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Facilitating Growth & Development by Connecting to International Legal Frameworks

Charlotte Ku[*] & Andrew P. Morriss[**]

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[*] Professor, School of Law, Texas A&M University, cku@law.tamu.edu
[**] Professor, Bush School of Government & Public Service and School of Law, Texas A&M University, amorriss@tamu.edu

Globalization has created a complex network of legal systems and interactions with multiple differences, gaps and arbitrage opportunities. These have generated business opportunities and market growth. The transformation of offshore regulatory and tax "havens," defined primarily by the absence of particular onshore laws, into international financial centers ("IFCs"), defined by the presence of different laws from onshore jurisdictions and robust regulatory regimes, is an example of where adaptation and transmission of legal innovations have enabled them to add value by lowering transactions costs. This transformation provides insight into the role law and legal institutions play in fostering innovation while strengthening cost-effective regulation, growth, and development. IFCs have found ways to 'monetize' their sovereignty and, in the process, turn themselves into high-income countries.[1] What we examine in this paper are ways their transformations can improve overall governance, facilitate global recognition of financial innovations, strengthen regulatory regimes, and promote the development of others.

This may be a surprising claim for many readers, as a standard part of the debate over IFCs' impact on other jurisdictions is that IFCs are engaged in "unfair" regulatory competition that results in a "race to the bottom." IFCs are portrayed as enabling money laundering of criminal proceeds and undermining national and international efforts to ensure sound banking, insurance, and financial practices. For example, Oxfam argued that offshore financial centers are "an increasingly important obstacle to poverty reduction" because they are "depriving governments in developing countries of the revenues they need to sustain basic services and the economic infrastructure upon which broad-based economic growth depends."[2] . The Tax Justice Network argues similar effects for developed countries resulting in "enormous political and economic inequalities" shifting tax burdens from corporations to individuals and disproportionately to women and disadvantaged minorities.[3] Other critics find that tax havens operate outside the rule of law and process of regulation.[4]

This framing of IFCs' roles ignores that such activities occur everywhere. We argue that the dominant narrative of tax avoidance and criminal activity obscures the benefits that the legal innovation made possible by IFCs provides in strengthening law and regulation not only in the financial sector, but also in global governance more broadly and the contribution their legal regimes make to economic development. Critics' tax-focused accounts fail to recognize the impact of the development of human capital and infrastructure that support ongoing diversification, innovation, regulation, and implementation to meet a wider range of needs including of smaller enterprises and investors. This human capital does not stay contained within national or sectoral boundaries, but moves and adapts to overcome the rigidities that challenge so many of the regimes attempting to govern in a globalized world. Even some IFC critics recognize this process. For example, Ronen Palan sees their development as pitting today's international system of insulating

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[1] For a critical view of "commercializing sovereignty," see Ronen Palan, *Tax Havens and the Commercialization of State Sovereignty*, 56 International Organization, Winter (2002), 151-76.
[2] Oxfam, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication* (London: Oxfam Publications, 2000): 1.
[3] Tax Justice Network, Corporate Tax Haven Index available at https://www.corporatetaxhavenindex.org/en/.
[4] Raymond Baker, *Capitalism's Achilles Heel* (Hoboken, NJ: John Wiley & Sons, 2005), p. 194.

the state in law and institutions against the internationalization and mobility of capital with the following result:

> In employing sovereign rights as commercial assets…tax havens perform an important if controversial act: They demonstrate clearly the manner by which the modern state system not only accommodates globalization but also produces in subtle ways the infrastructure of globalization. In prostituting their sovereign rights, tax havens provide important legal platforms for globalizing financial and, increasingly, other types of services. Thus, a virtual world of a state system can exist beside the "real" state system, feeding on its juridical and political infrastructure.[5]

The reality of today's world is one in which states and governments cannot "effectively control everyone everywhere."[6] Resisting this reality makes regulation and economic development more costly, less effective, and widens the gap between the haves and the have nots. Examining IFC innovation and networking beyond tax and regulatory avoidance provides a more realistic understanding of what the IFC experience can tell us about closing the gap in the inherent power and economic inequalities that exist.

Moreover, IFCs' own development is a case study in the benefits of jurisdictions connecting to networks of professionals. By demonstrating how ideas move across jurisdictions and how cross-jurisdictional structures add value , IFCs facilitate transactions in jurisdictions where local legal systems and services are not yet adequately developed or available to support. We first describe how IFCs' legal systems promote innovations that reduce transaction costs. We then explain their roles as regulatory capacity builders and examine how the networks of professionals, regulators, and judges contribute to ongoing innovation and capacity building.

1. Necessity as the Mother of Invention[7]

Over the past 70 years, many smaller jurisdictions have evolved into international financial centres (IFCs) with impressive rates of growth (although there remains disagreement over exactly which jurisdictions should be classified as IFCs).[8] A 2006 study noted an IFC growth rate of 3.3% as compared to a 1.4% growth rate worldwide.[9] This growth comes from an expanding business in handling multinational transactions for businesses and individuals. Transactions going through financial centers were estimated in 1998 at US$6 trillion.[10] One quarter of all corporate activity is

[5] Palan (2002), 172. See also Katharina Pistor, *The Code of Capital: How the Law Creates Wealth and Inequality* (Princeton: Princeton University Press, 2019).
[6] Erin A. O'Hara and Larry E. Ribstein, *The Law Market* (New York: Oxford University Press, 2009), p. 66.
[7] We previously explored these issues in Andrew P. Morriss and Charlotte Ku, *The Evolution of Offshore: From Tax Havens to IFCs*, IFC Review (February 2020).
[8] There are generally thought to be 35-45 significant IFCs worldwide. However, the International Monetary Fund's *Background Paper on Offshore Financial Centers* listed 70 jurisdictions. International Monetary Fund, *Background Paper on Offshore Financial Centers* (Washington: IMF, June 23, 2000), Table 1.
[9] Dhammika Dharmapala and James R. Hines Jr., "Which Countries Become Tax Havens?" National Bureau of Economic Research Working Paper No. 12801 (2006), p. 6.
[10] Andrew Edwards, *Review of Financial Regulations in the Crown Dependencies* (1998).

estimated to pass through or reside in IFCs together with 20% of the world's private wealth and 22% of worldwide bank external assets.[11] Although such estimates are often based on everything from strong assumptions to wild guesses, there seems little doubt that a significant number of transactions flow through IFCs, even if there is deep disagreement over why they do so.[12] For many IFCs, the financial sector has become a mainstay of the economy[13] employing large portions of the population (up to 20% in the case of Jersey, for example) and improving community-wide governance, including the rule of law.

1.1. Characteristics of IFCs

Although different in their historic origins and in the types and range of financial products and services they offer, IFCs share some common characteristics that make them qualitatively different from onshore jurisdictions:

1. They are generally physically small in size (from less than 100 sq. km to 15,000 sq. km) with few natural resources and populations under 1 million. This means a small labor force and domestic market with few options to build an economy other than financial services, tourism or exporting their labor force.[14] Managing non-resident funds is therefore a characteristic together with a large ratio of net exports in financial services to GDP.[15] Financial services and tourism can also leverage each other as happens in the Cayman Islands where an estimated 40% of its tourism industry is estimated to derive from financial center business.[16]
2. Given the importance of the finance sector to these jurisdictions, they are generally committed to open economies. The successful IFC is politically stable and supports strong and effective legal infrastructure and services.
3. IFCs lack domestic resources or alternative sources of economic activity and have small internal markets. Financial activity in these jurisdictions is therefore not based on physical assets, potentially giving them an advantage in handling digital transactions.
4. IFCs have few alternatives for economic development, which makes them aggressive in innovating in law. Their small size encourages such innovation by reducing the transaction costs of government and regulatory activity that can be conducted in close physical proximity to innovators and allows ease of access to regulators.
5. There is broad public awareness in successful IFCs of the importance of the business that depoliticizes measures related to offshore business. This policy-making environment is less

