt to

1364 Interview with Mr Alasdair Robertson, Partner of Maples and Calder, (Grand Cayman, 14 January 2008).

1365 The UK may be an exception in this regard, in that the UK has over the past decade taken a specific policy decision to develop its financial services sector. G Brown, ‘The Right Way to Help the City Thrive’ Financial Times (London 18 October 2006) <http://www.ft.com/cms/s/1/896ffec0-5e05-11db-82d4-0000779e2340.html> accessed 12 February.

1366 By way of example, the recent proposed changes in the UK’s domicile rules may affect whether fund managers continue to operate from the UK. HM Treasury, ‘Paying a Fairer Share: A Consultation on Residence and Domicile’ (January 2008) <http://www.hm-treasury.gov.uk/consultations_and_legislation/residence_domicile/consult_residence_domicile.cfm> accessed 12 February 2008.
absorb that portion of the market that is mobile and that perceives that the risk-return ratio is no longer acceptable.\textsuperscript{1367} While this may be thought analogous to the behaviour of vultures, to the extent that maintaining the efficiency of economic flows may be said to mitigate against market inefficiencies that would occur if market participants did not have access to such options, it may also be viewed as a mechanism for the development of efficient regulation.\textsuperscript{1368} In contrast, activities such as those observed in the context of the ‘three-pronged initiative’ described in section 6.5.2 may be viewed as somewhat more predatory, in that competitors are attacked rather than left to make their own errors.

\textbf{7.5.4 Emulation of Financial Regulation}

Emulation as a tool in regulatory competition may, at first glance, be thought available to all jurisdictions. The evidence however, suggests that as a practical matter it is not. As noted above, large onshore jurisdictions are unlikely to be able to implement or maintain the tax-related advantages conferred by OFCs. Nonetheless, onshore jurisdictions may be viewed as emulating offshore jurisdictions to the extent that they have created regulatory carve-out and ‘light-touch’ regulatory environments in order to attract and retain hedge fund activity.\textsuperscript{1369}

\textsuperscript{1367} Discussed in section 2.3.1 and section 4.1.
\textsuperscript{1368} Discussed in section 2.1.1 and 3.9.1.
\textsuperscript{1369} Discussed in section 6.1 and 6.2.
As among offshore jurisdictions that have similar tax-neutral structures, competition will likely be driven by non-tax concerns. By way of example, Bermuda pioneered the use of segregated account companies through private acts of Parliament. The Caymans Islands followed by amending its Company law in 1998 to introduce what was perceived as a more efficient form of vehicle, and Bermuda in response then introduced its public legislation, the Segregated Accounts Companies Act in 2000 in order to compete with the Cayman Islands’ second iteration innovation. More recently, the BVI has followed this lead and introduced the Segregated Portfolio Companies Registration 2005. Are there, then, competition tools which are more available to onshore jurisdictions?

7.6 Club-Based Standard Setting and Regulatory Competition

In the international regulatory space in which hedge funds operate, there is no de jure centralised body that could take a role equivalent to that of the centralised level in Tiebout’s model. Rather, within the global financial architecture under which the countries reviewed in this work operate, a large measure of control is exercised by a select group of developed and economically dominant nations, with the G7 group of leading industrial nations taking a core role in this regard. The G7 nations function as the core element within an array of overlapping issue-specific clubs, as this term is

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1370 Discussed in sections 4.3.1.a and 5.3.8.c.
1372 Discussed in section 2.2.
1373 Global governance is discussed in section 2.4.1.
used in the context of Keohane’s club-model of governance. In this regard, the G7 states have assumed a dominant role in the formation and growth of a network of international organisations that serve to monitor and regulate cross-border economic activity. They do this in part by conducting trans-regulatory processes that may be viewed as the emergence of a form of de facto global governance.

The members of these self-selecting clubs have by their extra-territorial actions, in effect, sought to seize a position in many ways analogous in authority with that of the centralised level of regulatory governance in a federal two-level single sovereign state model. The range of regulatory options available to national regulators may be limited at the outset by institutional constraints or factors giving rise to bargaining strengths and weaknesses. Within the dynamics of multilateral/international organisations, devices such as global dramas or cause célèbre, exclusion, and non-transparency may also be utilised by dominant states to gain competitive advantage.

