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Regulatory Arbitrage: What's Law Got To Do With It?

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Abstract: This paper explores regulatory arbitrage from a legal point of view. I start from the assumption that legislators will sometimes wish to prevent regulatory arbitrage and examine legal tools available to this end. To back up the underlying assumption, I present two perspectives on the phenomenon of regulatory arbitrage. One perspective stresses its competitive element, the other one focuses on instances of arbitrage as unwanted avoidance of a legal regime. It is suggested that from both perspectives we will find that – at least sometimes – regulatory arbitrage is unwanted. I move on to illustrate how EU and U.S. legislators have dealt with an example of unwanted arbitrage. The main part of the paper then deals with legal tools to suppress arbitrage. The main focus is on legislative drafting techniques such as choosing a narrow wording, a broad wording, anti-evasion rules or the concept of abuse. I conclude with a glance at problems of regulatory arbitrage in a corporate setting.

Keywords: regulatory arbitrage, cash-settled derivatives, transparency directive, CSX corp. v. Children's inv. fund, legal security

JEL Classification: K22, K42, K00

Table of Contents

Introduction
1 Why Should the Law Care About Regulatory Arbitrage?
  1.1 Arbitrage and Avoidance
  1.2 Arbitrage and Competition
  1.3 Guiding Assumption: Arbitrage is Sometimes Unwanted
2 Illustrating Unwanted Regulatory Arbitrage: Cash-Settled Derivatives
  2.1 Background: What is a Cash-Settled Derivative?
  2.2 The EU Response to Cash-Settled Derivatives
  2.3 The U.S. Response to Cash-Settled Derivatives
3 The Legal Toolbox: How to Deal with Unwanted Regulatory Arbitrage?
  3.1 Legislative Drafting-1: Narrow Wording
  3.2 Legislative Drafting-2: Broad Wording, the Spirit of the Rule and the Critique of Legal Formalism

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3.3 Anti-Evasion Rules and Avoidance
3.3.1 Elements of Anti-Evasion Rules
3.3.2 Balancing Legal Security and the Avoidance of Arbitrage
3.3.3 Abusive Practices
3.3.4 Implications for Corporate Compliance
4 Summary
References

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Introduction

Was nicht verboten ist, ist erlaubt[1]
Non omne quod licet honestum est[2]

That which is not prohibited, is allowed[1] – yet, not everything which is allowed is also honest behavior.[2] The two quotes, the former from a German classic, the latter from an ancient roman jurist, mark the complicated relationship between the law and regulatory arbitrage. On the one hand, legal rules exist to provide a secure framework for citizens. This implies that actions which do not cross the – verbal – lines drawn by legal rules are, naturally, not prohibited. At the same time, behavior which complies with the wording, but not with the spirit of a rule will often be perceived as non honestum (dishonest). This is especially likely if we are

1 Schiller, Wallenstein, Chapter 3, First Appearance.
2 Liebs (2007) D.50, 17, 144, the author is Iulius Paulus a roman jurist who lived in the 3rd century p.c.

faced with conduct escaping unwelcome legal consequences which economically similar actions would have entailed.

1 Why Should the Law Care About Regulatory Arbitrage?

Given that regulatory arbitrage is not a commonly agreed-upon, let alone an established interdisciplinary technical term, this section presents two very different perspectives on regulatory arbitrage. They stand in for the ends of a spectrum of opinions held and methods applied when describing the phenomenon of arbitrage. The paper does not contribute to scholarship defining or evaluating the pros and cons of regulatory arbitrage. It starts from the assumption that arbitrage is *sometimes* unwanted and explores the tools to suppress it.

1.1 Arbitrage and Avoidance

For most authors, the term regulatory arbitrage has a negative connotation. "A general understanding of regulatory arbitrage implies an avoidance strategy"[3] with actors "explicitly looking for ways to decrease their regulatory burdens".[4] Such avoidance strategies are usually understood as an attempt at crafting a well-tailored transaction with the sole purpose of not qualifying for a specific regulatory regime.[5] Many have stressed that behavior of this type will, more often than not, only be open to elite players with access to financial advisors and highly sophisticated corporate lawyers.[6] While a domestic[7] regulator aims at efficiently supervising regulated entities, so it is suggested, their advisors help them to exploit

3 Willeson (2017) 77; on an „avoidance industry" of lawyers and accountants see Riles (2014) 65; Shah (1997) 101.

4 Barkin (2015) 172; see, in a similar vein, Kunkel (2019); Stânescu and Bogdan (2020); Thiemann and Friedrich (2016); Thiemann and Lepoutre (2017).

5 Willeson (2017) 78 further introduces a separation between „strategic" and „transactional" regulatory arbitrage (at pp. 78 et seq); overview of definitions at Pollmann (2019) 7 et seq.

6 Fleischer (2010) 230 „ byproduct of high-priced lawyering"; 231: „sophisticated lawyers at elite law firms consciously tweaked the structure of the deal to minimize regulatory costs"; 281: „wealthy parties are often in a better position to plan around the rules"; Black (2002) 180 „legal entrepreneurship"; Knoll (2002) 63: "regulatory arbitrage is unfair because the less wealthy and less sophisticated often are unable to avail themselves of the arbitrage".

7 Barry (2010) 74: „regulatory arbitrage is not created by a difference between several regulatory regimes".

loopholes and gaps in that regulatory regime.[8] The underlying assumption is that, in the relevant area, regulatory standards are not crafted well enough. In line with that thought, regulatory arbitrage is defined as "the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment".[9]

Authors who address regulatory arbitrage as making use of a gap between the "real" economic substance of a transaction and the "misguided" view the regulator applies – or is forced to apply due to a lack of well-crafted rules – will usually use terms such as *structuring*,[10] *avoidance*,[11] or even *manipulation*.[12] The regulator, these authors assume, sets certain rules to which regulated entities must conform.[13] However, some entities find a way to bypass the rules by making use of something akin to a legal "trick". Their business logic, what they "actually" do, is the same as everyone else's. By framing it as something entirely different, not captured by the regulatory regime in place, they avoid certain legal consequences.

1.2 Arbitrage and Competition

Linking regulatory arbitrage to avoidance strategies is not the only way to describe the phenomenon. Instead, regulatory arbitrage has been portrayed as an economically efficient process which eventually results in the regulatory costs of a certain transaction to converge at the lowest level. To use a market-based metaphor: "Regulatory requirements should be viewed as the price of conducting certain business activities in a particular jurisdiction".[14]

This view is maybe best illustrated analogizing it to the model of *financial* arbitrage.[15] Financial arbitrage can be modeled as a risk-free trade, executed

8 Fleischer (2010) 229.

9 Fleischer (2010) 230, see also *id* at 14 and Barry (2010) 73, Partnoy (2009) 1019, Pollmann (2019) 2, and Partnoy (1997) at 227: „basic concept in modern finance: a party to a financial transaction may use a variety of different trading strategies to achieve the same economically-equivalent position".