[11] Palan (2002), 156.
[12] Richard Gordon and Andrew P. Morriss, *Moving Money: International Financial Flows, Taxes & Money Laundering,* 37 Hastings International & Comparative Law Journal (2014).
[13] M.P. Hampton and J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, 30 World Development (2002) 1657-73.
[14] IFCs that do not fit this profile include the U.S. and UK that function as IFCs with Ireland, The Netherlands, Liechtenstein, Switzerland, Malta, and Israel also players in the IFC space. See IMF (2000).
[15] Ahmed Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition*, IMF Working Paper WP/07/87 (April 2007).
[16] Tony Freyer and Andrew P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*, 45 Arizona State Law Journal (2013), p. 1360 citing Vassel Johnson in the Cayman Hansard (December 4, 1985).

likely present in onshore jurisdictions where business and social concerns are pitted against each other.[17]

6. Many of the IFCs are relatively new to the international financial scene taking advantage of the opportunities created by a post-World War II international financial system that could meet neither the capital nor structural needs of a globalizing economy. Prior to developing their financial industries, jurisdictions like Cayman and Guernsey relied on small-scale agriculture or tourism, with Cayman functioning as essentially a barter economy until 1960.[18] IFCs generally have complementary relationships with major financial markets.[19]
7. The IFCs' small size allows them to innovate in the development of regulatory regimes to ensure the long-term soundness of the financial services and products they offer and to foster ongoing innovation.[20] The emphasis on legal infrastructure, supervisory practices, and regulation have provided IFCs important access to and involvement with major international regulatory bodies and standard setters.

These characteristics combined after World War II to enable these jurisdictions to innovate more quickly than larger jurisdictions, finding ways to leverage their main asset – sovereignty – in the development of new products and competition for business.

1.2. Development of IFCs

Before World War I, the international financial order was built around the gold standard; several relatively free trade zones (the British Empire, the French colonial empire, the American zone of influence) and multinational businesses, including banks serving international businesses such as First National City Bank (the forerunner of Citibank), consumer product companies such as Unilever, and natural resource producers such as Royal Dutch/Shell. By the end of World War II, that financial order was shattered not only by the war, but by Nazi and Soviet efforts at autarky, tariff wars, the Great Depression, and the liquidation of UK overseas assets to pay for both world wars.

The new global financial order – constructed under the Bretton Woods framework established in 1944 – poured millions in dollars into the world economy through the Marshall Plan and US military spending abroad. The United States enjoyed an export boom as countries devastated by the war bought capital goods to rebuild their infrastructure and economies.

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[17] See Nico S. Hansen and Anke S. Kessler, *The Political Geography of Tax H(e)avens and Tax Hells*, 91 American Economic Review No. 4, (2001) 1103-1115 (showing that higher income individuals are supportive of the industry where lower income individuals may prefer access to higher levels of government services and therefore less likely to stay in a tax haven).

[18] Freyer and Morriss (2013), 1300.

[19] See Juan Carlos Suarez Serrato, Unintended Consequences of Eliminating Tax Havens, *National Bureau of Economic Research Paper* (December 2019), Dhammika Dharmapala, *Do Multinational Firms use Tax Havens to the Detriment of Other Countries?*, CESifo Working Paper No. 8275 (February 2020) and Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr. *Economic Effects of Regional Tax Havens*, National Bureau of Economic Research Working Paper 10806 (September 2004).

[20] Andrew P. Morriss, "The Role of Offshore Financial Centers in Regulatory Competition," in Andrew P. Morriss (ed.), *Offshore Financial Centers and Regulatory Competition* (Washington, DC: American Enterprise Institute, 2010) pp.130-32.

Decolonization prompted reverse migration from Britain's newly independent colonies, with returning ex-colonials seeking British banking and financial services inside the sterling zone, but outside the UK's high tax regimes. This demand grew in the 1960s as top marginal tax rates soared in most developing economies and the United States began efforts to restrain foreign access to US capital markets through voluntary restraints and mandatory methods such as the Interest Equalization Tax (IET). The Eurodollar market resulted—based in the City of London but taking advantage of connections to jurisdictions associated with the UK. The slow expansion of the international network of tax treaties aimed at eliminating double taxation began after World War II: in 1950, there were just 60 such treaties and only Britain (18), West Germany (6), the United States (5), the Netherlands (3), Austria (2), Hungary (2), and Sweden (2) had more than one.[21] Today, there are over 5,000 such treaties.

This situation created opportunities for jurisdictions that had historic ties to major economies but were not subject to those jurisdictions' laws and regulatory regimes. These early mover IFC jurisdictions had rudimentary financial infrastructure in place to service industries such as casino-based tourism in the Bahamas or the oil refining industry in Curaçao. These included the Channel Islands and the Isle of Man in Europe, Hong Kong in Asia, Bermuda and other British and Dutch Caribbean territories in the Americas. As at least semi-autonomous jurisdictions, these territories were not subject to the banking reserve requirements that UK and US banks faced at home and lacked the high direct taxation rates that became increasingly common in developed economies in the 1950s and 1960s. The contemporaneous marketing of these jurisdictions as "tax havens" (in what was originally a benign use of the term) captures their original role as places to escape from onerous legal requirements and tax burdens imposed elsewhere.

Close to major financial markets, and with steadily improving communication infrastructure, jurisdictions such as Jersey and the Bahamas established bank-oriented financial businesses that legally located transactions outside UK and US domestic regulation. Jurisdictions such as Curaçao took advantage of tax treaties like the 1955 extension of the US.-Netherlands treaty to overseas Dutch territories to create opportunities for businesses in one jurisdiction to access capital markets in others. Others such as the Cayman Islands explicitly set out to develop financial industries, and did so with the encouragement of UK colonial officials looking for long-term development strategies.[22] This first stage of development was characterized by jurisdictions using their growing autonomy as, in effect, a walled garden into which economic activity could be attracted by offering protection from other jurisdictions' taxes and regulations. In a world economy with relatively few tax treaties providing relief from double taxation and where exchange controls and parochial barriers like the IET impeded international investment, such walled gardens added value at the cost of some leakage of tax revenues by wealthy investors.

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[21] Treaty numbers throughout are from our calculations using data derived from the IBFD database of tax treaties. Double taxation was a problem that had been attracting attention since the early twentieth century and the League of Nations had begun work on model treaties to eliminate it, work which the United Nations and the OECD both took up after World War II. *See* Andrew P. Morriss and Lotta Moberg, *Cartelizing Taxes: Understanding the OECD's Campaign Against 'Harmful Tax Competition',* 4 Columbia Journal of Tax Law (2012).

[22] See Rodney Gallagher, *Survey of Offshore Finance Sectors in the Caribbean Dependent Territories* (London: British Foreign and Commonwealth Office, 1990); Morely Ayearst, *The British West Indies: The Search for Self-Government* (London: Allen and Unwin, 1960) p. 45; Freyer and Morriss (2013).

1.3. Climbing the Value Chain: From Walled Gardens to Value-Added

The erosion and then collapse of the Bretton Woods framework in 1971 created new opportunities for offshore jurisdictions. For example, Britain's abrupt shrinkage of the sterling area in 1972 and its termination of capital and exchange controls in 1979 created demand for ways to hedge the now greatly expanded currency risks of floating exchange rates. Domestic financial systems sought to limit the exposure of financial institutions to exchange rate risks and coordinate bank supervisions after the messy collapses of Germany's Herstatt Bank and Franklin National Bank in the United States in 1974. At first, many of these steps to rebuild the international financial order, such as the 1988 Basel Accord, had little immediate impact on offshore jurisdictions. International focus was on the risks of expanded cross-jurisdictional banking, cross-border consumer investment funds (from the headline-grabbing collapse of Bernard Cornfield's Investors Overseas Service), and the defaults and restructurings that followed after the massive expansion of international lending to developing countries in the 1970s.[23]

Legal, accounting, and other financial services industries grew in these financial centers as they developed. The Caymans went from no lawyers in 1960 to attracting Oxbridge graduates working at City firms by the early 1970s. Armed with this talent, many small financial centers began to explore moving up the value chain in the 1970s and 1980s. They sought to increase profits by growing both the volume of transactions and the proportion of the value of each transaction occurring in their jurisdictions. This began the transformation of these centers from offshore regulatory and tax havens into centers where local law was designed to add value to transactions. This added value is a significant factor in IFCs' ongoing productivity and sustainability for two reasons:

1. The networks and relationships created by an initial innovation laid important groundwork for future innovation and business development; and
2. Over time, it is the expertise and efficiency generated by innovations in these jurisdictions that attract business from onshore and not low tax returns. These services simply may not be available at needed levels onshore and is a reason why onshore jurisdictions do not move to shut down IFCs. There is, in fact, evidence that the presence of an IFC may promote business onshore—1% likelihood of an onshore enterprise establishing an IFC affiliate versus 2/3 of establishing something in a neighboring jurisdiction. [24]

Offshore insurance markets provide an example. Bermuda developed a role as an offshore jurisdiction in the 1930s. In the early 1960s, U.S. lawyer Fred Reiss chose Bermuda as the jurisdiction where he would pioneer the captive insurance industry, sowing the seeds for more complex transactions later. In the 1970s, the Cayman Islands persuaded Harvard's hospital system to locate its medical malpractice captive there, in part by passing an insurance law and taking the first steps to regulate offshore insurance to reassure Harvard that its insurance company would not have dodgy neighbors. In both cases risks elsewhere were shifted with the aid of IFC legal regimes.