It is important to note however, that the dominant club states continue to also operate at a level that may be viewed as analogous to the decentralised level in Tiebout’s model and so remain competitors of ‘non-club’ jurisdictions and therefore are conflicted.

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1375 Gstöhl (n1144). Discussed in section 2.4.1.
1376 These organisation include the FSF, FATF and the OECD.
1377 The ‘club’ model is discussed in sections 2.4.6 and section 6.1.3.d.
1379 Keohane (n1374). States may be excluded from the negotiations and the negotiation-process may be non-transparent. Keohane opined that maintaining the confidentiality of the negotiations resulted in a domestic policy that was easier to manage and was in the collective best interest of the negotiators. In this regard Michael Zürn observed that under such conditions ‘the opportunity of strategic manipulation of information is wide open to decision-makers’. M Zürn, ‘Democratic Government beyond the Nation State: The EU and Other International Institutions’ (2000) 6 European Journal of International Relations 2,193-194.
Thus, it is unsurprising that their actions may be interpreted as an indication that they
do not view themselves as being bound to act with the impartiality typically assumed in
relation to the centralised level within a single federal state model.\textsuperscript{1380}

The self-selected sovereign nation members of the exclusive clubs, unlike the
central level in the Tiebout’s model, enjoy no democratic mandate and are competitors
of non-club jurisdictions. Given this set of circumstances, the question ought to be
asked: do the international standards set by the clubs actually reflect the collective
concerns of all residents in the system or are these standards biased to favour the club
nations? If the public services provided at this de-facto centralised level are biased
toward the interests of club nations, then it is likely that non-club jurisdictions that find
themselves to be economically marginalised may take measures to opt out of a system
that they may view as lacking in legitimacy, potentially resulting in a less stable system
in the long term.

There is some justification for the argument that, having assumed the de facto
role of the centralised governance, there ought to be a mechanism in place to ensure
that the club fulfils their obligation to take into consideration the economic
consequence of their action on non-member economies. There would be the possibility
of any conflicts of interest affecting club members being appropriately and
proportionately managed by the international community if there was transparency and
disclosure to the wider global markets.\textsuperscript{1381} One possible approach, as suggested by

\textsuperscript{1380} Discussed in sections 6.5.2, 2.4.1 and note 130. Riker observed that in true federalism, both levels of
government rule ‘the same land and people’.
\textsuperscript{1381} AM Slaughter, ‘Disaggregated Sovereignty: Towards the Public Accountability of Global
Slaughter would be for the interaction with the club to be conducted in a manner that is sufficiently transparent to be monitored by the ordinary voter.\textsuperscript{1382}

However as observed by Keohane, holding the powerful organisations that make up the club accountable would require an effective ‘meshing together’ of mechanisms of internal and external accountability.\textsuperscript{1383} The transparency required to achieve this is inconsistent with the utility of clubs as perceived by powerful states.\textsuperscript{1384}

7.7 WHY DO THE ONSHORE JURISDICTIONS ALLOW THEIR OFFSHORE COMPETITORS TO CONTINUE TO EXIST?

The evidence indicates that onshore jurisdictions have the geo-political and economic power to shut down OFCs, but have chosen not to do so. This choice suggests a recognition that the existence of the OFCs provides benefits to onshore jurisdictions, or at least a recognition that whatever unwelcome effects onshore jurisdictions experience as a result of OFCs do not justify the elimination of OFCs. If there are benefits produced by OFCs what might they be?

