

The Selective Incorporation of Foreign Legal Systems to Promote Nepal as an An International Financial Services Center

by

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Abstract

This paper, which is to be published in a slightly altered form in a forthcoming Oxford University Press symposium volume on Regulatory Reform, addresses a problem confronting many developing countries: How should a country draw on foreign legal systems to develop its own system of financial regulation. Although addressed to a specific problem confronting the Kingdom of Nepal — developing a regulatory structure that will encourage foreign financial firms to establish international operations in Nepal — the paper presents a general framework for analyzing the utilization of foreign legal models for regulatory reform, and then advocates a particular reform strategy for Nepal: the selective incorporation of foreign legal systems into Nepalese law.

Under the proposed system of selective incorporation, Nepal would first determine which foreign regulatory systems are sufficiently well-developed and well-administered to oversee foreign firms establishing international financial service operations in Nepal. Firms located in any of these selected jurisdictions could then apply to establish operations in Nepal without having to meet any additional Nepalese regulatory requirements, provided those applicant firms agreed to conduct their Nepalese operations in accordance with their home country's regulatory requirements and to submit their Nepalese operations to home country supervision. So, for example, a British bank might establish operations in Nepal and be supervised under the law of England, whereas a Swiss bank with Nepalese operations might comply with Swiss law. In this way, selected foreign legal regimes would be incorporated into Nepalese law.

After exploring the surprisingly large number of precedents for selective incorporation, this paper considers the advantages and disadvantages of this approach to regulatory reform for both Nepal and foreign financial firms. The paper then considers a number of possible objections to this approach, including the potential for inadequate supervision of Nepalese operations, the implications of the approach for countries whose laws are incorporated into Nepalese law, and the ramifications of the approach for the political economy of Nepal.

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This paper arises out of a project sponsored by the United Nations Development Programme to assist the Kingdom of Nepal in becoming an attractive host jurisdiction for the international financial services industry. My specific assignment was to recommend a regulatory structure that would be both effective in overseeing financial intermediaries that choose to do business in Nepal and practical in light of Nepal's existing legal and professional resources. What emerged from this project was a novel recommendation. In contrast to traditional legal reform strategies, which depend in large part upon the development of indigenous legal structures, the premise of my proposal for Nepal is that, for purposes of establishing itself as an international financial services center, His Majesty's Government of Nepal would be better served by selecting a limited number of existing, well-developed legal regimes and then allowing qualified foreign firms to establish international financial operations in Nepal as long as the firms conduct their Nepalese operations in accordance with one of the legal regimes that His Majesty's Government has selected. Under my proposed approach, a Swiss bank establishing an international lending office in Nepal could elect for its operations to be governed by Swiss law, whereas an English insurance company setting up a Nepalese facility could choose to follow the law of England or perhaps the law of Bermuda.

I refer to this approach as the selective incorporation of foreign legal systems. The approach is selective in two important respects. First, this legal structure would apply only to those financial intermediaries that limit their activities in Nepal to international financial operations (generally precluding retail operations in Nepal). Second, the number of foreign legal systems eligible for incorporation into Nepalese law would be limited to a small number of jurisdictions with well-established regulatory capabilities. These safeguards ensure that foreign financial intermediaries will

not disrupt existing Nepalese financial markets, but will be subject to experienced and cost-effective supervisory oversight.

My analysis in this Paper is divided into four parts. Part I presents my understanding of the reasons why Nepal seeks to develop an international financial services center as well as the various advantages and drawbacks of establishing Nepalese operations from the perspective of foreign financial firms. Part II reviews three different paths Nepal could pursue in developing a legal framework to facilitate the creation of an international financial services center within its borders: (i) developing an indigenous regulatory structure; (ii) developing legal rules based on established foreign models; or (iii) directly incorporating foreign legal regimes. The emphasis in this part is on the third of these alternatives, which is the legal framework the balance of the paper explores. In addition to comparing direct incorporation of foreign law to other approaches, I review various ways in which other jurisdictions currently incorporate foreign laws into their own legal systems, particularly in the area of financial services regulation.