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[23] See Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997* (Cambridge, 2011).
[24] See Dharmapala (2020). See also Desai, et al. (2004).

The funds industry sought similar legal infrastructure in the 1980s, leading many IFC jurisdictions to pass laws and expand regulatory infrastructure to support them. These laws enabled new types of transactions and screened out bad actors, making these jurisdictions attractive to legitimate businesses. As an example, the Bahamas passed almost 20 major financial-services-related statutes in the 1980s and 1990s. These established or revised legal frameworks to regulate banking, companies and other business entities, funds, insurance, and trusts, and created the infrastructure to collaborate with international law enforcement efforts to stop money laundering and corruption. Other offshore jurisdictions undertook similarly extensive expansions of their legal infrastructure.

Offshore jurisdictions also expanded their regulatory infrastructure, establishing independent regulatory bodies outside of government, and separating promotional from regulatory efforts. Guernsey adopted this strategy early and created the Guernsey Financial Services Commission in 1987.[25] Others soon followed. Expertise for these new regulatory bodies drew on the British colonial and Commonwealth practice of recruiting needed experts from outside a jurisdiction. This provided access to internationally recognized and trusted personnel. For example, among the six members of the first board of the Cayman Islands Monetary Authority (established 1997)[26] were a UK Financial Services Authority employee, a Canadian banking supervisor, and a retired senior partner of KPMG Peat Marwick; three of the six had received honors from the UK government. Jurisdictions also started case-by-case information exchanges with other jurisdictions through treaties (e.g. the Mutual Legal Assistance Treaties negotiated in the 1980s and 1990s between the UK on behalf of many of its overseas territories, a number of independent IFC jurisdictions, and the United States).

These investments in local legal and regulatory infrastructure were key to the emergence of these jurisdictions as places where value was added to transactions and 'suitcases of cash' were not welcomed. In contrast to the earlier goal of simply enabling avoidance of onshore regulations or taxes, offshore jurisdictions now sought to provide for varied and higher quality business structures than those available onshore. For example, Guernsey pioneered the protected cell company structure for insurance in 1997. That legislation quickly spread to other jurisdictions and also began to be used for funds. Jersey's 1984 substantive (and not simply procedural) Trust Law created a statutory framework that increased certainty of outcomes, and created confidence in clients that Jersey trusts could be relied upon. This was accompanied by a parallel transformation of the trustee and corporate services providers from small, privately-held, single-jurisdiction businesses into publicly-held, multinational, multi-jurisdictional companies and an accompanying development of a licensing scheme for those working in the sector. These ideas soon spread to other IFCs.

By the end of the 1990s, successful jurisdictions offered distinctive value propositions and were becoming important players in a more complex international regulatory environment. IFC customers were international companies, multi-jurisdictional families, investors, financial institutions, and insurance companies. IFCs were places to increase profits, benefit from special

[25] See Guernsey Financial Services Commission website at https://www.gfsc.gg/.
[26] See Cayman Islands Monetary Authority website at https://www.cima.ky/.

purpose vehicles, and in the case of insurance companies, to accumulate reserves.[27] Successful IFCs jurisdiction were also well-governed. A 2006 study found that the likelihood of success for an aspiring IFC rose "from 24 percent to 63 percent as governance quality improves from the level of Brazil to that of Portugal"[28] and the top tier IFCs met or exceeded the compliance scores of many onshore jurisdictions for international standards. As a result, IFCs began to help increase worldwide regulatory capacity in coping with the development of these products.

Moreover, onshore jurisdictions became concerned that offshore competition was eroding their fiscal autonomy and diminishing their regulatory efforts. Initially focused on the erosion of the tax base and money laundering of the proceeds of crime, international regulatory efforts turned to security concerns after 9/11. This growing international regulatory regime required IFCs to continue adding to their legal infrastructure. For example, the Bahamas passed more than ten major statutes to address new international requirements after 2001 in addition to updating existing laws. IFCs also had to commit resources to interacting with new regulatory regimes, such as MoneyVal for European jurisdictions or the Caribbean Financial Action Task Force for Caribbean jurisdictions, and with private standard-setters like the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

This account of the evolution of IFCs offers two important contributions to discussions of the role of law in development. First, as development stories, IFCs demonstrate the value of building robust legal systems. By creating the legal rules, judiciaries, and regulatory infrastructure to enable sophisticated trust, insurance, funds, securitization, financing, and other transactions, IFCs went from simply collecting fees for registering entities to supporting dense local networks of skilled professionals in accounting, finance, insurance, law, and wealth management. As we describe below, IFCs accomplished this by adapting foundational legal concepts from abroad and then innovating to create value-added legal products.

Second, the sophisticated legal regimes IFCs built allow both developed and developing economies access to legal structures not initially available elsewhere. For example, captive insurance and other alternative risk management techniques such as catastrophe bonds allow for sophisticated risk shifting that offers developing economies the opportunity to protect themselves from droughts and other natural disasters.[29] To access these structures requires a sophisticated insurance regime, a regulator with experienced personnel who understand the nuances of captive business plans, and regulations that both screen out bad actors and streamline processes for legitimate ones. Other jurisdictions can recognize IFC jurisdictions' legal regimes and permit local entities to make use of those legal frameworks for domestic insurance needs, much as the United States permits captives licensed in Cayman or Bermuda to insure many risks in the United States. Over time, domestic capacity may develop, as it has for captives in the United States, where Vermont, South Carolina, Tennessee, and other states are now vigorously competing with offshore jurisdictions to license captives for U.S. risks. Even where it does, IFCs continue to innovate and exert competitive pressure on the domestic regulators to keep up.

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[27] Financial Stability Forum, *Report of the Working Group on Offshore Centres of the Financial Stability Forum* (Basel, Switzerland, Financial Stability Forum, 5 April 2000), p. 10.

[28] Dharmapala and Hines (2006).

[29] World Bank, *World Bank Catastrophe Bond Provides Financial Protection to Mexico for Earthquakes and Named Storms* (March 9, 2020). These bonds were created in Luxembourg. *Ibid*.

2. IFCs Act as Regulatory Capacity Builders[30]

As Paul Rubin noted in his study of the legal needs of post-Communist states, the relative price of skilled legal talent in transition economies for drafting legal codes, statutes, and regulations is high.[31] The same is true of developing economies. Even in developed economies, these are scarce resources. Investing these scarce resources in developing sophisticated legal regimes diverts those resources from use in adding value in the economy by creating business entities, drafting contracts, and solving clients' problems. IFCs provide legal regimes which can help shift risks, create investment vehicles, and solve governance problems – in short, to reduce transactions costs – by enabling access to the services that can channel investment to both developing and developed economies. For example, a study by the consulting group Capital Economics for Jersey Finance, identified £0.5 trillion in inbound investment from Jersey entities into the United Kingdom (equivalent to 5% of the stock of foreign assets in the UK).[32] Similar studies by the same firm estimated investment flows into the United States and Canada $3.1 trillion from the Cayman Islands, $90 billion from BVI, and $180 billion from Jersey. These three jurisdictions channeled $250 billion into Latin America and the Caribbean, $910 billion into Europe (not including the UK), $750 billion into China and Hong Kong, $800 billion into the remainder of the world.[33]

2.1. Adding Capacity to the Global Legal Environment

Emily Jones and Peter Knaack noted that one of the weaknesses of the global financial regulatory environment was its rigidity particularly as related to developing countries. They found that:

> the existing regimes of regulation and standard setting institutions followed a core-periphery logic, imposing a rigid dichotomy between standard-setters and standard-takers. [These regimes] also focus exclusively on promoting financial stability. We argue that both attributes are increasingly problematic in today's world of globalised finance. Developing countries outside of standard-setting bodies are highly integrated into global finance and while they are not systemically important, they are greatly affected by the regulatory decisions taken in the core.[34]

This adverse effect can be tempered by IFC's experiences in developing regulatory regimes capable of adapting to the rapid evolution of financial markets while providing opportunity to meet the specific needs of other economies through innovation.