10 Gilson (1984) „business lawyers as transaction cost engineers"; Calomiris and Mason (2003): example of credit card securitisation as a means of avoiding minimum capital requirements; Friedrich and Thiemann (2018) for leasing.

11 Willeson (2017) 77.

12 Fleischer (2010) 230.

13 See Friedrich (2020); Stânescu and Bogdan (2020).

14 Nabilou (2017) 563.

15 See Mellor and Shilling (2017) 22 et seq. for an introduction; also: Nabilou (2017) 562 et seq.; see also Fleischer (2010) 243 analogizing regulatory arbitrage to inefficiencies in capital markets; overview at MacKenzie (2003) 350 et seq.; showing why regulatory arbitrage does not lead to price convergence: Partnoy (2009).

whenever two goods are priced differently, depending on where they are sold. Financial arbitrageurs will exploit such price differences by buying cheaply in one place and selling at the higher price in the other place. Economic theory predicts that, because sellers compete, financial arbitrage will eventually lead to prices converging at the lower level. It eliminates a price difference for two identical goods. In this way, financial arbitrage is described as helping to overcome market inefficiencies.[16]

Drawing an analogy to this understanding of financial arbitrage, it seems natural to propose that regulatory arbitrage may also contribute to more efficient markets. Whereas financial arbitrageurs are expected to eventually lower the price of a good, regulatory arbitrageurs are assumed to drive the regulatory costs associated with a specific transaction down.[17] Such effects may be best illustrated if we picture the arbitrageur as facing a choice between different jurisdictions for his endeavor. The competition-view of regulatory arbitrage presupposes that regulators, located in different jurisdictions, compete for relevant transactions or corporations. In order to attract more business and to win the competition they will wish to adjust regulatory prices. Actors are modelled as ready to leave their domestic regulator's world if another jurisdiction offers them a more attractive environment for an identical transaction.[18]

The analogy to financial arbitrage is particularly compelling if the arbitrageur chooses between competing "legal markets" offered by different national jurisdictions. The arbitrageur then weighs pros and cons of these jurisdictions and settles for something he conceives as the "best offer". But regulatory arbitrage does not always involve moving places. Authors who stress the element of avoidance when describing regulatory arbitrage[19] are usually concerned with instances of reformatting a transaction under one national regulator's regime. To capture this form of "repackaging-arbitrage" under the competition approach, the focus will be on different regulatory sectors available in one jurisdiction. "Regulatory arbitrage" so it is suggested, "refers to shifting activities from a heavily regulated financial sector to an unregulated or lightly regulated financial sector with the aim of maximizing profits by taking advantage of regulatory differentials".[20] The "legal markets" on offer are not different national jurisdictions, but differently regulated sectors of one jurisdiction. Modelling these sectors as engaged on a competitive

16 Licht (1998) 590 et seq.; Partnoy (2009) 1018: „the law of one price".

17 Partnoy (2009) 1018.

18 For more details see Riles (2014) 71: „jurisdictional arbitrage", suggesting to counter moving-places arbitrage with a conflict of laws approach; on tech companies: Pollmann (2019); on the internet more broadly: Wu (2017) 9 with examples of "geographic evasion".

19 See above 1.1.

20 Nabilou (2017) 563.

"market for regulation", a possible prediction could be that a move from one sector to another will lead to regulatory adjustments which better reflect the needs of business and/or consumers.

1.3 Guiding Assumption: Arbitrage is Sometimes Unwanted

The preceding descriptions of regulatory arbitrage as avoidance as opposed to competition mark the ends of a spectrum. Even scholars who generally view arbitrage as avoiding a legal regime will agree that widespread avoidance could sometimes be a sign of a flawed regulation.[21] Conversely, scholars who model arbitrage as an efficient market mechanism are still busy to point out instances of market failure. This surfaces not only in the extensive discussion on whether regulatory arbitrage will lead to a "race to the top"[22] or to a "race to the bottom".[23] Others doubt that national regulators, let alone different sectors of one jurisdiction are competing for the largest "market share of regulation". After all, it has been pointed out, some entities engaged in regulatory arbitrage might not bring attractive business, but rather come across as "lemons",[24] triggering enforcement costs and negative reputational effects.[25]

It is beyond the scope of this paper to assess whether the avoidance or the competition approach to regulatory arbitrage paints a more realistic picture of the phenomenon. Quite probably, both approaches capture important elements: "arbitrage creates both inefficiency and unfairness".[26] For the endeavor pursued here, it is sufficient to assume that regulatory arbitrage is *sometimes* unwanted from the legislator's and the regulator's point of view. This assumption is warranted under both approaches. The competition approach accepts market failures, the avoidance approach suggests as a general rule to suppress arbitrage.

21 Knoll (2008) provides an example on making use of regulatory inconsistencies in tax law.

22 Overview at Radaelli (2004) 6 et seq.

23 See Barkin (2015) 174; Carruthers and Lamoreaux (2016) 76, 86 et seq.; Radaelli (2004) 2; a nuanced view is to be found at Boyer and Kempf (2017) 1, suggesting that we do not so much see „a weakening of regulatory standards as the inability to efficiently regulate the risk-taking by banks when they are freely able to direct their investment flows worldwide" and at Boyson, Fahlenbrach, and Stulz (2016) arguing that banks predominantly use regulatory arbitrage if they want to be riskier than allowed by capital regulation; focusing on the link to property and creditor rights: Houston, Lin, and Ma (2012); suggesting that „not all differences among legal regimes are inherently worth fighting for": Riles (2014) 73.

24 See Langevoort (2008) 4.

25 See in more detail Friedrich and Thiemann (2017) 68 et seq.; Stânescu and Bogdan (2020).

26 Knoll (2002) 63.

2 Illustrating Unwanted Regulatory Arbitrage: Cash-Settled Derivatives

Before scrutinizing in more detail the legal toolbox, an example will illustrate how two legislators, one European, one U.S., have dealt with unwanted regulatory arbitrage. Most securities laws require the owners of publicly traded shares to report their stake once they cross certain thresholds. This information is deemed relevant for management, for other shareholders and for potential investors.[27] Disclosing the size of a significant holding to the market can have a number of consequences for the owners of shares which they might wish to escape. There is the concern of front-runners,[28] of preventing voting strategies and of raising the acquisition price in a pre-take-over situation. Furthermore, under EU take-over law a mandatory bid has to be made as soon as a large shareholder has acquired control of the target company, Art. 5 para. 1 EU Directive 2004/25. The bidder will usually wish to time the mandatory bid so that market conditions are attractive. Additionally, the EU Regulation 236/2012 on short sales requires reporting net short positions in shares starting at 0.5% and in intervals of 0.1% after that, Art. 6 para. 1, 2. The regulatory environment created by rules of this type gives incentives to delay disclosure[29] or to avoid the need to report one's holding in the first place. Given that only whoever qualifies as a shareholder falls under the disclosure obligation, this makes legal arrangements attractive, which do not entail ownership of shares, but allow for a situation which is economically equivalent to the position of a shareholder. Cash-settled equity derivatives have been a common – if hotly debated – example of such a structure.