Part III of the paper offers a more complete explanation of the theoretical justifications for a regime of direct incorporation of foreign laws. After reviewing some preliminary analytical points, I explore the numerous advantages of incorporating foreign legal rules into this specialized area of the Nepalese economy. In brief, the approach would reduce the amount of time it will take Nepal to develop an effective legal regime for the regulation of international financial operations; it would lower the long-costs of developing and maintaining that legal system; it would introduce the Nepalese to some of the world's most advanced financial regulatory systems; and it would ensure that Nepal's legal system in this area will be continuously updated as regulatory techniques develop

in the future. The direct incorporation of foreign laws could also make Nepal a more attractive jurisdiction for foreign firms. By incorporating well-established legal structures into Nepalese law, the approach would allow foreign financial firms establishing offices in Nepal to comply with the regulatory requirements with which they are already familiar and around which substantial amounts of legal authority and regulatory experience have already developed. From the perspective of foreign investors, the incorporation of familiar legal regimes should reduce the risks associated with investment in Nepal, thereby decreasing the overall costs of that investment.

In Part III of the paper, I review a number of potential objections to the incorporation of foreign laws into Nepal, considering the validity of the objections and, in some cases, suggesting how the framework could be refined to address various concerns. In this analysis, I attempt to consider utilitarian as well as broader political or cultural objections to direct incorporation of foreign law. As to the latter set of concerns, my treatment is cursory, but I attempt to respond to the principal concerns this approach may raise for some readers.

Finally, Part IV concludes with a discussion of a number of the practical issues that His Majesty's Government of Nepal should take into consideration in the development of future legislation and regulations to implement this proposal. The goal of this final section is to provide a link between the theoretical analysis, which forms the bulk of the paper, and the concrete task of implementing a regime of selective incorporation to facilitate the development of an international financial services center in Nepal. I also suggest a number of areas for further investigation and analysis.

I. Background

As a prelude to the analytical section of this paper, I begin with a brief overview of two perspectives on developing an international financial services center in Nepal. The first perspective is that of the Nepalese; the second is that of foreign financial firms that might choose to locate operations in Nepal. This section is skeletal and impressionistic. The assumptions underlying this summary will be clarified in various respects later in the paper, but may require further refinement in the future.

A. Nepal's Goals in Becoming an International Financial Services Center

Like the leadership of many developing countries, His Majesty's Government of Nepal seeks to improve the well-being of its people by expanding its economy and thereby increasing the country's standard of living. While many developmental strategies could contribute to this process, establishing an international financial services center in Nepal is a comparatively attractive approach. Through licensing fees and related revenues, financial services firms would generate modest amounts of additional income for the Nepalese government. In addition, the development of a financial services center in Nepal would provide new employment and business opportunities for a variety of sectors of the Nepalese economy, ranging from transportation to communications to hotels and a host of other support services. This increased ancillary business activity could generate further revenues for His Majesty's Government of Nepal. Equally important, the development of an international financial services center will introduce Nepalese professionals and government officials to sophisticated financial transactions and the regulatory practices of the most advanced

industrialized countries. Over time, this exposure will enhance the human capital and business skills of the Nepalese people, giving the country a genuine comparative advantage that could last well into the next century. As Nepal develops these business skills and as the international financial community has greater exposure to the country, international investments in other areas of the Nepalese economy could also increase.

This approach also has very few of the drawbacks typically associated with many other developmental strategies. To begin with, developing a financial services center does not require substantial capital investment. In addition, unlike, for example, natural resource extraction or large-scale manufacturing, financial services centers generate little pollution or other environmental degradation. Indeed, to the extent that foreign financial firms operating in Nepal will be restricted to international transactions, the creation of an international financial services center in Nepal will have little direct connection to the Nepalese economy, aside from the positive spillover effects described in the preceding paragraph. Moreover, as Nepalese institutions do not currently play a major role in international finance, the establishment of foreign financial intermediaries in Nepal will not displace local business activity nor compete with Nepalese financial institutions.

B. The Perspective of Foreign Financial Firms

From the perspective of foreign financial firms, Nepal is simply one of many possible jurisdictions in which to locate offshore operations. To a very considerable degree, Nepal must compete with other established financial services centers — from Hong Kong to Mauritius to the major markets of London and Tokyo — as well as other countries that have developmental

aspirations similar to Nepal's. Without careful consideration of the needs and interests of potential foreign investors, Nepal will have difficulty creating a viable financial services industry within its borders. This section offers a brief catalog of the advantages and disadvantages of establishing operations in Nepal from the perspective of foreign financial firms.