\textsuperscript{1382} ibid.
\textsuperscript{1384} ibid.
The evidence identified in the present work suggests that OFCs bring significant benefits to onshore jurisdictions and as such are likely to remain an important part of global financial architecture. In this regard Hines has noted:

[OFCs]…appear to stimulate greater investment activity, and permit governments to tax more mobile international capital less heavily than purely domestic capital. …. As a result the international community is unlikely to summon the collective will necessary to persuade or force…[OFCs] to abandon their policies and [OFCs] will continue to play an important role in world affairs.\textsuperscript{1385}

Once this insight is absorbed, one can readily appreciate that the incentive of larger states to exercise their regulatory and geo-political muscle to create disincentives for hedge funds to select OFCs as their base is, in practice, more constrained than it might first appear. To the extent that the observations of Hines and others are correct, it would be counter-productive for onshore jurisdictions to shut down OFCs, as to do so would create capital-access disadvantages for any onshore jurisdiction that might be tempted to disable the conduits of capital that flow through OFCs. On the other hand, the lesson for OFCs would appear to be that their relative autonomy is contingent on continuing to provide, and being perceived by onshore jurisdictions as providing, this menu of benefits at a politically acceptable cost. How then are these observations to be related to observations in the regulatory competition literature?

\textsuperscript{1385} Hines (n1355).
Regulation conveys both costs and benefits to regulatees.\textsuperscript{1386} Given the choice and all else being equal, regulatees may be expected to choose regulatory regimes that minimise their net regulatory burden.\textsuperscript{1387} Stiglitz, by way of example, observed that all taxes, direct or indirect, distort economic behaviour and cause ‘deadweight’ losses.\textsuperscript{1388} This distortion may become more pronounced when the same good or activity is subjected to such losses at different rates in different jurisdictions.\textsuperscript{1389} Relative to onshore jurisdictions, offshore jurisdictions may provide the regulatee with tax and regulatory products which are better matched to their particular activity, and consequently afford benefits, or at least the possibility of limiting ‘deadweight’ loss. However, onshore legislators may be less concerned with limiting the economic losses of regulatees than they are with limiting political losses.

Hertig has observed in the context of the EU, and with specific reference to the domicile of collective investment funds, that the tax-saving resulting from registering such funds in Luxembourg rather than in the Member State in which they are distributed, brings efficiency benefits to the EU.\textsuperscript{1390} This is perhaps best summarised by Shaviro, who observed

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\textsuperscript{1386} Examples of benefits include increase in reputation, decrease in competition, or greater commercial certainty. G Hertig, ‘Regulatory Competition for EU Financial Services’ in DC Esty and D Geradin \textit{Regulatory Competition and Economic Integration: Comparative Perspectives} (Oxford University Press, Oxford 2001) 228.
\textsuperscript{1387} ibid.
\textsuperscript{1388} This is generally applicable to all taxes other than lump sum taxes such as head taxes. JE Stiglitz, \textit{Economics of the Public Sector} (Norton New York 1988) 478-479.
\textsuperscript{1390} ibid, 224.
When there is trade across jurisdictional boundaries, each jurisdiction may be inclined to impose tariffs burdening imports. This is generally inefficient; it results in deadweight loss by inducing consumers to substitute locally produced goods for those they would have preferred if not for the differential tax treatment. Gains from trade across jurisdictional boundaries by people with different areas of comparative advantage are therefore lost. …the opportunity to create gains through trades without being impeded by tariffs is a kind of public good, the scale of provision of which is the entire trading area.\textsuperscript{1391} 

In the same context, the European Commission and the EU Council of Ministers articulated no such concern in relation to the restriction of allocation of fund activity, as between EU financial services providers and those outside the EU.\textsuperscript{1392} 

Tiebout observed that regulatory competition facilitates innovation in regulatory design by allowing for a closer match of regulatory structures to the regulatory needs of non-homogenous regulatees.\textsuperscript{1393} In this regard, financial markets that are located offshore have tended to allow for innovations in the structuring and operations of financial vehicles in order to attract commercial activity at an institutional level.\textsuperscript{1394} As observed by Hertig and Shavio, this in turn brings efficiencies to global markets, by allowing regulatees to minimise deadweight loss and add economic benefits.\textsuperscript{1395} Further, Desai, Foley and Hines observed that the use of OFCs gave rise

\begin{flushright}
1392 Discussed in section 4.3.6.a at note 649.
1393 Discussed in section 2.1.2.
1394 Shaviro (n1391).
1395 \textit{ibid.}
\end{flushright}
to the ‘offshore effect’ that stimulated growth and investment in onshore affiliates of OFC entities.\textsuperscript{1396}