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[30] We previously explored these issues in Charlotte Ku and Andrew P. Morriss, "IFCs Act a Regulatory Capacity Builders," *IFC Review* (August 2020).

[31] Paul H. Rubin, *Growing a Legal System in the Post-Communist Economies,* 27 Cornell International Law Journal (1994) 10.

[32] Alexandra Dreisin, et al., *Jersey's Value to Britain: Evaluating the Economic, Financial, and Fiscal Linkages between Jersey and the United Kingdom,* (St. Helier: Jersey Finance 2016), p. 4.

[33] Capital Economics, *The Importance of IFCs in the Global Economy,* p. 17, Appendix C in Cayman Finance, *The Cayman Islands: An Extender of Value to the USA* (Georgetown: Cayman Finance, 2020).

[34] Emily Jones and Peter Knaack, *Global Financial Regulation: Shortcomings and Reform Options*, 10 Global Policy (May 2019), p. 193.

Financial markets frequently evolve too quickly for effective regulation based on a single dimension. Reflecting on the 2008 global financial crisis, the former Bank of International Settlements (BIS) general manager and chief executive officer Malcolm Knight noted that a persistent governance challenge in financial regulation was the constantly innovating nature of the financial services industry. Because these innovations can alter the structure of the financial system, "new risks arise that are not well understood by investors or the financial institutions that develop them, with the prospect that severe financial stresses may arise and not be managed effectively".[35]

IFCs provide one way to address this lacuna because they are qualitatively different competitors in the international marketplace for transactions. Adding IFCs to the mix brings to the marketplace a group of competitors insulated from some of the domestic political pressures that undermine larger jurisdictions' commitments to fiscal stability. This role is particularly important as onshore governments have strong incentives to find ways to limit competition to provide themselves with additional room to maneuver in economic policy. According to economist Barry Eichengreen, governments have been facing increased difficulty to maintain fiscal stability over the twentieth century as restrictions on trade diminished. At first, large economies resorted to exchange controls to prevent market pressures from "punishing them for defecting from the prior regulatory bargain." But these restrictions were not sustainable in a world of increased capital flows: "The conjunction of free trade and fettered finance was not dynamically stable."[36] In addition, the Mundel-Fleming Trilemma illustrates the tradeoffs many governments face, being able to secure just two of three policy goals (stable exchange rates, open capital markets, and sovereignty over domestic monetary policy.)[37] Given the size of funds either passing through or residing in IFCs, any effort to put an end to these practices would require levels of cooperation that even IFC critics recognize would require states to give up sovereign rights at a level which effectively would spell the end of the so-called Westphalian [state] system."[38]

As noted earlier, IFCs are a major source of new products and legal structures, which they provide for use outside their own borders. Their experience with these provides IFC regulators with a head start in understanding the potential risks and stresses these innovations impose on the existing regulatory framework. Their regulatory responses help guide global responses. For example, IFCs were among the leaders in licensing corporate and trust service providers and have quickly adapted more general licensing regimes for legal vehicles to innovations such as the development of special regulatory regimes for insurance linked securities (ILS) vehicles.

While IFCs' financial product innovations are readily recognized, their developments in regulation are equally important. Given the importance of reputation to sustain a strong financial services industry, IFC regulators have more "skin in the game" than do regulatory bodies in larger

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[35] Malcolm D. Knight, *Reforming the Global Architecture of Financial Regulation the G20, the IMF and the FSB*, CIGI Papers No. 42 (September 2014), 14.
[36] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton, NJ: Princeton University Press, 1998), pp. 4, 73.
[37] Catherine R. Schenk, *International Economic Relations Since 1945* (London: Routledge, 2011), p. 5.
[38] Palan (2002), 173.

economies. A single Madoff case could be fatal to a small jurisdiction's reputation.[39] Large economies such as the United States, European Union, or China might weather multiple regulatory failures and Ponzi schemes, and such disasters can recur without investors doing more than shrug. As Nassim Nicholas Taleb has argued, skin in the game is an important creator of appropriate incentives in finance and IFC regulators have much more at stake than do large economy regulators.[40] IFC regulators and professionals understand that a healthy financial sector depends on their effective regulation, track-record, and reputation. This differs from the onshore regulator and professional focused on stability, where Taleb concludes that "[a]t no point in history have so many non-risk-takers, that is, those with no personal exposure, exerted so much control."[41]

IFCs' role in regulatory innovation was recognized as early as the 1998 UK Home Office review of the Crown Dependencies (CDs) (Jersey, Guernsey and the Isle of Man), known as the "Edwards Report". Commissioned by an arm of the UK Government not particularly sympathetic to IFCs, to review the CDs' laws, systems, and practices for regulation as well as for the combatting of financial crime and cooperation with other jurisdictions,[42] the Edwards Report recognized that the CDs provided:

> *Innovation and flexibility*. The offshore centres are sometimes better able than the larger centres to test out innovative financial products such as new insurance or investment vehicles. They can respond flexibly and quickly to the changing needs of international customers and markets. In the larger centres, the ramifications of change are typically wider.
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> *Regulation.* The offshore centres may also be able to lead the way in certain areas of regulation. Examples are the regulation of Trust and Company services providers.[43]

More than 20 years later, IFCs are still providing "innovation and flexibility" and often "leading the way" in regulation. They continue to innovate and to lead because they are embedded in a densely layered set of networks through which ideas about laws, regulations, best practices, and solutions are spread. Accountability for these networks is provided through democratically elected governments and legislatures. In the case of the Channel Islands, a Financial Ombudsman for Jersey, Guernsey, Alderney, and Sark has added a further measure of public oversight and transparency since 2014.[44]

Internal IFC regulatory innovation and experience contribute to global and regional regulatory and policy bodies overseeing international financial regulation. One example is IFCs' participation in the Basel Committee on Banking Supervision (BCBS). Created to address the regulatory weaknesses that led to the 1974 collapses of a German and an American bank caused

[39] See U.S. Securities and Exchange Commission, Office of Inspector General, Case No. OIG-509, *Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme* (August 2009).
[40] Nassim Nicholas Taleb, *Skin in the Game: The Hidden Asymmetries in Daily Life* (New York: Random House 2018).
[41] Taleb (2018), p. 6.
[42] Andrew Edwards, *Letter of Transmittal*, *Review of Financial Regulations in the Crown Dependencies* (October 1998), 24.
[43] Edwards, *Report,* (1998), section 17.5, paragraph 201.
[44] See information about the Channel Islands Financial Ombudsman at https://www.ci-fo.org/.

by foreign exchange speculation noted above, the BCBS did not initially include IFCs. However, in the 1980s Jersey States' Economic Advisor Colin Powell brought IFCs and the BCBS together. Powell went on to forge "the longest and closest relationship between the BCBS and non-G10 regulators."[45] This collaboration gave the BCBS the benefit of IFC banking regulators' experience and expertise. Where possible, a collaborative approach seems preferable to the system of "reputational and competitive incentives" pressuring developing countries to adopt international standards even if they are ill suited to the situation by failing to take into account the particular needs and conditions of developing economies.[46] An interactive approach provides regulatory innovation to address new products and services in a rapidly changing and complex financial sector while gaining greater understanding of the practice and its potential effects on the global financial system. It is an approach that enlist more who have "skin in the game" and overcome the rigidity that threatens the present regulatory system over the long term.

