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UNEVEN REGULATORY TREATMENT OF DIFFERENT FUNDED POSITIONS – REGULATORY ARBITRAGE OPPORTUNITY?

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Abstract Regulations treating in a diversified way different types of funded positions introduced over decades, do not take into consideration the increasing opportunities of financial innovation and regulatory arbitrage. These opportunities seem to significantly benefit the most sophisticated market agents, for whom this costly opportunity makes economic sense as they typically engage in gigantic transactions. However, the answer to the question of whether such a diversified system of regulations is socially desirable seems to be negative.

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INTRODUCTION

Funded positions, being one of four major types of financial transactions, include such diverse forms of risk-taking as bank loans, capital market investments, and units in collective investment schemes. The basic characteristic which they have in common and which distinguishes them from other types of financial transactions is that they all involve the transfer of capital, not only the transfer of risk. Therefore, when entering into a funded position – providing a loan or buying stock for instance – the risk-taker (bank, investor) becomes exposed to the risks via a payment, and the risk itself is of losing the invested capital (Benjamin, 2007, p. 21).

The goal of entering a funded position by risk-takers is certainly receiving income on the invested capital. Despite the different forms of the income – interest on debt, dividends on shares, appreciation of stock value – and different bargaining power of entities entering funded positions, ranging from small

investors to banks, hedge funds, insurers, this main objective remains the same. However, regardless of this functional similarity, different funded positions are regulated differently.

Having different regulations over the course of the years seemed reasonable as different transactions served different purposes. In recent years, however, considering the rapid growth of the financial sector in recent decade (Philippon, 2008), more and more overlapping business lines (countless examples could be quoted here, for instance – in the case of Poland – rapidly increasing popularity of individual retirement accounts merged with life insurance), a wide stream of financial innovations, decentralization (Schwarcz, 2013) and convergence of funded positions, it seems like significant differences in the regulatory treatment of varied funded positions are no longer justified. Rather, they seem to create regulatory arbitrage possibilities, typically available to the most sophisticated market agents in particular.

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This hypothesis is examined in the article. The article is structured in the following way: the second section serves as a case study of regulations of funded positions in the United Kingdom. In this section, differences in regulatory treatment of funded positions there are described and reasons which serve as a rationale behind the particular legal solutions are provided. In the third section what led to the emergence of these differences is described, together with the consequences of their presence in the financial laws. In the conclusion, elimination of regulatory discrepancies from the regulatory treatment of different types of funded positions is suggested.

REGULATORY DIFFERENCES BETWEEN FUNDED POSITIONS

Funded positions, heavily regulated in general, differ from each other in such dimensions as fiduciary duty, authorization requirements, disclosure agreements, promotion regulation, and product regulation (Benjamin 2007, p. 219-258). These differences in particular relate to the case of the United Kingdom's regulations, however, their equivalents are similar in numerous countries.

Fiduciary duty (obligation of one party – the fiduciary – to place the client's, in this case: investor's, interests above their own) distinguishes equity and managed fund investors from debt holders. The former group is protected by fiduciary duties of directors (and shadow directors) towards the company, in this case assimilated to its shareholders as a group, or by duties of managed funds' managers. Borrowers, on the other hand, do not owe fiduciary duties towards lending banks (and banks do not either, towards their depositors). As fiduciary protections for lenders and holders of debt securities do not exist, they may, however, replicate them in a contract.

This is understandable when one considers the fact that equity holders are owners of a company, which makes the company's directors – their employees. Debt holders, on the other hand, remain outside of the structure of the enterprise.

In terms of authorization requirements under the Financial Services and Markets Act 2000, managed funds differ from both security issuers and borrowers. Issuing securities is not a regulated activity, neither is borrowing from a bank, yet fund managers generally do require authorization as their business is likely to involve such regulated activities as managing

investments, establishing a collective investment scheme, dealing with investments as an agent, giving investment advice, or arranging deals in investments. This regulation seems clear when one realizes that investors in managed funds have much lower control regarding what their capital is invested in, as opposed to security holders and lenders who are able to choose whom in particular they lend to or in what they invest.

As far as disclosure regulation is concerned, the most developed regime applies to issuers of securities on a regulated market, who are subject to disclosure of a prospectus, annual 'disclosure of disclosures', periodic financial reports, significant interests in shares, and market abuse disclosure requirements. Regulated funds are obliged to disclose a prospectus and periodic financial reports – both less detailed than issuers. Unregulated funds and borrowers from banks are not subject to any specific disclosure requirements, though banks can – as usual – impose certain contractual duties of disclosure on borrowers. This rule naturally aims at making sure that security holders, especially minority shareholders with low negotiation power have all relevant information to make careful decisions about their investments. The negotiation position of banks, which constitute the majority of lenders, seems strong enough for them to be able to demand any information they desire without specific regulation imposed.