2.1 Background: What is a Cash-Settled Derivative?

A derivative is a financial instrument characterized by its link to an underlying asset.[30] In the case of equity derivatives, the underlying asset is a share. Often, equity derivatives are used to hedge the risk of price movements of a specific stock or to speculate on such movements. A "put option" insures against a downturn in

27 US law requires a 13D filing once 5% are crossed. EU law grants discretion to Member States: Art. 9 para. 1 of Directive 2004/109 requires disclosure of a holding once the thresholds of 5, 10, 15, 20, 25, 30, 50 and 75% are crossed.
28 Empirical data at Christofferson, Danesh, and Musto (2018).
29 US Law following SEC Rule 13F allows institutional investors to delay disclosure for up to 45 days.
30 See Partnoy (1997) 223 et seq.

share prices, because it grants the right to sell shares at a specified "strike price" agreed upon in the option contract. When prices fall, but the strike price has been locked in at the previous (higher) level, the party holding the option does not need to worry about falling prices. Conversely, a "call option" hedges against a rise in share prices, because it allows to buy shares for the strike price, which will stay fixed, hence is in comparison low when prices rise.

An option contract requires payment of a "premium". This insures against uncertain future price movements. Additionally, derivatives can serve as a speculative tool. Consider a trader betting on share price movements, for example in a short sale. A derivative will be attractive for him, because the trader pays the premium, but does not need to buy the actual shares. He needs to invest less capital for the anticipated gain, in this manner potentially levering his deal many times over.

"Cash settlement" refers to what happens when the option is being exercised by the purchaser of the derivative. One possibility is to physically deliver the shares which are the object of the contract. If derivatives are used to hedge against price movements, this will often be the contract of choice. However, instead of choosing this structure, the parties may agree on settling only the resulting cash position (the difference between the strike price and the price at which the shares trade when the option is exercised) without a transfer of actual shares. Unless the actual shares are needed, cash settlement is a good option, due to its lower transaction costs.

What does all of this have to do with ownership or the position of a shareholder? If an option contract grants the right to physical settlement, the option holder is not (yet) the owner of the shares. Hence, he would not fall under a rule which tied reporting requirements (or other duties) to actual ownership – a potential opportunity for regulatory arbitrage. For illustration, imagine a take-over situation involving a listed company. If only actual ownership qualified, a hedge fund could build a position in call options and, once he has enough options to reach the intended stake, demand physical settlement. Neither management nor shareholders or future investors would have noticed. The rise in stock prices, which we see once the market becomes aware of a take-over plan, a practice called "creeping in", would not happen. Naturally, most regulators have become aware of this structure.[31] This is why today's securities laws are usually worded more broadly. They are not restricted to actual share ownership, but catch a contractual structure which grants a right to an eventual transfer of shares as well.

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31 See for example U.S. Code of Federal Regulations (CFR), Title 17, § 240.13d-3 para. (d)(1)(i)(A); Art. 13 para. (1); Directive 2004/109/EC of 15 December 2004 L 390/38 (no longer in force), now as amended by Directive 2013/50/EU of 22 October 2013 L 294/13.

The case of cash-settled derivatives is controversial since this form of option contract does not provide for physical delivery. Under a contract of this type, ownership is never transferred. Could we say that this situation, a "synthetic long position", presents an opportunity for arbitrage? After all, arbitrage is a situation in which the economic benefits are preserved. This seems doubtful, to the extent that cash-settled call options do not confer the right to ask for physical settlement by way of actual delivery of shares.

But now market conventions come into play. Even though the seller of the option (the "short" party) is not contractually required to physically settle, business practice for him is to still buy the shares when concluding the contract. Not doing this will *ceteris paribus* expose him to significant price fluctuations, a risk he will wish to minimize.[32] Upon expiry or unwinding of the derivative, this "short" party will typically[33] want to get rid of the shares. The business expectation, more often than not, is that the buyer of the hedge (who is "long") is in a position to ask for transfer of those shares. While this is not a contractual right, and therefore doesn't trigger reporting requirements, it still seems to be common practice,[34] even expected from the short party. A bank unwilling to do so, it is claimed, will take a reputational hit in the business community.[35]

Against this background, the opportunity for regulatory arbitrage is clearly visible. The hedge fund, which, in our example, is interested in concealing the stake it has been building up, knows, that the counter-party to its hedge will eventually sell the shares. The hedge fund's management also knows when this will be the case, and might even have the right to unwind the derivative at a point in time they choose.

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32 CSX Corp. v. Children's Inv. fund Mgmt. (UK) LLP, 562 F.Supp.2d 511, 542: „With very minor exceptions, whenever TCI terminated a swap, the counterparty sold the same number of physical shares that were referenced in the unwound swap and it did so on the same day that the swap was terminated". Overview of business practices at De Nardis and Tonello (2010) p. 2. Critical: Donahue (2010) 221, 225, 237.

33 But see Brief of Amici Curiae ISDA and Securities Industry and Financial Market Association, in CSX Corporation v. TCI Fund Management, U.S. District Court, Southern District of New York, 06/02/2008 (https://www.sifma.org/wp-content/uploads/2017/05/csx-corporation-v-the-childrens-investment-fund.pdf), p. 10: „counterparties generally may hedge equity swaps with referenced shares, it is far from invariably so […] a hedge can take many different forms".

34 For the UK see The UK Takeover panel, Consultation Paper PCP 2005/01 (http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/pcp200501.pdf), p. 5: „it is frequently the expectation of a holder of a long CFD that the counterparty will ensure that the shares to which the CFD is referenced are available to be voted by the counterpart and/or sold to the holder of the CFD on closing out the contract". On German cases of using derivatives to „creep in" see Langenbucher (2018) § 17 n. 81 et seq. („Schaeffler/Conti", „Deutsche Bank/Postbank").