1. Advantages of Nepal's Geographic Location.

As analyzed in some detail in various reports prepared by Collins & Associates, Nepal's geographic location offers several advantages to foreign firms.¹ It is in a time zone that overlaps with European and Asian financial centers, and it is near a number of growing economic markets in southern and southeast Asia. In addition, democracy is secure in Nepal, and all political parties are eager to attract foreign investment in general and investment associated with an international financial services center in particular. Finally, English is widely spoken in the country, and the culture is generally considered to be hospitable to foreigners.

As is discussed in more detail below, the Nepalese legal structure is not as a general matter well suited for foreign investment at the present time. (Indeed, the primary purpose of this paper is to explore ways of enhancing the attractiveness of Nepal's legal environment.) There are, however, certain features of Nepal's legal system that make it uniquely attractive to foreign investors. For example, Nepal currently has a tax treaty with India that is substantially similar to the Indian-Mauritius tax treaty. Under this treaty, corporations resident in Nepal enjoy special tax benefits on investments in India. In addition, Nepal and India have entered into certain foreign exchange

¹ See Collins & Associates, *A Financial Future for Nepal: Creating an International Financial Services Center* (1996).

agreements, which may make it easier for Indian corporations to do business with firms located in Nepal than with entities from most other countries around the world. As a result of Nepal's tax treaties and foreign exchange agreements, some foreign firms may regard Nepal as a uniquely advantageous location from which to engage in investments in India or transactions with Indian counter parties and also to conduct other financial operations in the region.

2. Drawbacks of Nepal

Nepal also has certain characteristics that diminish its attractiveness as an international financial services center. The current state of its telecommunications industry and other infrastructure lags behind existing financial centers such as Hong Kong and Singapore. More important for purposes of this paper, Nepal lacks the sort of established legal system, experienced regulatory apparatus, or pool of financial expertise generally associated with leading financial centers. In preparing this paper, my assumption is that foreign firms would find Nepal a more attractive jurisdiction for establishing financial operations if the country could offer a more developed legal environment in which to do business. The goal of this paper is to consider how His Majesty's Government of Nepal could best develop a legal system that would help attract foreign financial operations to the country.

II. Approaches to the Development of a Nepalese Regulatory Structure

This section offers an overview of several possible approaches to the development of a new regulatory structure for an international financial services center in Nepal. I outline three basic approaches: indigenous models, domesticated foreign models, and direct incorporation of foreign

law. The third of the approaches — direct incorporation of foreign law — is the focus of the balance of this paper. The discussion of the section does not present a complete description of direct incorporation, but rather relates the approach to more familiar methods of regulatory development.

At the outset, a few words of introduction are in order. To begin with, it bears emphasis that regulatory systems typically consist of two distinct elements. The first element is substantive regulation — the formal rules that govern economic activities. These rules range from capital requirements for banking institutions to canons of contract interpretation used to determine the meaning of commercial agreements. Some substantive rules are mandatory; others are default requirements that parties can waive or alter if they choose. Second and distinct from substantive legal requirements are mechanisms of enforcement. Even mandatory substantive rules (such as bank capital requirements) have little meaning unless the legal system in which they exist also includes some mechanisms of enforcement. In industrialized countries such as the United States expert administrative agencies typically play an important role in enforcing financial regulation. In addition, private parties may participate in enforcement by, for example, bringing law suits to enforce contracts or in some jurisdictions actually ensuring compliance with public statutes through private rights of action.

The establishment of effective enforcement mechanisms is in many respects a more complex process than the initial development of substantive rules. Often, enforcement actions generate disputes over factual issues, legal standards, and the application of law to facts. When parties cannot resolve these disputes among themselves, a legal system must provide efficient and credible dispute resolution mechanisms. In advanced regulatory systems, these mechanisms typically include a

combination of administrative adjudications, judicial proceedings, and alternative dispute resolution techniques such as arbitration and mediation. A final step of enforcement is ensuring compliance with whatever final determinations the system's dispute resolution mechanisms generate.

This somewhat abstract discussion is directly related to the problem Nepal faces in turning itself into an international financial services center. To provide a viable legal structure, Nepal must develop not only substantive legal standards but also enforcement mechanisms to ensure compliance with those standards. There are, in my view, three basic approaches to this challenge.