Networks are important methods of generating and spreading solutions to problems. For example, the IFC-BCBS collaboration rapidly bore fruit in improving the international financial environment. In 1989, IFC regulators agreed to apply the Basel I standards to their banks; in 1991 Powell successfully advocated for more stringent standards, participation criteria based on effective banking supervision, and stronger sanctions against non-compliant regimes.[47] Without IFC participation, it is unlikely the consensus-driven Basel process would have been able to move this quickly. Similarly, the Edwards Report acknowledged that the CDs "have taken a leading role in seeing to promote high standards in the offshore generally."[48] This included spearheading the development of the Offshore Group of Banking Supervisors (OGS), including the Group's involvement with FATF processes, and development of the Offshore Group of Insurance Supervisors (OGIS) in 1993 (which later evolved into the International Association of Insurance Supervisors (IAIS)).

Although IFCs are small jurisdictions and so their regulators are smaller in absolute size than larger jurisdictions, their regulators are proportionate to the size of their financial sectors in terms of staffing per regulated entity.[49] IFCs invest in their regulatory bodies by recruiting internationally recognized experts. IFCs as jurisdictions are also deeply engaged with pan-jurisdictional bodies, ranging from interest groups like the IFC Forum to specialized organizations of regulators, such as the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

Participation of IFC regulatory staff in these bodies has a larger impact in a small jurisdiction than the homeopathic impact that participation of large economy regulators does on their home jurisdictions. IFC regulators often have high levels of industry experience, giving them deep knowledge of industry practices and connections, while comparable large jurisdiction regulators have less international and relevant private sector experience. IFC regulators have careers that span multiple jurisdictions, giving them an invaluable multi-jurisdictional network and

[45] Goodhart (2011), p. 417.
[46] Jones and Knaack (2019), 194.
[47] Goodhart (2011), 417, 424, 480.
[48] Edwards (1998), Report, section 17.5, paragraph 201.
[49] Andrew P. Morriss and Clifford C. Henson, *Regulatory Effectiveness & Offshore Financial Centers*, 53 Virginia Journal of International Law (2013), 417.

perspective. For example, all ten directors of the Jersey Financial Services Commission have significant professional experience in other jurisdictions, and include a former UK Financial Secretary, a former Central Bank of Ireland regulator, former CEOs of multi-jurisdictional firms, and multiple members with experience in European institutions and multinational regulatory bodies.[50]

The regulatory competition and innovation provided by IFCs qualitatively changes the larger market. As to the criticism that IFCs enable the looting of developing jurisdictions, global regulatory competition and innovation could force a loosening of the state controls that enrich the empires of many autocrats – in Africa, the former Soviet Union, and other locations.[51] Liberalizing capital flows might also have the effect of bypassing corrupt government-owned or government-influenced financial institutions.[52] Both democratically constrained and autocratic governments are affected by regulatory competition in important ways. Democratically constrained governments find the cost of inefficient policies increased by more vigorous regulatory competition, and so engage in less of it. Autocrats find their regulatory competition in financial matters makes many of the measures they have traditionally used to impoverish opponents too expensive to maintain in the long-run. Indeed, only autocrats with significant rents available from commodities and natural resources have been able to maintain their economies above the subsistence level in recent decades, while those without such rents have been forced to liberalize or forgo the rewards of economic growth. This competition is a significant benefit of the regulatory competition provided by IFCs.

3. Networks as Assets and Solution Providers

The IFC experience demonstrates the importance of depth in the regulatory system to cope with the regulatory demands of new financial products and services. IFCs provide that regulatory depth in ways that larger jurisdictions do not. Although seemingly counterintuitive – surely bigger regulators' larger staffs and resources have room for deeper expertise – the apparent contradiction is resolved by IFCs' greater "skin in the game" and ability to leverage their participation in dense networks of regulators, service providers, and multinational institutions.

While IFCs benefit from the international connections and networks that the global regulatory framework provides, the ultimate beneficiaries are consumers of financial products and services and the regulatory framework as a whole. In addition to supplying needed professional services, IFCs provide a necessary interaction between the market and regulators that addresses immediate needs and develops the capacity and structure to meet future needs in a timely manner, at a tolerable cost, and effective level of regulatory complexity. This is particularly important in finance, where innovation is centered on "the creation of new instruments by repackaging the cash flows generated by others."[53] Recognizing this relationship and fostering its development will be

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[50] The JFSC directors' biographies are listed on the Commission website, https://www.jerseyfsc.org/about-us/directors/

[51] George B.N. Ayitty, *Africa in Chaos* (New York: St. Martin's Press, 1998), p. 262.

[52] Daniel Drezner, *All Politics is Global* (Princeton, NJ: Princeton University Press, 2009), p. 128.

[53] Patrick Honohan, *Avoiding the Pitfalls in Taxing Financial Intermediation*, in *Taxation of Financial Intermediation: Theory and Practice for Emerging Economies* (The World Bank, 2003), 18. 1, 19-20 (2003)

important to address the core-periphery issue identified by Jones and Knaack and its negative effects on developing economies as well as the anticipated higher rate of innovation and resulting complexity in financial products and services to come. What is most needed for development is a focus on strengthening the robustness of the overall global framework; IFCs have much to offer in that conversation.

3.1. Networks as a resource

IFCs bring to the table the expertise of a dense network of governments, regulators, and professionals in ways that larger jurisdictions cannot. For example, trust and company service providers have gone from an industry dominated by small, single jurisdiction businesses to one with large, multi-jurisdictional service providers, which are often publicly traded companies, such as JTC and CITCO. Keeping up with a rapidly evolving industry is difficult for large jurisdictions, where legislative and regulatory programs might be decades in the making. Moreover, part of what makes the spread of ideas for new products – whether a segregated portfolio company or the purpose trust -- possible is that jurisdictions are connected through the international regulatory framework for the financial system as well as through private sector networks. This is a far cry from the image of smaller jurisdictions being "relegated to the role of rule-takers" in a two-tiered regulatory system, with limited access to the channels of consultation within regulatory bodies.[54] It does suggest a convergence by those at the periphery to "converge on the regulatory standards and norms that prevail at the core," but a convergence that they can influence by leading in regulatory innovation.[55] The advantage, however, has limits principally as dictated by the major onshore economic powers.

If we look at the development of IFCs from the perspectives of networks, innovation, and governance, a fuller and larger system-wide picture emerges. We know that a key factor in innovation is to connect people.[56] Ideas are further generated by connecting with other technologies and market forces to drive down costs and to simplify it for broad application. In a world of increased complexity, striving for simplicity in regulation seems counterintuitive. Yet, it is precisely simplicity that generates resilience and flexibility to adapt to new challenges and ideas. For all the world to benefit from innovation, all ideas and people related to a particular sector need pathways to connect not only for financial gain, but also for seeding the next regulatory and financial innovation. As Matt Ridley noted in his treatise on innovation:

> Innovation happens when ideas can meet and mate, when experiment is freely encouraged, when people and goods can move freely and when money can flow rapidly towards fresh concepts, when those who invest can be sure their rewards will not be stolen.[57]

We see this in the physical world where technologies combine to give us the next great innovation. The development of the automobile and its relationship to other technologies provides such an example: "The inventors of the motor car did not have to invent wheels, springs or steel.

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[54] See Jones and Knaack (2019), 193.
[55] *Ibid.*, 194.
[56] Matt Ridley, *How Innovation Works* (New York: Harper 2020), p. 9.
[57] *Ibid.*, 371.

If they had done, it is unlikely that they would have ever produced working devices along the way."[58] We recognize this phenomenon less in the world of governance and knowledge generation, but it is no less significant. The IFC experience provides insight into this phenomenon. The interplay of business opportunity, expertise, and connection to international frameworks is an evolving story that sheds light on the role of law and legal institutions in economic growth and development.

It is important to note that the offshore legal network is much more than a passive recipient of international norms and law. As the comparative law scholar Alan Watson noted, "transplanting is, in fact, the most fertile source of development" in the law.[59] As a result, IFCs are increasingly playing an important role in the development of the law of financial services. The varied backgrounds and legal cultures IFCs bring to this process is an important ingredient in developing opportunities and solutions to emerging problems. As Watson concluded, "law like technology is very much the fruit of human experience…. and once invented their value can readily be appreciated, and the rules themselves adopted for the needs of many nations."[60] IFCs can therefore serve as the incubators and laboratories for innovation rather than outliers or renegades. Recognizing their role both in innovation and bringing them into regulatory regimes as participants can also ensure greater relevance of international regulation for the smaller jurisdiction giving it a stake in the ongoing resilience of that regime.