35 De Nardis and Tonello (2010) p. 2.

Summing up, a hedge fund – or any other investor – who might wish to avoid reporting that it has been building up a stake in a corporation's shares will often be tempted to buy cash-settled derivatives. The combination of the wording of relevant regulatory rules and business practices allows this form of avoiding the regime which is in place for shares. Given the business practice of the short party handing over shares despite a lack of an underlying contractual duty to that end, we can say that the economic substance of the transaction is being preserved, but reporting requirements are not triggered.

Both, the U.S. and the EU have endeavored to close this loophole, yet in different ways. The EU has adapted the legislative wording of its transparency regime. The U.S. has relied on a more general rule capturing schemes of avoidance. A proposed bill, aimed at changing the wording, has so far not been passed.

2.2 The EU Response to Cash-Settled Derivatives

The EU Transparency Directive regulates instances which trigger reporting requirements. Its 2004 version tied disclosure to the acquisition or disposal of

> "shares […] to which voting rights are attached"[36] or "financial instruments that result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached".[37]

With the rise of more complex derivatives, the EU legislator observed that:

> "Financial innovation has led to the creation of new types of financial instruments that give investors economic exposure to companies, the disclosure of which has not been provided for in Directive 2004/109/EC. Those instruments could be used to secretly acquire stocks in companies, which could result in market abuse and give a false and misleading picture of economic ownership of publicly listed companies".[38]

Along those lines, the second Transparency Directive of 2013 saw the formerly narrow wording broadened:[39]

> "In order to ensure that issuers and investors have full knowledge of the structure of corporate ownership, the definition of financial instruments in that Directive should cover all instruments with similar economic effect to holding shares and entitlements to acquire shares".[40]

36 Art. 9 para. 1 Directive 2004/109/EC of 15 December 2004 L 390/38 (no longer in force).
37 Art. 13 para. 1 Directive 2004/109/EC of 15 December 2004 L 390/38 (no longer in force).
38 Recital (9) of Directive 2013/50/EU.
39 Directive 2013/50/EU of 22 October 2013 L 294/13.
40 Recital (9) of Directive 2013/50/EU.

Previously, the rule required ownership of shares, to which voting rights are attached, or an entitlement to acquire such shares. Today, the rule applies to financial instruments which are

> "referenced to shares […] and with an economic effect similar to that of [options] […] , whether or not they confer a right to a physical settlement".[41]

The gap between economic substance and regulatory treatment has been narrowed down, by introducing a broad instead of a narrow term. Any financial instrument with an effect which is "similar" to that of an option qualifies under reporting requirements.

2.3 The U.S. Response to Cash-Settled Derivatives

While the EU makes regulatory arbitrage more difficult by extending the wording of the relevant rule to cover a "similar economic effect", the U.S. has, so far, opted for a different approach. The ground rule for reporting is formulated in Schedule 13D SEA:

> "any person, who […] is directly or indirectly the beneficial owner of more than five percent […] shall, within 10 days after the acquisition, file with the Commission, a statement […]".[42]

Under this rule, a hedge fund which has acquired a cash-settled derivative qualifies, if it is considered a "beneficial owner". This is determined on the basis of § 240.13d-3 para. (a) SEA:

> "For the purposes of sections 13d and 13g of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement or understanding, relationship or otherwise has or shares:
>
> 1. Voting power, which includes the power to vote, or to direct the voting of, such security and/or
>
> 2. Investment power, which includes the power to dispose, or to direct the disposition of, such security".

41 Art. 6 para. 9 (b) of Directive 2013/50/EU; on German law (§ 38 para. 1, s. 1, no. 2 WpHG) see Jüngst and Bünten (2019); Weidemann (2016).
42 Code of Federal Regulations (CFR), Title 17, § 240.13d-1.

Generally, a cash-settled derivative confers neither voting power nor investment power and, accordingly, no beneficial ownership.[43] However, the rule goes on to state that "any person who […] creates or uses a trust, power of attorney, pooling arrangement, or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership […] or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements […] shall be deemed to be beneficial owner […]".[44] Under this latter rule, the Court of Appeals of the Second Circuit held that a hedge fund using cash-settled derivatives had violated Section 13D, because it made use of a "scheme to evade the reporting requirements".[45]

While the decision turned on a number of specifics of that case, it shows an important difference between the strategies chosen by EU and by U.S. law. The former's legislative bodies passed a new rule to specifically catch one form of unwanted arbitrage. It clearly signals the type of transaction which is targeted, but does not necessitate proof of any form of intent on the side of the arbitrageur. The latter relies on a general evasion rule. It is broad enough to catch many situations of regulatory arbitrage, but turns on the arbitrageur having set up a "scheme" to evade the reporting requirements.

Interestingly, the U.S. debate on how to treat cash-settled derivatives has not yet come to an end. Instances of takeovers of corporations often raise political awareness of gaps and loopholes in regulation. After a century-old paper mill in Brokaw, Wisconsin, went bankrupt and activist hedge funds were blamed,[46] Senator Baldwin introduced a bill appropriately named the "Brokaw Act".[47] Similar to the EU broadening its definition, under the Brokaw Act beneficial ownership would include derivatives which grant "a pecuniary or indirect pecuniary interest".[48] Reporting requirements would be triggered "whether or not the right or instrument shall be subjected to settlement in the underlying

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43 But see the *obiter dictum* in CSX Corp. v. Children's Inv. fund Mgmt. (UK) LLP, 562 F.Supp.2d 511, 545 et seq., focusing on the specifics of the case but at the same time hinting at the possibility of a broad, purposive interpretation.

44 § 240.13d-3 para. (b).

45 CSX Corp. v. Children's Inv. fund Mgmt. (UK) LLP, 562 F.Supp.2d 511; critical comments at Donahue (2010) 221, 225 and Black (2008) claiming in a somewhat circular fashion that because the derivative did not qualify as beneficial ownership, there could be no scheme to that effect; criticizing the „circular fallacy": Grundfest, Hu, and Subrahmanyam (2008).

46 https://www.cnbc.com/2017/08/30/small-wisconsin-town-making-hedge-funds-very-nervous.html.

47 Introduced 8/3/2017, 115th Congress, 1st Session, p. 1744; the same claim has been made by Donahue, 4 Brook. J. Corp. Fin. & Com. L. (2010) 221.