A. Development of an Indigenous Regulatory Structure

At one extreme, Nepal could seek to develop its own indigenous regulatory structure to police international financial operations in the country. Exactly what shape such a legal system would take is an intriguing question, but one that we need not pause to consider in any great detail for current purposes. Theoretically, the system would build upon existing Nepalese institutions, reflecting the political economy of the country as it now exists and incorporating the current regulatory philosophies of the Nepalese polity.² The resulting legal structure would be distinctively Nepalese.

Although the development of indigenous regulatory structures has a certain romantic appeal,

² It is, to be sure, artificial to speak so late in the twentieth century, of entirely indigenous legal systems. Rather than a pure archetype, however, this approach is meant to represent a tendency in developing legal institutions. The approach is also reminiscent of the distinctive path of regulatory developments in various European nations, the United States, and some Asian countries. Although in my view proponents of regulatory uniqueness often overstate their case, there is a growing academic literature contrasting the paths of regulatory development in various industrialized countries. See, *e.g.*, MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS* (1994).

its drawbacks for countries such as Nepal are apparent and manifold. The costs of developing effective regulatory systems are substantial, and, at this point in time, few developing countries would attempt to design an entirely new regulatory system for sophisticated financial transactions.

Particularly if the reason for developing such a system were to attract foreign investment into a specialized sector of the economy, developing indigenous legal structures would be a dubious path.

Many years of experience would be needed to resolve uncertainties over the substance of new and unique legal rules, and issues of enforcement and regulatory credibility could take decades to resolve.

Particularly in an area as complex as financial regulation, indigenous legal structures offer an unlikely path for development.

B. Domesticating An Existing Foreign Regulatory Structure

The alternative of domesticating an existing foreign legal structure is, in contrast, a common approach to legal developments. Many countries take legal structures developed in one or more jurisdictions and domesticate them for local application. Examples are legion. During the Great Depression of the 1930s, the United States used the English Companies Act as a model for the Securities Act of 1933. Similarly, much of Japan's financial regulatory structure was modeled on American legal structures as they existed in the years following World War II. The South Korean regulatory system builds on turn-of-the century German precedents. The process of adopting modified foreign legal structures is perhaps most apparent today in the formerly centrally-planned economies of Eastern European and the Asian mainland. In Russia, China, Vietnam, and many other countries, foreign legal experts are now helping local legislatures modify existing foreign legal

systems to meet local needs.

Despite its popularity, domesticating foreign legal structures is no simple task. As mentioned above, regulatory systems consist of two basic parts: substantive rules and enforcement mechanisms. Often, efforts to domesticate foreign laws limit themselves to substantive rules. In extreme cases, domestication consists of little more than the translation of foreign statutes. But adopting foreign regulatory systems without inquiring into the public and private institutions necessary to ensure their enforcement is fraught with peril. After all, formal rules without effective mechanisms of enforcement will generally fail to achieve their purposes.

Undeniably, many ongoing law reform efforts are extremely attentive to the need for both substantive rules and enforcement mechanisms. In Russia, for example, the authors of that country's new corporate law — built on American and European models — were acutely aware of the inadequacies of Russian judicial and regulatory systems, and therefore modified the law's substantive provision in an effort to achieve a higher degree of “self-enforcement.”³ Similarly, in the field of banking regulation, the Basle Committee on Banking Supervision recently issued a paper on Core Principles for Effective Banking Supervision, which outlines a model for banking regulation that covers both substantive requirements and enforcement mechanisms.⁴

What these more sophisticated exercises illustrate is that domestication of foreign legal systems entails a combination of foreign legal structures and indigenous institutions. The approach

³ See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

⁴ See Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Apr. 1997) (consultative paper available at <http://www.bis.org>).

has an advantage over reliance on purely local legal institution in that existing foreign models are used to define the general outlines of legal development. But that outline is likely to be incomplete and even misleading in various respects. If, as is often the case, the model is the U.S. federal securities law, adopting the formal substantive rules of the U.S. statute will not provide a country anything close to the regulatory system that exists in the United States. The U.S. system depends not just on formal legislative enactments, but also on the existence of a well-functioning federal agency (the SEC), plus a series of self-regulatory organizations (including the New York Stock Exchange and other self-regulatory organizations), plus extremely well developed accounting and legal professions plus a huge body of experienced investors and analysts, plus a complex array of dispute resolution systems (most notably the federal judiciary with an established body of precedents and several large arbitration bodies). A country that adopts U.S. federal securities law has taken only one relatively small step toward achieving an effective system of securities regulation.