The regulation of promotion applies very severely to fund units, less so to investment securities, and does not exist in relation to bank loans (except for the borrower being protected against the lender).

It seems that harsh regulations applied to managed funds can be explained in a similar way to authorization requirements, and lax regulations regarding lenders again by the fact that typical lenders are banks.

Unlike loans and investment securities, regulated funds (but no private funds) are subject to exhaustive product regulation, which once again can be explained by the 'indirect' manner of investing in managed funds.

A few conclusions can be drawn from the analysis above. Firstly, lenders – typically banks – seem underprotected (none of the fiduciary, authorization, disclosure, promotion, product regime protections applies to them). On the other hand though, the regime for financial collateral and set off in the financial markets are more creditor-friendly, furthermore banks, being institutions with a strong

negotiation position, can replicate regimes of other funded positions via contract. Secondly, investors in securities are not protected by issuer authorization or product regulation, but they benefit from exhaustive disclosure regulation and are protected by fiduciary duty. Therefore, the regulator makes sure they have all the knowledge needed to make a decision about investment, yet does not interfere with what their capital is invested in.

It is worth emphasizing that these differences seem perfectly understandable if one sticks to the traditional understanding of particular funded positions, and so considers bank loans, capital market investments, and units in collective investment schemes as they were decades ago, distinct from each other for example in terms of owners of the capital invested. However, they seem no longer justified when one takes into account financial innovation leading to more and more hybrid positions being available on the market. Their emergence together with different regulatory treatment of funded positions that, in fact, converge, creates regulatory arbitrage opportunities which shall be analyzed in detail in the next section.

REGULATORY ARBITRAGE OPPORTUNITIES

Victor Fleischer in his comprehensive article (2010) defines regulatory arbitrage as the manipulation of the structure of a deal to take advantage of the regulatory-regime inconsistency, economic-substance inconsistency, or time inconsistency of a transaction and its regulatory treatment. The analysis of uneven regulatory treatment of different funded positions deals with inconsistency of economic substance. Unlike regulatory regime inconsistency, it can take place within a single regulatory regime. It means that two transactions with the same or significantly similar cash flows receive different regulatory treatment. It leads to a regulatory arbitrage opportunity of carving up economic cash flows in such a way as to reduce regulatory costs via changing the formal transaction structure – while changing the business deal underneath as little as possible. Certain institutions (banks) and transactions seem especially prone to regulatory arbitrage – assembling SPVs to securitize risky credits in order to take them off a bank's balance sheet is a recently popular example (mentioned by Alan Greenspan already in 1998).

Analysis of the regulatory arbitrage possibilities regarding funded positions can be divided into four

questions: (a) do regulatory arbitrage possibilities exist within this group of transactions, (b) is their existence merely of historic reasons or is it still justifiable, (c) are they equally accessible to all market agents, (d) do they create or destroy value for the economy. These questions will be addressed below.

As the reader realized going through the second section of the article, differences between regulatory treatment of loans, debt and equity securities, and managed funds, are very significant. Joanna Benjamin (2007) argues that this inconsistent and fragmented regulation of funded positions was developed in response to particular market failures and needs, quite often outdated from today's perspective. For example, restrictive scheme promotion regulation which applies only to private funds and is not reflected in any other European jurisdiction except for the UK dates back to 1930 and was supposed to protect small investors in funds from salesmen's pressure. It did not apply to securities because small investors were not buying them back then (Benjamin, 2007, p. 252-253). If the protective rationale is still valid, security investors should be protected by this regulation, too, as investing in securities is no longer a prerogative of institutional investors and very wealthy individuals.

This brings the issue of law construction in general: as law constructed in 1930 reflected the market situation back then, should today's law – since it is impossible for law to be universal, regardless of the times – reflect the current situation on the markets, with increasing convergence of funded positions? Differences between „overdeveloped“ securities regulation and bank regulation were emphasized by Wood already in 1995, yet increasing convergence makes them more and more dangerous. Joanna Benjamin (2007, p. 257-258) mentions the example of a company X wishing to raise capital from Y, which can choose different structures of the funded position, such as issuing securities directly or placing them in a private fund, converting fund units into bonds.