48 Sec. 2(b)(3) of the Brokaw Act.

equity security".[49] A plan or scheme to evade regulation would no longer be required. Critics of the Bill argue that the "creative" use of cash-settled derivatives can be accepted as market practice. Performing the existing checks for evasion, hence insisting on a *mens rea* element, so it is claimed, will be sufficient.[50]

3 The Legal Toolbox: How to Deal with Unwanted Regulatory Arbitrage?

We described regulatory arbitrage as the choice of a specific legal structure which avoids an unwanted regulatory treatment. Why, we might ask, is this possible in the first place? After all, it has been suggested that "regulatory arbitrage can be eliminated by crafting legal rules that accurately track the economic substance of transactions [...] if there is no gap to take advantage of, there is no risk of regulatory arbitrage".[51]

3.1 Legislative Drafting-1: Narrow Wording

The question how we "craft legal rules" does indeed lie at the very heart of regulatory arbitrage. Legal rules, the basis for regulatory action, are language-based. For any transaction to qualify for regulatory enforcement, it has to display the features which appear in the relevant legal text – for example the characteristics of "shares" or of "voting rights". Whenever a legislator chooses a legal term, this involves a certain "willingness to abstract" on his part.[52] Out of the variety of situations, actors, contractual structures and more, legislators distill a typical, paradigmatic set-up. In that way, the legislator's decision on how to handle a situation, treat the actors or the contractual structures can be made operational.[53] When drafting the fitting term for this generalizing exercise, the legislator must make a choice between broader and narrower legal terms.

49 Sec. 2 (b)(f)(2)(i)(I) of the Brokaw Act.
50 See e. g. Brav, Heaton, and Zandberg (2018).
51 Barry (2010) 73; see also Knoll (2002) 63: "arbitrage that exploits legal inconsistencies is inefficient because the authorities could eliminate the additional costs parties incur contracting around inconsistent rules by rewriting those rules".
52 See Langenbucher (2017) 150, 158 et seq.
53 Langenbucher (2017) 161.

A narrow wording offers legal security for both, the regulated, who know what to expect, and the regulator, whose sphere of competence is framed in precise words.[54] At the same time, very precise wording will often lead to restrictions in regulatory enforcement. Coming back to the example of cash-settled derivatives, we see that reporting requirements were (pre-2013 under EU law and still today under U.S. law) narrowly framed and tied to ownership of shares and to voting rights. A financial derivative which does not come with a right to acquire shares fell clearly outside that narrow wording.

While offering legal security of this type helps to create an attractive marketplace for investors, it also implies accepting a certain degree of under-enforcement on the side of the regulator when faced with a situation outside the precise wording. Hence, the narrower the legal terms, the more significant the leeway for arbitrage: the chance to structure a transaction (or any other relevant issue) in a way which does not change its economic substance, but falls outside the legal term's narrow verbal boundaries.[55]

3.2 Legislative Drafting-2: Broad Wording, the Spirit of the Rule and the Critique of Legal Formalism

If a legislator is unwilling to accept the under-enforcement linked to a narrowly framed rule, he will opt for the opposite direction. Broad, general terms grant considerable discretion to the regulator, allowing for more efficient enforcement. Consider once again the EU reaction to cash-settled derivatives outlined above.[56] If any financial instrument with a "similar economic effect" to a share qualifies for reporting obligations, as the EU regime assumes, this form of arbitrage becomes very difficult. The "gap to take advantage of"[57] has disappeared because the broad, general rule invites the regulator to "see through" the chosen structure of a transaction. Similarly, interpreting a rule in light of its purpose, goal or spirit enhances the regulator's options enforce and sanction behavior which seems similar to the one the legislator had intended to capture.

With this in mind, why can we not simply rule out arbitrage in this way? Pragmatic counter-arguments immediately spring to mind: What about "normal" investors who, with a perfectly legitimate business interest in mind, hold a simple put option, drag along and tag along rights or irrevocable undertakings? What

54 On certainty as a „key demand" Black (2002) 179.

55 See Black (2002) 180 on why passing ever more rules will not fix the problem („rule overload").

56 See above at 2.2.

57 See above 1.1. and Barry (2010) 73.

about a lien on a share or an agreement which gives acquisition rights to a third party?[58] How can we know if the regulator will consider these as having "similar economic effect"?

More substantive concerns point in the same direction. Any modern state following the rule of law and relying on due process will take pride in the notion of predictability of state action *vis-à-vis* citizens based on legal norms. What does not fall under the wording of a legal rule is typically *nicht verboten* (not prohibited). Where the rule in question is broad or open-textured, there are institutions such as regulators and courts to determine their meaning. The degree to which foreseeability is granted and legitimate trust on the side of citizens is honored depends on the type of state action in question. Sending a citizen to prison can only be done if an unambiguous legal provision allows for it. By contrast, settling a dispute between two private citizens via a state court may be more open to courts interpreting legal rules and principles – after all, one private party's loss due to a court's liberal interpretation will be the other private party's gain.

Insisting that conduct can violate the spirit of a rule but still be "perfectly legal" puts an emphasis on legal security, foreseeability and on the words of a legal text. For some, this has the unpleasant ring of legal formalism. It has been suggested that "one source of regulatory arbitrage is associated with 'legal formalism' […] a relatively dominant approach in legal thinking and jurisprudence […]. The emphasis on literal interpretation […] constitutes a platform from which many of the intra-jurisdictional regulatory arbitrage opportunities can potentially be launched".[59] With its "emphasis on literal interpretation […] even if it ill serves the purpose of the rule"[60] formalism has been described as carrying a conservative bias,[61] a "tyranny of the past"[62] or even a "spirit of rightwing Hegelianism"[63]. Sticking to the words of a legal text makes arbitrage possible, so the argument runs, because it allows selling a transaction which is identical from an economic point of view as legally distinguishable. An obvious remedy, so it has been claimed, is to turn to broad wording or to a more creative, purposive interpretation.

Of course, the effects of broad wording or of an interpretation in light of the spirit of a rule vary greatly, depending on the area of the law we consider. In constitutional law, it is especially apparent that insisting on the wording of a provision, which does not adequately reflect current culture and values endorsed

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58 See BaFin Emittentenleitfaden 2013 p. 141; more critical Drinhausen and Eckstein (2018), § 21 WpHG und Marktmissbrauchsverordnung-Meldepflichten note 49.

59 Nabilou (2017) 581–582.

60 Nabilou (2017) 581–582.

61 On these and the following quotes see Langenbucher (2017) 45 et seq.

62 Calabresi (2016) 8.

63 Unger (1996) 76; general overview at Ely (1980) 4.

by most, narrows the protection offered to a citizen against state action. Put differently: a broad reading of the constitution will usually grant citizens more rights, not less. By contrast, interpreting criminal law rules in a broad and goal-oriented fashion curbs civil rights of those who have invested trust in how the law was framed.