The efficiencies generated in OFCs arguably translate into global benefits in the form of greater access to capital, reduced risk, and lower capital costs.\textsuperscript{1397} This raises the question of why these innovations are not implemented in the onshore markets. The answer once again would appear to relate to the politics of onshore jurisdictions.\textsuperscript{1398}

A significant part of the reason for executing hedge fund related innovations offshore may be ascribed to the body of ‘red tape’ or bureaucracy in the onshore markets.\textsuperscript{1399} At this juncture it is important to note that while some of the efficiencies generated by these financial innovations may appear to be negligible when viewed on a per transaction basis, they may become significant when amassed over a sizeable number of transactions, or on significant assets under administration. Hence, any savings or efficiencies derived from these innovations may be insufficient to compensate the hedge fund organiser for the cost and risks attached to onshore jurisdictions. In contrast, the risks of innovations may be justified in a lower-cost offshore venue.

The availability of ‘offshore testing facilities’ may also serve the interests of onshore jurisdictions. This observation may be derived by analogy from the interaction of Delaware with the US Congress where, as observed by Roe, the authority of

\textsuperscript{1396} Desai (n1355); MA Desai and JR Hines, ‘Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions’ (2002) 55 National Tax Journal 3. Discussed in section 6.5.5.

\textsuperscript{1397} Calomiris (n1355).

\textsuperscript{1398} Discussed above at 7.5.

Congress can ‘trump’ that of Delaware. Nonetheless, Delaware’s dominance is tolerated because it serves three valuable functions:

1. In justifying strong regulation. Congress, knowing that Delaware provides corporate flexibility, can more easily enact rigid rules, rules that it knows will be tempered in Delaware. If Delaware seems weak, Congress can be strong.

2. In facilitating anti-corporate posturing. Similarly, if Delaware provides a contractarian corporate law and a good forum for arbitration, Congress can more easily attack corporations. Delaware can take care of the core efficiency issues, and Congress doesn’t need to be overly wary that it is severely damaging the corporate contract when it makes populist laws, because Delaware can mitigate the costs….

3. In giving Congress cover and deniability. If something goes wrong, Congress need not take responsibility. It doesn’t need even to point a finger. Everyone knows states make corporate law. If there’s a scandal, or a failure, the states have failed, and the U.S. Congress can ride in to the rescue.

Roe argues that in effect, Delaware serves as a de facto agency for the US Federal government. By analogy, OFCs may also be viewed as providing similar agency services to onshore jurisdictions. In this context, OFCs may be viewed as providing a ‘testing ground’ for the development of efficient regulation, while simultaneously providing a convenient ‘buffer’ for political directorates in onshore jurisdictions.

The large and diverse populations in onshore jurisdictions and their public interest concerns serve as a fundamental force contributing to the complexity of

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1401 ibid.
regulatory structures in onshore jurisdictions. Accordingly, the regulatory structures in onshore jurisdictions, constrained by populist concerns, are designed to mollify the greatest number of the resident voters, rather than to respond to the concerns of institutional investors. Thus, there may be relatively little interest in onshore jurisdictions in removing unnecessary or ‘deadweight’ regulatory-compliance costs associated with the operations of complex structures such as hedge funds unless there is clear and compelling evidence that doing so will bring proportionate political benefits. By way of analogy, in the context of the offshore insurance market the following has been observed:

…capital providers attempted to create a US liability company…. After three years or so of trying the company was not able to build its operations because it was unable to secure sufficient state licenses to conduct business on a countrywide basis and therefore recognizing that the market opportunity was gone, the effort was abandoned. The US insurance regulatory system, with its 50 state license requirements, burdensome and often contradictory state rules and a focus on regulatory requirement unnecessary for a wholesale insurance market (Which is targeted at sophisticated commercial insurance and reinsurance customers) is a major impediment to capital formation of insurance companies in the United States today. 1402 (emphasis added)

Consistent with the matching principle imbued in Tiebout’s model, the regulatory structures of OFCs may provide in some contexts a closer match with the regulatory requirements of some sophisticated and institutional regulatees that do not require the same degree of regulatory protection as individual residents. The regulators