3.2. IFC networks

Helping spread ideas are multijurisdictional law firms and other professional services firms, including banks, insurance managers, and trust companies. Using *The Lawyer's* annual ranking of the "magic circle" of offshore firms, we examined the connections among jurisdictions by these multijurisdictional law firms with at least 20 lawyers (21 of the 30). Figure 1 provides an illustration of these connections.[61]

These networks are extensive. Among these twenty-one law firms, two-thirds had offices in at least three jurisdictions. Among those with multiple offices, the median number of IFC jurisdictions in which they had a presence was five. Examining the biographies of the partners in these firms, we find it is common for partners to have experience in multiple jurisdictions.

A second means of examining these networks is through professional associations. The Society of Trust and Estate Practitioners (STEP) is "a global professional body, comprising lawyers, accountants, financial advisors and other practitioners that help families plan for their futures" and has 20,000+ members over 96 jurisdictions. (Joining STEP requires combinations of professional experience and certification through courses; it is not simply a matter of paying a fee.) We compared numbers of members listed in STEP's online directory by IFC and normalized the numbers by jurisdictions' total population and found much higher concentrations of STEP members in IFCs than in onshore jurisdictions, an indication of a robust professional network tying

[58] *Ibid*., 253.
[59] Alan Watson, *Legal Transplants: An Approach to Comparative Law* (Athens, Georgia: University of Georgia Press 1993), p. 95.
[60] *Ibid*., 100.
[61] We are working on a more elegant graphic.

IFCs together.[62] (See Figure 2). IFC professionals also connect through IFC-specific organizations, such as IFC Forum, which plays a critical role in helping to coordinate responses to international regulatory measures.

There are similar connections through other professional service providers. Aon, for example, offers captive management services in ten IFC jurisdictions; JTC, which manages trusts and provides other corporate services, has offices in twelve IFC jurisdictions; Bermuda-based Butterfield Bank has offices in seven IFC jurisdictions; and accounting firm BDO has offices in more than fifteen IFC jurisdictions. Many of their competitors have similarly global networks.

IFC courts exhibit significant multi-jurisdictional ties among their personnel. These ties can come from movement of personnel or by institutional links. As examples of the personal links, Ian Kawaley, the former Chief Justice of Bermuda, sits as a judge in Cayman, and Sir William Bailhache, formerly Bailiff in Jersey sits on the Guernsey Court of Appeal. and Sir Michael Birt, another former Bailiff in Jersey, sits in both Guernsey and Jersey. Institutionally, the Bailiff of Guernsey sits on the Jersey Court of Appeal. Many other IFC courts have a similarly international flavor.

IFC regulators also have wide connections to other IFCs. For example, of the six members of the Bermuda Monetary Authority executive team, two have significant experience in other IFCs and three more have significant non-IFC overseas experience. Many other IFC regulators exhibit similar pan-jurisdictional experience. In addition, IFC regulatory agency staff and leadership work together on behalf of their jurisdictions in international meetings of regulators, such as IAIS and IOSCO and participate in inspection teams as part of the assessment process for compliance with international anti-money laundering and other financial standards.

IFCs are also bound together through treaty networks. Although jurisdictions without personal or corporate income taxes have historically had little need for tax treaties, many IFCs impose direct taxes, albeit at lower levels than most larger jurisdictions. And more recently, even non-direct tax IFCs began to sign tax information exchange agreements (TIEAs) with other jurisdictions (in part because the signing of at least twelve agreements was an element in not being blacklisted by the OECD). Examining the pattern of such agreements, we found twenty of the forty-four jurisdictions with the greatest number of TIEAs were IFCs. The experience of negotiating and maintaining these treaties provides IFC governments with an additional network of connections with other IFC governments.[63]

These various networks all provide channels by which legal innovations move among IFCs, enabling these small population jurisdictions to harness the creativity and innovation of a group much larger than exists within their borders. This suggests a strategy for both developed and developing economies: build similar networks by recruiting regulators and judges from across jurisdictions, facilitate the development of cross-jurisdictional professional services firms by facilitating multi-jurisdictional practices, join pan-jurisdictional associations of regulators, and

[62] There were a total of 5,758 STEP members in IFC jurisdictions, from a total membership of 11,981.
[63] A future version of this paper will include more extensive analysis of this data, which we are just starting to digest.

adapt regulatory regimes from peers rather than inventing them from whole cloth or mimicking the complexity of large economy regimes.

3.3. Platforms for Innovation

IFCs did not start as *tabula rasa* legal jurisdictions but built their current legal systems on what they inherited from metropolitan powers (for former colonies and current overseas territories) or predecessor states. Jurisdictions with a British legal heritage generally began to attract financial services using company law derived from existing English statutes and common law; IFCs with other heritages started with baselines derived from other sources (e.g. Curaçao from Dutch law; Liechtenstein from Austro-Hungarian, German, and Swiss law).

These initial statutes were often far out of date when the financial centre business began. For example, the Bahamas had a company law based on Britain's 1866 company law; Barbados' dated from 1910, BVI's from 1885, the Channel Islands' from 1861, Gibraltar's and Hong Kong's from 1929, the Isle of Man's from 1931, and Vanuatu's English option (while it was the Anglo-French Co-Dominium of the New Hebrides) from 1948. Some jurisdictions had no relevant statute: Cayman had none when it separated from Jamaica and the creation of its first companies act in 1960 was a crucial first step down the road to becoming an IFC (or, indeed, having a modern economy at all).[64]

As offshore jurisdictions launched efforts to bring financial business to their territories, they modernized their laws often by drawing on counsel from a parent jurisdiction as Cayman did in 1960 hiring English counsel to adapt English statutes at the prompting of the then-British Administrator.[65] By using English models for their company laws,[66] as many IFCs did, these jurisdictions had available both the substantial body of English precedent and the extensive literature on the English acts as aids in applying their own companies' law. For example, Palmer's *Company Precedents,* first published in 1877, and which had grown into a dense resource by the 1960s, provided an authoritative guide to resolving many practical issues within English-law based companies laws. The early non-common law offshore jurisdictions either had similarly robust metropolitan sources (the Netherlands Antilles and the Netherlands) or invested in developing their own (Liechtenstein's *Personen- und Gesellschaftsrecht* (P.G.R.) – a comprehensive statute that a contemporaneous review termed "very rich in corporate forms"[67]). The rich legal heritage English and other onshore company law provided was a key factor in generating these innovations. Where this heritage was not present, efforts to create *sui generis* jurisdictions like Sealand or Minerva could not produce acceptable innovation or gain recognition and others like San Marino or Andorra could only offer the simplest structures.

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[64] Freyer and Morriss (2013).

[65] Freyer and Morriss (2013).

[66] Some jurisdictions' modernization efforts looked to other models: Barbados based its 1982 company law reform on Canadian law, reflecting a growing customer base among Canadian businesses. Nevis based its 1989 reform on Delaware law (following Panama, which had copied Delaware's statute in 1929), looking to capitalize on potential Panamanian customers' unease with the Noriega government's ties to drug cartels (which prompted the U.S. invasion in December of that year).

[67] Marcus Wyler, *The New Civil Law of the Principality of Liechtenstein,* 8 Journal of Comparative Law & International Law, no. 4 (1926), 204.

IFCs did not simply copy English or other onshore models. The 1967 Companies Act, for example, did not provide for distinct entities for small companies although it did distinguish between public and private companies.[68] As a result, English companies of all sizes were bound by the same requirements for filing annual accounts, restrictions on making loans to directors, and so on. English law's distinctions between shareholders and directors could "become a nuisance" for small companies.[69] Such provisions served little purpose in IFCs since the vast majority of companies created offshore had relatively concentrated ownership and often were primarily passive vehicles for holding assets. Making themselves attractive to their target clientele thus required IFCs to adapt, rather than merely copy, English or other model company laws. Once the door to change was opened, it remained ajar for further innovations.