Against this background, it is not surprising that we often witness regulatory arbitrage in areas of the law where a premium is placed on legal security. Securities law provides an example, being usually backed up by fines for perpetrators, at times even by the threat of imprisonment. Tax law, to name another example, orders us to pay money to the state. When breaking it we face fines as well as, potentially, imprisonment. The more intrusive the state action under the relevant rule, the more important are clear verbal boundaries.[64] This is evident where the violation of a rule leads to imprisonment – an idea embodied by the principle of *nulla poena sine lege*.[65] Monetary fines or loss of shareholder voting rights hurt less than prison but, obviously, are still enormously significant sanctions attached to "crossing the lines".

What does this entail for regulatory arbitrage? At first glance, a promising venue to combat regulatory arbitrage could be to adjust the interpretation of the relevant rule in light of its spirit. A closer look has revealed, however, that a more nuanced assessment is in order. What could come across as formalist insistence on a rule's wording is a key element of legal protection against intrusive state action.

Hence, the "gap between economic substance and regulatory treatment",[66] often, is the result of a balancing task faced by the regulator. Legislators and regulators wish to grant legal security for market participants, but at the same time to allow for efficient enforcement. They will generally be unhappy when becoming aware of avoidance strategies built around their rules and enforcement practices. However, for legal rules to serve as reliable guidelines for future behavior, they are also very attentive to providing a clear line between what type of conduct falls under the rule and what does not. Individuals will rely on its wording, corporations will shape their compliance programs accordingly,[67] investors will take decisions on that basis and regulators will tailor their enforcement strategy to match.

64 Black (2002) 179; on tax law: Knoll (2002) and Knoll (2008).

65 Black (2002) 179.

66 Fleischer (2010).

67 See Donahue (2010) 221, 249 (criticizing the purposive approach of the court towards beneficial ownership): „This will make compliance and administration difficult […] such a vague, uncertain, and subjective standard is unworkable"; on arbitrage and compliance see below at 3.3.4; Langevoort (2017) 937.

3.3 Anti-Evasion Rules and Avoidance

Moving beyond legislative drafting via broad rules and interpretation, another obvious candidate for a closer look at the economic substance of a transaction are anti-evasion rules such as § 240.13d-3 para. (b) SEA:[68]

> "Any person who […] creates or uses a trust, power of attorney, pooling arrangement, or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership […] or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements […] shall be deemed to be beneficial owner […]".

3.3.1 Elements of Anti-Evasion Rules

Anti-evasion rules provide the regulator with a forceful tool to react when faced with economically similar but legally distinguishable actions. Such rules will typically display three features: the elements making up the misuse, some form of intent on the side of those employing it and the legal consequence attached to the anti-evasion rule.

Some rules rely on one broad, catch-all term, such as "any intentional abuse". Usually, however, we see the elements making up the misuse as well as the form of intent spelled out in more detail. Take § 240.13d-3 para. (b) SEA as an example. Firstly, it names a specific list of potential tools of misuse: "trust, power of attorney, pooling arrangement". It then goes on to address a broader category of instruments: "any other contract, arrangement, or device". Using broad wording of this type, a citizen or a corporation is alerted to the fact that the regulator will take a close look at all kinds of instruments, rather than a specific list. By the same token, anything which does not – as a minimum – fall under the open-textured category of "arrangement, or device" will not qualify.

The most salient feature of anti-evasion rules is their requirement of a specific state of mind on the side of the person who might be evading the law. In contrast to simply choosing a very broad wording, anti-evasion rules require some form of intent or wilfulness. § 240.13d-3 para. (b) SEA requires "a plan or scheme to evade the reporting requirements" which has been interpreted as an intentional causal link between the chosen legal structure and the evasion of reporting requirements.[69] Note how the legislator in this way grants a certain degree of legal security and foreseeability. A relevant transaction should not be merely the unintended side-effect of a specific structure or transaction. Instead, a "plan or scheme" has to be

68 Emphasis added, see above 2.3; for German law see § 42 *Abgabenordnung* (on tax law).
69 Donahue (2010) 255.

established. Of course, granting foreseeability in this way comes at a cost. It falls to the regulator, who is convinced that there has been such a "plan or scheme", to show why this is the case. He will have to prove that the person evading the rule was intentionally involved in a "plan or scheme" in order to evade reporting.[70]

Lastly, anti-evasion rules have to inform us about the intended legal consequence. § 240.13d-3 para. (b) SEA employs a legal fiction to that end. The person evading the rule "shall be deemed to be beneficial owner". The law will treat him *as if* he had been a beneficial owner all along; hence the reporting requirements in question directly apply. The "gap between the economic substance of a transaction and its regulatory treatment"[71] is closed. The arbitrageur will be regarded as if he violated the rule and faces any sanction attached to that.

3.3.2 Balancing Legal Security and the Avoidance of Arbitrage

Note how the particular form of anti-evasion rule leading to a legal fiction implies a form of retroactivity. Technically, the person evading the rule was, at the time, not a "beneficial owner". Only once the regulator has established that his behavior constitutes a "plan or scheme" to evade the rule, will he be "deemed to be a beneficial owner". Such retroactivity can be very straightforward, if, for instance, fines apply. The person evading the rule will have to pay those fines at a later point in time. The situation is much more complicated if the rule which was being evaded entails other legal consequences. Consider, for instance, how some EU member states attach a loss of voting rights to incorrect reporting by the owner of shares. What happens if the person evading the rule has already voted in a general shareholder assembly? Will the entire vote be invalidated retroactively? Will only his vote be disregarded? What about the other shareholders or third parties who may be affected by that general assembly's vote?

The balancing exercise a regulator faces becomes clear if we, once again, come back to the U.S. rule and the European reaction to cash-settled derivatives.[72] Remember how under EU law financial instruments "referenced to shares […] and with *economic effect similar* to that of [options] […] , whether or not they confer a right to a physical settlement"[73] trigger reporting requirements. Instead of a general anti-evasion norm, the specific rule about reporting has been framed in a

70 For a similar problem concerning insider trading prohibitions under EU law (regulators, pre-2013, had to show that an insider "took advantage" of a piece of information rather than simply "used" it) see Langenbucher (2010) 452.

71 Fleischer (2010) 230, 239.

72 See above 2.

73 Art. 6 para. 9 (b) of Directive 2013/50/EU, emphasis added; on German law (§ 38 para. 1, s. 1, no. 2 WpHG) see Jüngst and Bünten (2019); Weidemann (2016).

broader way. The economically similar transactions cease to be legally distinguishable. Undoubtedly, for the regulated, the EU technique entails a lower degree of legal security and foreseeability than its U.S. counterpart in § 240.13d-3 para. (b) SEA. The term *similar economic effect* is considerably more open-textured than the "arrangement, or device with the purpose or effect of divesting such person of beneficial ownership [...] or preventing the vesting of beneficial ownership". In addition, it does not require the regulator to prove intent as part of "a plan or scheme to evade the reporting requirements".[74] Instead, if a regulator determines that a certain financial instrument qualifies the retroactive effect we mentioned kicks in. The market participant may or may not have been aware of this risk. He will be treated as if he violated reporting requirements.