1402 US Senate Committee on Finance, ‘Statement of the Association of Bermuda Insurers and Reinsurers, Donald Kramer, Chairman and CEO of Ariel Reinsurance Company – Informational Hearing – Offshore Reinsurance, United States Senate Finance Committee’ (September 26, 2007) <http://www.senate.gov/~finance/sitepages/hearing092607.htm> accessed 12 February 2008. This is consistent with ‘market fatigue’ as identified by Maloney. Maloney (n1399).
in onshore jurisdictions clearly recognise this difference in regulatory needs, and have designed regulatory carve-outs to provide a ‘light touch’ regulatory structure in some contexts. However, as a result of the public interest concerns of their large underlying populations, onshore jurisdictions are constrained in designing their regulation to consider the regulatory needs of the wider public at a more detailed level before allowing a carve-out to be effected. In contrast, OFCs’ default position may be viewed as the functional equivalent of the carve-outs designed by onshore jurisdictions.

Regulatees typically have the burden of various compliance costs in order to qualify for regulatory carve-outs in onshore jurisdictions, if only in proving that they qualify for the carve-out. Further, multiple levels of regulation or overlapping forms of regulation within a federal state, increase the potential for regulatory mismatches as seen from the perspective of the regulatee. Similarly, complex and uncoordinated regulation within a single jurisdiction may result in regulatory change that in turn creates commercial uncertainty for the institutional regulatee. Such uncertainty may undermines the institutional regulatees’ trust in onshore regulatory structures.

In contrast, the smaller populations of offshore jurisdictions with fewer development options may be less constrained by diverse public interest concerns, and

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1405 The Goldstein case discussed in section 6.2.9 is an example of regulatory changes applied to institutional customers as a result of political tension.
thus are able to pre-commit to a responsive regulatory structure that engenders the trust of the regulatee.\textsuperscript{1406} In effect, offshore jurisdictions are able to provide by default more flexible regulatory environments that match the regulatory needs of the institutional and sophisticated investor for which onshore carve-outs are created. This is reinforced by the efficiencies identified by Hines and others.\textsuperscript{1407}

The pre-commitment of OFCs to responsive regulation ensures that they provide a regulatory framework that serves as a relatively frictionless conduit for the deployment of mobile capital around the world.\textsuperscript{1408} The interconnectedness of offshore jurisdictions and onshore jurisdictions results in a symbiotic relationship that provides offshore jurisdictions with benefits such as jobs and some public sector revenue while the onshore jurisdictions gain the benefit of efficient access to capital. As observed by Kramer, in the context of insurance structures, the use of offshore jurisdictions allows the deployment of capital:

\begin{quote}
...to meet market needs whether in the United States, Asia, Latin America, Europe or the rest of the world. Capital is not trapped in regulatory frameworks that limit the insurer’s flexibility to exit and enter markets.\textsuperscript{1409}
\end{quote}

\begin{footnotesize}
\textsuperscript{1406} Romano (n1313).
\textsuperscript{1407} Hines (n1355).
\textsuperscript{1408} In this context ‘frictionless’ describes the efficient ‘coupling’ of several jurisdictions to meet the regulatory needs of the underlying investors and to allow the deployment of capital with the least deadweight loss. This extends to the timeliness and quality of the regulatory, legal, accounting, and banking services provided. By analogy, OFCs may be viewed as similar to airport ‘hubs’ which facilitate the flow of passengers and goods around the world. R Johns, Tax Havens and Offshore Finance (Pinter, London 1983). Discussed in section 4.1.2.
\textsuperscript{1409} Kramer (n1402).
\end{footnotesize}
In summary, the evidence indicates that onshore jurisdictions support the use of OFCs or at least tolerate their use by hedge funds within limits. They do so, firstly, because OFCs provide allocative efficiency that translates into a lower cost of capital and the potential for increased productivity in onshore jurisdictions, and secondly because the use of OFCs by hedge funds continues to serve the interests of onshore private sector actors. Similarly, onshore jurisdictions are likely to continue to tolerate OFCs as long as OFCs continue to serve the interests of powerful actors in onshore jurisdictions at a cost acceptable to onshore political interests.


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