Another important distinction between IFC and onshore companies acts is the frequency with which they are amended.[70] For example, the basic English statute is updated only infrequently with the last major update completed in 2006.[71] By contrast since 2010, the Bahamas has amended its companies act four times and Barbados and BVI amended theirs five times each. Many other IFCs follow similar patterns. Much as Delaware has gained a competitive advantage in the market for U.S. incorporations by keeping its statute up to date (with six amendments since 2010) and drawing heavily on the community of Delaware corporate lawyers to decide priorities,[72] IFCs are making the investment in regular updates, speeding the development of an IFC version of company law.

Sourcing innovation in English companies' law gives the lawyers and judges working in a wide range of IFCs a common starting point for solving problems and the toolkit of a sophisticated, well-developed set of precedents on which to draw in finding solutions.[73] It provides a crucial part of the legal foundation on which much of the IFC world is built. A precondition for innovation is thus the availability of a widely recognized legal tradition flexible enough to innovate, well-stocked with concepts with which to create new entities, open to new ingredients from other jurisdictions, and in the hands of a creative community and network of globally recognized experts able to combine ingredients in new ways. This requires more than a single entrepreneurial lawyer or government official. That might be enough – as it was to get Wyoming to create the LLC – to get a single statutory innovation adopted in a single jurisdiction. To create enduring innovation, however, takes a broader community. Two examples, the creation by the British Virgin Islands (BVI) of the International Business Company (IBC) and the spread of the limited liability company (LLC) structure from Panama to the United States and then to a large number of IFCs, illustrate this.

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[68] Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* (8th ed.) (London: Sweet & Maxwell 2008), pp.13-14.

[69] *Ibid*., 6.

[70] As Paul Davies and Sarah Worthington explain, "One major difficulty attending legislation as long as the Companies Act is that a major commitment of parliamentary time by the Government is required to get such legislation onto the statute books. Once there, ministers are likely to take the view that company law has had its turn for some while and will be reluctant to devote additional parliamentary time to proposals for its further reform." Paul L. Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th ed.) (London: Sweet & Maxwell 2016), p. 54.

[71] See UK Companies Act 2006 available at https://www.legislation.gov.uk/ukpga/2006/46/contents.

[72] Larry E. Ribstein and Erin Ann O'Hara, *Corporations and the Market for Law,* University of Illinois Law Review [2008].

[73] See interview with Ian Boxall cited in Freyer and Morriss (2013), 1366.

3.4. IBC Acts

One of the first IFC business entity innovations was the creation of the IBC. Starting with the solid foundation of their companies laws, the first IFCs focused on legal provisions allowing creation of companies that would act only outside their jurisdictions of incorporation to receive tax exemptions or substantial discounts on local taxes. Both ring-fenced tax regimes (via the U.S.-Netherlands tax treaty through Curacao and Aruba and the U.S.-U.K. tax treaty through the BVI) and "exempted company" structures quickly spread across the offshore world. These were simple structures, requiring little more than filing, recording, and fee-paying to create and additional fee-paying to continue entities.[74]

The first IBC Act to win widespread use was adopted in BVI in 1984 after the United States cancelled the extension of the U.S.-U.K. treaty to BVI over treaty shopping concerns.[75] In this case, the driver for innovation was an outside action: the loss of the treaty reduced BVI government revenue by the amount it spent on education creating urgency to find a replacement revenue source.[76] Importantly, without the benefit of the treaty, BVI needed the IBC to be more than a purely tax-driven structure. BVI's innovation was to combine simplicity and flexibility: it provided that non-BVI business by an IBC would not be taxed, streamlined procedures that kept costs down allowing companies without members and statutory mergers, and made available statutory tools for restructuring and reorganization. BVI also cleverly allowed company names to be written in Chinese characters, an innovation for a non-Chinese language jurisdiction and one that helped launch a boom in Chinese use of the BVI IBC—a relationship with China that continues to this day. BVI's legal system further gave it an advantage in that any future disputes among IBC owners would be resolved by courts with skilled judges and practitioners applying well-established legal principles, with an ultimate appeal to the UK's Privy Council. The idea quickly spread across a number of jurisdictions, with statutes similar to, and often clearly copies of BVI's adopted by over twenty.

An important innovation was that the BVI drafters of the 1984 Act drew heavily on Delaware law, taking advantage of that jurisdiction's extensive investment over time at advancing its statute through the Delaware Court of Chancery.[77] The market leader for offshore companies when BVI launched the IBC was Panama, which had previously used Delaware law (albeit the 1927 version) as the basis for its company law. BVI's IBC provided a significantly more modern interpretation of the Delaware statute, well-drafted English language legislation, and a superior appellate court system. When the United States invaded Panama in 1989, it gave the BVI IBC a substantial boost from investors seeking political stability and the two statutes' common heritage in Delaware law made transitioning from Panama to BVI easier for law firms and companies alike.

[74] Some of these early efforts used the name "International Business Company" for such companies. Barbados, along with Antigua, Grenada, Jamaica, and St. Vincent and the Grenadines, experimented unsuccessfully with special tax regimes for what they called IBCs in the 1960s and 1970s. As Bruce Zagaris noted in a 1981 review, these efforts led to legislation that was "seldom used" in any of the jurisdictions adopting that earlier model. Bruce Zagaris, *Barbados Develops as a Low-Tax Jurisdiction,* 15 The International Lawyer, no. 4 (1981), 676.

[75] Craig M. Boise and Andrew P. Morriss, *Change, Dependency, and Regime Plasticity in Offshore Financial Intermediation: The Saga of the Netherlands Antilles,* 45 Texas International Law Journal (2009).

[76] Jason Smith, *Interview, Lewis Hunte*, BVI Beacon (Sept. 20, 2012), 10.

[77] *Ibid*.

The BVI IBC Act's Delaware DNA and the jurisdiction's focus in drafting on solving practitioners' problems were more than lucky choices. The primary draftsman for the BVI IBC Act, BVI Attorney General Lewis Hunte, asked two experienced company law practitioners to aid him in drafting the law so he "could know what particular difficulties they experienced during the practice of company law. They were able to tell me and I was able to write a decent act."[78] This connection between drafting and solving practitioners' real world problems is a constant across IFCs, where both organized and informal means of consultation between the financial community, legal community, and government are a matter of course and made easier by small jurisdictions' professional communities' compact size.

In this instance BVI's competitive advantage came both from being first and from delivering quality services in creating and managing IBCs. The problem for later entrants was that it was hard to distinguish their IBC and themselves from BVI's statute and BVI. With a statutory scheme built around simplicity, there was little room for competing by adding bells and whistles. Jurisdictional choice for IBCs were thus more likely to be determined by factors such as a convenient time zone, a service-oriented registrar, and the recommendations of law firms and consultants. Although some jurisdictions attempted to compete with BVI on price, UK solicitor Milton Grundy (who had co-drafted Belize statute) concluded that – at least at the price levels for IBCs – cost was "overrated" as a decision factor.[79]

In the 2000s, IBCs and exempt company regimes began to come under increased pressure from the OECD and EU, particularly with respect to whether or not these entities have sufficient economic substance to warrant legal recognition outside their home jurisdiction. In response, some jurisdictions have modified their overall corporate tax structure (e.g. Guernsey and Jersey's adoption of "zero/10" corporate tax structures) to continue to compete in this market. The result has been effective tax competition, perhaps too effective to suit the higher tax rate jurisdictions in the EU, such as France and Germany. In response to this pressure, BVI evolved its IBC into the BVI Business Companies Act in 2004, phasing out the IBC Act in 2006.

One of the most important consequences of BVI's success with the IBC Act and its successor was to give BVI an important role in the network of offshore law firms. Of the firms regularly listed in *The Lawyer's* ranking of top 30 offshore law firms, fifteen have offices in BVI, the most of any jurisdiction in which those firms operate. BVI's connections through these firms to other IFCs both bring it business and mean that the BVI legal profession is closely connected to developments in other jurisdictions. This network helps distinguish BVI from its competitors which have successfully copied its statute and highlights the critical role human capital plays in both turning well-drafted words on paper into successful legal innovations and keeping a jurisdiction at the forefront of a market.

From a development perspective, the BVI IBC and its successors have proven an important vehicle for channeling investment into emerging economies, particularly into China. BVI IBCs offer a well-developed set of corporate governance principles for investors, lowering the

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[78] *Ibid*.