Of course, there are established standards to grant legal security and foreseeability. Regulators will disclose what they consider a similar economic effect, using official guidelines, questions & answers lists, as well as decisions in individual cases. Market participants, such as traders and hedge funds, will acquire knowledge on deciding when a specific derivative qualifies as having similar economic effect. Quite possibly, a forum for "expert talk" will develop. Lists of financial instruments with and without "similar economic effect" will be discussed and, often, we will see instances of the unique form of lobbying taking place in expert circles.[75]

Both reactions by a legislator provide a viable tool to tackle regulatory arbitrage. A general rule such as § 240.13d-3 para. (b) SEA can be called upon in any individual case of misuse. It allows to "look through" the arrangement chosen by the parties if they were intentionally evading a legal requirement. However, intent has to be proven by the regulator. Alternatively, a legislator may introduce a term focusing not on misuse, but on the economic substance of a transaction – on what was the "real intention", as it were. This makes the regulator's task more straightforward, but can be riskier for market participants, at least until clear regulatory guidelines have been issued. The choice between the two is up to the legislator, who will weigh legal security and foreseeability against efficient enforcement. Importantly, there is not one clear answer to which value trumps the other. Rather, decisions depend on context, on the weight assigned to legal security and legitimate expectations of citizens if contrasted with the impact of the relevant behavior, on the intent of the arbitrageur (or the lack thereof) and on the area of the law in question.

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74 On the limits of the "intent-to-evade approach" see Katz (2010) 6.

75 See above 2.3.

3.3.3 Abusive Practices

Closely related to anti-evasion rules are attempts to tackle abusive practices. This concept captures behavior which follows the words of the law, but intentionally disregards its purpose. Usually, this is entrusted to judges, deciding individual cases. A VAT tax case of the European Court of Justice illustrates the fine line between compliance and abuse – and hence between following the words of the law and unwanted avoidance-arbitrage.[76] On the one hand, the Court held that the law cannot be relied upon "solely for the purpose of wrongfully obtaining advantages provided for by […] law".[77] On the other hand, "legislation must be certain and its application foreseeable by those subject to it [and the] requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences".[78] Thus, tax law "does not require [citizens] to choose [one of two transactions] which involves paying the highest amount of VAT. On the contrary […] taxpayers may choose to structure their business so as to limit their tax liability".[79] Following this jurisprudence, abuse requires that the application of a rule to the relevant behavior results in a situation contrary to the purpose of the rule. In addition, it must be "apparent from a number of objective factors"[80] that the sole viable purpose of a "purely artificial"[81] transaction is to qualify for a specific favorable treatment. Only if this can be established, the relevant transaction may indeed be "redefined" in order to fall under the relevant rule.[82] In cases of abuse "the principles of legal certainty and of the protection of legitimate expectations do not preclude" retroactive application of a law.[83] Put differently: A citizen purposefully entering into a transaction the sole purpose of

76 ECJ of 21 February 2006, C-255/02, Halifax et al. v Commissioners of Customs / Excise, I-1655. Similarly *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934) and *Commissioner v. Newman*, 159 F. 2d 848, 851 (2d Cir. 1947) – dissenting opinion.

77 Halifax note 69.

78 Halifax note 72.

79 Halifax note 73; for another example see two UK cases: In Shah v Shah (2011) EWHC 1902 (Ch), para (57) it was held that the parties may agree to a structure that was fiscally most advantageous; in Estera Trust (Jersey) Ltd v Singh (2019) EWHC 2039 (Ch) para (33) this was upheld but not extended to the different situation where the Court was asked to order one party to enter into a transaction for the purpose of saving tax for another party; at para (35) the proposition that a Court in a commercial context should make an order the consequences and sole purpose of which are the avoidance of a liability for tax that might otherwise arise was rejected.

80 Halifax note 75.

81 ECJ of 22 November 2017, C-251/16, Edward Cussens v T.G. Brosnan, note 79; critical on the Court's interpretation as a "general principle": Leczykiewicz (2019).

82 ECJ Cussens, note 46.

83 ECJ Cussens, note 44.

which is to evade a specific legal regime does not merit the protection afforded by principles of legal security and foreseeability. At the same time, anti-evasion rules and the concept of abuse teach us another lesson: Evasion and abuse are the exception to the rule. "*Was nicht verboten ist, ist erlaubt*".[84] It is, under normal circumstances, not the citizen's duty to worry about the most fitting interpretation of a legal rule, or to explore what type of behavior regulators and courts might consider illegal in light of the spirit of a rule. As long as their behavior falls within the verbal framework of a legal text, and there is no plan to avoid a specific rule, it is *prima facie*, "perfectly legal".[85]

3.3.4 Implications for Corporate Compliance

In the preceding sections I have suggested a number of legal tools at the disposal of regulators who wish to suppress regulatory arbitrage. The focus was on the balance between the provision of legal security for citizens, which pointed towards narrow, formal rules, and the need to not only account for abusive practices and circumvention but also for intentional violation of the spirit of the rule. For the individual citizen, this does not entail a general duty to work out the spirit of a legal norm, or its "best" interpretation.[86] Nor does a citizen usually have to ponder or predict how regulators will understand a specific rule as long as there is a reasonable interpretation compatible with that citizen's conduct.

I have so far neglected the fact that regulatory arbitrage is often encountered in a corporate setting, involving groups of actors. Management establishes general rules, boards oversee strategies, compliance department's work on details and people "on the ground" decide in their daily conduct whether there is reason to make sure a certain transaction is in line with the law. Setting up an appropriate organizational structure is, in a corporate context, regular management duty.[87]

This involves what we may call "strategic legal planning". Regulatory arbitrage often surfaces in the context of innovative transactions or deal structures. The individual person "on the ground" might have chosen a particular structure in order to avoid a specific regime. He might also be simply following an innovative business strategy, unaware of a specific legal regime kicking in. It falls to

84 Whatever is not forbidden, is permitted.

85 See Partnoy (2009) 1037.

86 Dworkin (1986) 88 et seq. on the notion of a (hermeneutic) „best“ interpretation of legal texts, focusing on judges.

87 Langenbucher (2014) 344 et seq. "*Rechtsermittlungspflichten*" (duties to establish the law in question).

management to set out guidelines on how the corporation will identify legal risk of this type and how it will approach open legal questions which the regulator has not yet settled. A reasonable reading of the relevant legal framework will have to be established.[88] Typically, this involves in-house counsel. In more complicated cases, the in-house assessment will have to be backed up by legal opinions from an external law firm. On top of that, some courts have asked board members to perform an additional plausibility check.[89] Asking for plausibility checks of this type is not about requiring supreme legal expertise for board members. Rather, courts hope to rule out "friendly" opinions, given *pro forma* in the spirit of a tick-the-box exercise.