Another interesting example are Eurobonds (therefore, securities) as opposed to syndicated loans. Both are similar functionally (or are 'close economic substitutes'), with a syndicate of investment banks providing capital and taking the borrower's credit risk, yet the bonds are emitted to investors from outside the banks, though the banks agree to buy any remaining bonds themselves (Benjamin, 2007, p. 181-182). Due to regulatory discrepancies mentioned in the second section, bondholders are more

protected than borrowers in international syndicated loan markets, even though differences between them in respect of patterns of holding, repetition of advances, underwriting (Hughes, 2006), and liquidity (Bowles & Fox, 2007), are narrowing. This is a bright example of regulatory arbitrage: functionally similar syndicated loans and Eurobonds are treated differently by regulators. Interestingly, more and more often borrowers seeking urgent funding turn to hedge funds rather than banks for loans (it is estimated that hedge funds represent currently more than half of the money invested in the leveraged loan market; Bowles & Fox, 2007), exploiting regulatory differences between the two.

Regulatory arbitrage is a costly activity as engaging in it is possible only with the support of professional lawyers. Typically, only large companies can afford employing elite law firms to arrange more aggressive deal structures which, as Fleischer put it, „push the regulatory frontier“, and corporations with established political connections are more effective in bargaining over the regulatory treatment of a deal. As data shows (Fleischer, 2010, p. 230), well-established corporations with strong governance structure do engage in more aggressive regulatory planning than start-ups or closely held firms. As argued by Fleischer (2010) and Knoll (2005), this makes the existence of regulatory arbitrage opportunities unfair, as only the „rich, sophisticated, well-advised, and politically connected“ parties are able to avoid regulatory burdens which the rest of the society is unable to do. Therefore, the rest of the society pays the higher regulatory cost, which seems against the rule of social justice.

Regulatory arbitrage can take the form of using ready-made financial instruments or, more and more frequently recently, of financial innovation. With the development of financial engineering and ease of repackaging cash flow streams in order to create hybrid instruments, the classical division of funded positions, as described in the second section of the article and as addressed by regulations, is no longer valid (Knoll, 2005, p. 64). As argued by Smith & Smithson already in 1990, among the major reasons for financial innovation activities one should mention inconsistencies of the regulatory and tax regimes. As added by Miller (1991), these two can be even described as a primary reason for innovating.

It can be argued that financial innovation is positive for the economy in that sense that it responds to market

needs by creating new, tailored financial instruments. However, these instruments are largely unregulated or regulated in a way which is not suitable for them, and, as mentioned above, rather than responding to market needs, they serve as a means of regulatory arbitrage by making it possible for institutions to evade financial regulation by creating positions prohibited, or at least discouraged, by regulators. Obviously financial innovation is a revenue-generating activity for the parties involved – had this not been the case, entities would not undertake it. The question arises, however, of whether existence of these lucrative opportunities and the regulatory arbitrage they lead to is efficient from the society's point of view, whose welfare should be the main focus of law makers. The answer seems to be negative – the extra benefits earned by parties involved in financial innovation and regulatory arbitrage are obviously reflected in relatively higher burdens transferred onto those tax payers who do not make use of regulatory arbitrage. It makes the existence of regulatory arbitrage, as Fleischer (2010, p. 234) puts it, „privately beneficial and socially wasteful“, even though, according to him, without further investigation it is not correct to claim that a particular arbitrage technique is socially positive or negative. If the regulation is, for example, generally poor, and driven by particular interest groups, regulatory arbitrage opportunities which other parties can exploit might increase social welfare. However, if one sticks to the objective of having good and fair laws, it can be argued that regulatory arbitrage opportunities should be excluded from the landscape.

CONCLUSIONS

Funded positions vary, and so does – in many aspects – their regulatory treatment, which seems understandable when one ignores the transactions' convergence and the increasing presence of financial engineering. However, taking those into account one must agree that the regulatory discrepancies lead to opportunities of financial arbitrage, which, as argued by many, are unjust – as typically sophisticated market participants exploit them at the cost of the rest of the society which is unable to avoid the regulatory burden. According to Fleischer (2010, p. 229), regulatory arbitrage opportunities „undermine the efficiency of regulatory competition, shift the incidence of regulatory costs, and foster a lack of

transparency and accountability that undermines the rule of law”, which makes them undesirable.

What should be emphasized, however, is that these regulatory arbitrage opportunities were not too significant a couple of decades ago, when the regulations were written. However, as times change, people invest in different assets than they used to (e.g. individuals now do buy securities), new instruments enter the market, etc. The sometimes outdated law, which is still in place, rather than protecting weak market agents, attributes more power to the already strong agents, who are able to take further advantage of the regulatory arbitrage. As this state

is undesirable, regulatory arbitrage opportunities should be eliminated. Revising the law and creating rules which more precisely address the current situation is necessary, though difficult. Ways to solve the issue would include focusing more on parties, rather than transactions themselves, and/or using wider legal definitions that would automatically address new financial instruments. Whichever way is chosen to approach the problem of inconsistencies in legal treatment of similar financial transactions, it seems desirable to rule them out of the financial laws.

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