[79] Milton Grundy, *Offshore Business Centres: A World Survey* (7th ed.) (London: Sweet & Maxwell, 1997), p. vi.

transactions costs of creating corporate vehicles for cross-border investment. They do so without adding a second layer of tax, further reducing transactions costs.

3.5. The LLC

One of the most successful innovations in business law in the past fifty years is the limited liability company (LLC).[80] The story has a straightforward beginning. The Hamilton Brothers Oil Company had experience with a Panamanian unincorporated business entity, the *limitada.* It sought a U.S. entity that provided the *limitada's* limited liability and pass-through tax characteristics.[81] The company's lawyers drafted a proposed statute and shopped it first to Alaska (which failed to pass it in 1975 and 1976 "apparently for political reasons unrelated to the proposals") and then to Wyoming, where the proposal met with a more enthusiastic reception. Once the statute was adopted, the company, its tax advisors, and Wyoming battled with the U.S. Internal Revenue Service (IRS) for several years over whether or not the new entity qualified for federal pass-through tax status. Few paid attention— only 26 LLCs had been established by 1988.[82]

In 1988, the IRS finally conceded partnership tax status to the Wyoming LLC and U.S. use of the LLC quickly exceeded expectations. The LLC provided corporation-levels of limited liability without the extra layer of corporate tax in a flexible format that allowed those designing entities maximum freedom to structure them as they wished. As the LLC's popularity grew, the American Bar Association's Tax and Business Sections established committees to study the LLC, identify issues, share resources, and help state legislative drafting committees pass their own LLC acts. These modifications of the Wyoming model were constrained by the need to preserve pass-through tax status and so considerable effort went into ensuring that other states' LLC statutes passed muster with the IRS. An extensive effort by the bar spread the LLC to other U.S. states and eventually prodded the IRS into issuing clear guidance on the tax status, which allowed the further development of the entity beyond the relatively narrow initial Wyoming version.

IFCs quickly began to adopt their own versions of the LLC, starting with Anguilla and Dominica in 1994. The pattern here differed from the IBC adoptions, with rapid adoption by eight jurisdictions in a three-year period, then another ten years until twelve had done so. Some of the most well-established IFCs (Bermuda, Cayman, and Jersey) were among the late adopters although there were also well-established early adopters (Bahamas, Isle of Man).

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[80] The history of the LLC in the United States is thoroughly described in Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure,* in Steven A. Bank and Kirk J. Stark (eds.), *Business Tax Stories* (New York: Foundation Press, 2005).

[81] At least some accounts trace the *limitada* back to the German GmbH, filtered through the French S.A.R.L., and into Panama via within-the-family civilian law borrowings. Closing the loop, Panama adopted a revised statute in 2009 for its version of the LLC. U.S. corporate law expert William Carney argues the true source for the LLC is the English unincorporated joint stock company and links the specific language in the original Wyoming statute to various existing Wyoming business entity statutes provisions. William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 University of Colorado Law Review (1994) 856.

[82] Joseph P. Fonfara and Corey R. McCool, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?,* 23 Land & Water Law Review (1988), 523.

Unlike the IBC, the key to the LLC is not simplifying the law but creating a powerful and flexible business entity. LLCs' deviations from corporate law norms and their mixture of quasi-partnership governance with a corporate-like entity makes crafting an LLC statute more of an exercise in thinking through potential future problems and providing courts with guideposts to address them. As happened in the LLC's spread among U.S. states, each jurisdiction made its own modifications to their LLC statutes' details, producing a diversity of options for potential clients comparing jurisdictions. In particular, jurisdictions' existing mixes of entities helped shape their versions of the LLC. For example, Jersey already had a sophisticated limited liability partnership statute, revised in 2017, which provided many of the benefits of an LLC. The island nonetheless added an LLC entity to the mix, in part because Jersey believed that catering to the familiarity of U.S. fund managers and investors with the LLC would bring it additional business.[83] These differences demonstrate the diversity made possible by a wide array of jurisdictions.

IBCs had required excellence in execution by the home jurisdiction and so what BVI's competitors needed was to meet or exceed BVI's ability to deliver fast, quality service. LLCs also demanded a higher level of legal sophistication within the IFC legal community because LLCs' design flexibility both gives them their advantage as a business entity and means there are fewer statutory safeguards built in. Thus as the LLC spread among IFCs, their legal and financial communities played critical roles in adapting the concept to each jurisdiction's market and other legal systems. The presence of a legal community with depth has proven critical to using an IFC LLC to its full potential. Clients still wanted fast, quality service in registering their offshore LLC but they also needed a higher degree of professional assistance to take full advantage of the opportunities the LLC offered than was the case with the IBC. This underscores the importance of the human networks within and among jurisdictions. Copying the "best" LLC statute from elsewhere will do little to advance a jurisdiction if it does not have the expertise within its legal and financial communities to identify opportunities for using LLCs and craft specific implementations of LLCs to enable clients to take advantage of those structures. Given the volume of activity surrounding the expansion of the LLC globally, and the need both to compete against and learn from U.S. jurisdictions' LLCs, practitioners and regulators need a global network to make their jurisdictions' LLC statute a success.

4. Conclusion

IFCs provide two important contributions to the study of law's role in development. First, as development stories, IFCs are significant successes. Using their sovereignty and law-making power as an asset, IFCs have made their legal systems into drivers of economic growth through the development of specialized legal entities, effective regulatory regimes, and leveraging their network of peer jurisdictions. Focusing on transaction costs-reducing legal innovations has enabled them to succeed despite poor natural resource endowments, small domestic markets, and limited opportunities. Second, the critical role that networks play in their success suggests an alternate path to success from the idea that harmonization is the key to integrating into the world economy. Rather than harmonizing, IFCs have focused on differentiating their legal systems from others' by drawing on each other and constantly replenishing the knowledge and experience of

[83] *Jersey introduces LLC legislation in bid to attract US investment,* International Investment (13 Sept. 2018).

their industry, regulatory, and government networks to support ongoing innovative and durable problem-solving as a means of attracting business. As the captive insurance and LLC examples demonstrate for the U.S. states of Vermont, Wyoming, and Nevada, lessons from the offshore IFC experience are applicable to closing income disparities within a country.

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Figure 1

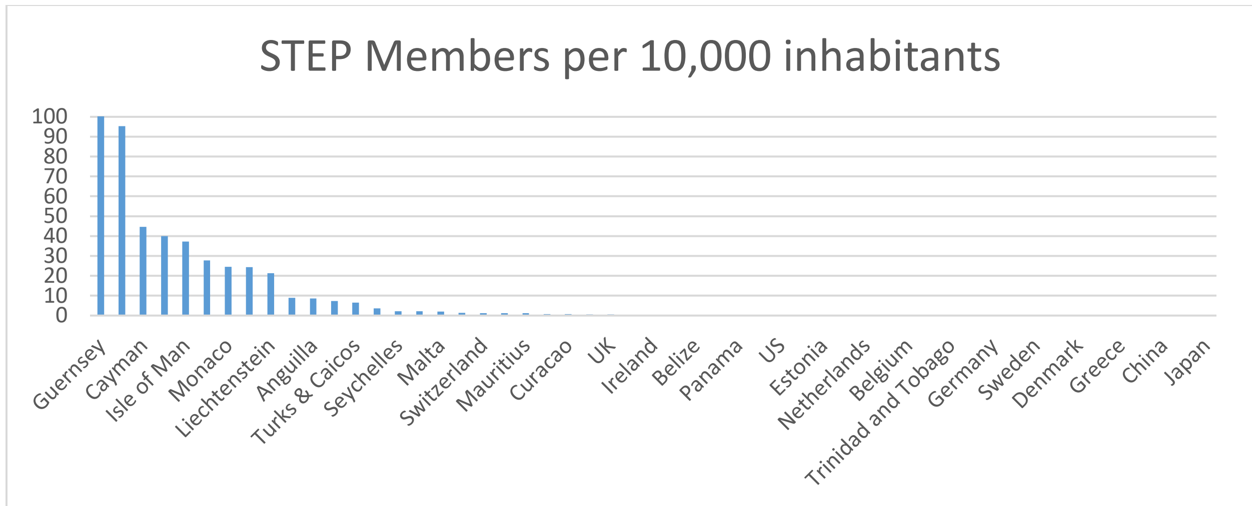

Figure 2