Understanding how corporations deal with the fact that responsibility for lawful behavior is spread across a number of players involves a glance at corporate culture. Some managers will prefer to always adhere to a well-established reading of potentially relevant rules, even if this involves foregoing an innovative structure as long as there is no clear regulatory guidance. Others may prefer to push on the boundaries of how legal rules could be understood.[90] This typically coincides with a more aggressive corporate culture, ready to break with established practices and fight with the help of corporate lawyers for what could be an acceptable reading of the law. "Disruptive" tech companies have been held out as paradigm examples for this latte culture.[91]

Against this background, we might view corporate compliance as providing a second layer, as it were, to suppress regulatory arbitrage. The first layer concerns the individual actor's responsibility for his own conduct. The second layer concerns management's duty to supervise and structure how employees go about this decision. Setting up a compliance structure for this situation requires management to lay out a standard procedure. This may involve – for example – the type of question suitable for in-house counsel, instances where outside opinions have to be mandated or where a third opinion is called for.[92] When structuring compliance procedures along those lines, corporate boards will have to be aware of a number of behavioral characteristics of management and staff, reducing the incentive to

88 Langenbucher (2014) 344 et seq.

89 On German law see Langenbucher (2014) 344 on BGH, 20.09.2011, II ZR 234/09, "Ision", NZG 2011, 1271.

90 Partnoy (2009) 1026, 1033.

91 See Partnoy (2009) 1034 wondering whether there might be a correlation between a corporation emphasizing regulatory arbitrage and compensation incentives see also p. 1038 for situations of uncertainty; on „regulatory entrepreneurs“ going even further („beg forgiveness, not ask for permission“, „agressively favourable reading of the law“) see Pollmann and Barry (2017) 398.

92 Partnoy (2009) 1041 on opinion letters.

exploring the legality of one's conduct.[93] In the context of the Enron scandal, it has been pointed out, that "[i]nnovation in business strategies made the lines drawn in the historic norms of financial reporting increasingly artificial and outdated [...] In the eyes of many managers, financial reporting had lost its relevance and legitimacy"[94] and "managers gradually learned from experience that additional steps in the direction of lower-quality financial reporting paid off without serious penalty".[95] Add to this "rationalization and self-serving inference" as well as "competitive fear"[96] and the idea that managers "feel ethically obligated to minimize regulatory costs and maximize return to shareholders".[97]

Taking these behavioral traits together, motives for the classic compliance situation of breaking the law become apparent.[98] As to regulatory arbitrage, these motives may play out even more forcefully. This is especially likely, if regulatory arbitrage is not about a clear breach of the law – such as, for instance, corruption or money-laundering – but about the "grey" area of an innovative structure. Duties spelling out a good compliance structure will take these motives into account and aim at providing counter-incentives, a number of "lines of defense" as well as double or triple checks. Double-checking can be done, for example, by asking for an independent legal opinion on whether the new structure is indeed "perfectly legal". Typical behavioral features of outside counsel will have to be considered as well: "most lawyers view themselves as ethically *obligated* to provide every legal alternative to their clients"[99] and may be at risk of "going native".[100] Such effects make a good case for a triple check, illustrated by courts which demand a plausibility assessment of board members.[101]

93 See Partnoy (2009) 1025, 1034 on the usefulness of interdisciplinary research in this respect; see Langenbucher (2019) and Langevoort (2017) 949 on applying insights from social psychology (with a focus on self-control) to compliance.
94 Langevoort (2003) 18.
95 Langevoort (2003) 20.
96 Langevoort (2003) 18; Partnoy (2009) 1027.
97 Fleischer (2010) 271.
98 Highlighting psychological effects leading to illegal behavior being perceived as "not unethical": Darley (2005) 1182, 1185, 1191.
99 Fleischer (2010) 271.
100 Fleischer (2010) 270.
101 See above at note 87 and Langenbucher (2014) 344 on BGH, 20.09.2011, II ZR 234/09, "Ision", NZG 2011, 1271.

4 Summary

The paper presents legal tools to suppress regulatory arbitrage. It starts from the assumption that regulatory arbitrage is *sometimes* unwanted, hence the need for legislators and regulators to consider appropriate tools. This entails two claims. Firstly (and somewhat evidently): Although regulatory arbitrage can be a sign of efficient competition, market failure and externalities show where it is unwanted. Secondly: The fact that an arbitrageur successfully avoids a specific legal regime is not in itself sufficient reason to prohibit his behavior or deal structure. Instead, values such as legal security and foreseeability of state action have to be balanced against the harm brought about by avoidance of the legal regime.

The paper suggests two contributions to the debate.

Choices made when drafting legal rules are key to suppress unwanted regulatory arbitrage. Narrow wording is presented as scoring high on the provision of legal security but low on capturing unwanted avoidance strategies. By contrast, broad wording expands the options available to regulatory agencies and courts but may fail to honour legitimate expectations of citizens. The same goes for the interpretation of a legal rule in light of its goal or spirit. Anti-evasion rules and the concept of abuse try to strike a balance between these concerns. Behavior or deal structures which are economically similar but legally distinguishable from the conduct directly addressed by a relevant rule are *prima facie* "perfectly legal". However, granting legal security and foreseeability of state action in this way loses its legitimate justification if the arbitrageur abuses legal forms or if his conduct has the sole purpose of avoiding specific legal consequences. Both concepts, abuse and avoidance, require a certain state of mind of the arbitrageur, such as recklessness, willfulness or intention.

The legal framework of corporate compliance adds a second layer to the tools available to suppress regulatory arbitrage. While avoidance and abuse focus on the individual arbitrageur, compliance expands its reach to a corporation's group setting. An individual's liability for avoidance or abuse is complemented by liability of those shaping, pre-formatting and controlling his conduct. This includes compliance departments, managers and board members as well as legal advisors. It is their responsibility to organize work-flows so that legal rules are complied with. In addition, strategic legal planning and oversight is required. This is especially relevant if regulatory arbitrage comes in the form of innovative deal structures. At the time of their birth, it may not be clear if the regulator will subsume them under a relevant legal rule. Corporate compliance then includes forming a view on the regulators' most likely reaction and how the corporation intends to position itself.

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