In other words, many of the factors that impede the development of a wholly indigenous legal system also complicate the domestication of existing foreign legal structures.

C. Direct Incorporation of Foreign Regulatory Systems

A less well-recognized, but increasingly common approach to the problem of legal development is the direct incorporation of foreign regulatory systems into domestic legal structures.

Unlike other approaches, which depend on the development of domestic legal institutions (either wholly indigenous or derived from foreign models), this approach relies on the direct application of

foreign legal rules and enforcement mechanisms to certain activities conducted within a host country.

While the former approaches might be analogized to the domestic manufacture of legal institutions (based on either indigenous or foreign models), this third approach is more akin to wholesale importation of foreign laws.

While at first blush the direct incorporation of foreign laws may appear radical, the practice is in fact quite common in our global economy. This subsection reviews a number of ways in which the approach is reflected in current regulation of financial transactions, but as a prelude to that discussion, I note several non-financial areas where the practice is well established. Perhaps the most familiar case is the European Community. In a number of areas from product safety to labeling standards, European countries defer to the regulatory standards of member jurisdictions. So, for example, if a French liqueur complies with the alcohol production and marketing standards of France, that liqueur can be sold in Germany even if the beverage does not meet comparable German requirements.⁵ Under EC directives, home-country regulation in numerous areas is deemed to be adequate throughout the region.

⁵ Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein, [1979] E.C.R. 649, [1979] 3 C.M.L.R. 494 (Feb. 20, 1979).

Direct incorporation of foreign laws also exists outside the boundaries of common markets or trade unions. Russia, for example, recently authorized the distribution of all pharmaceutical products that the U.S. Federal Drug Administration (FDA) has approved for sale in the United States.⁶ As a result of this incorporation, Russia has in essence incorporated America's drug approval process into its legal system. While the incorporation is incomplete — the FDA does not have jurisdiction over Russian companies that sell other pharmaceuticals — the fact remains that Russia has incorporated an important element of U.S. law into its regulatory framework.

While the Russian FDA standard is striking for its originality, one can find many more mundane examples of incorporation of foreign laws. In intellectual property, for example, signatories to multinational treaties regularly give effect to certain aspects of copyright protections of foreign jurisdictions.⁷ Similarly, the cross-border enforcement of arbitration and judicial decisions requires the enforcing jurisdiction to give effect to a judgment rendered in a foreign country, often through the application of foreign law. In all these cases, foreign legal structures are at least partially incorporated into domestic laws.⁸

It is my understanding that Nepal itself already incorporates various kinds of foreign legal

⁶ See Bryan L. Walser, Shared Technical Decision making: The Multinational Pharmaceutical Industry, Expert Communities, and a Contextual Approach to Theories of International Relations (May 15, 1996) (unpublished manuscript on file with author).

⁷ See STEPHEN M. STEWART, INTERNATIONAL COPYRIGHT AND NEIGHBORING RIGHTS 45-46 (2d ed. 1989).

⁸ In the area of human rights enforcement, political theorists are making comparable inquiries about when foreign or transnational human rights jurisprudence should be transferred from one regime to another. See Laurence Helfer & Anne-Marie Slaughter, *Toward a Theory of Effective Supranational Adjudication*, 109 YALE L.J. 276 (1997).

structures into domestic legal system.⁹ In the area of international passenger aircraft, His Majesty's Government of Nepal accepts safety certifications from regulatory authorities in other countries.¹⁰

Similarly, the Nepalese Ship (License and Logbook) Act of 1970 allows the Nepalese government to accept the shipping capacity of a ship as approved by a recognized classification society of a foreign country.¹¹ And, under the Nepalese Drugs Act of 1978, the country allows certain drugs approved by foreign regulatory authorities to be distributed to the Nepalese public.¹² In these and other areas, Nepal relies upon foreign regulatory standards to safeguard the well-being of its citizens.

It is, however, in the area of financial regulation that direct incorporation of foreign laws has become most common. For purposes of analysis, one can distinguish between two basic uses of

⁹ Surya Dhungel of Lawyers Inc. of Kathmandu, Nepal, supplied the examples cited in this paragraph. See Letter from Surya Dhungel to Don Hutchinson (Aug. 29, 1997) (on file with author); Letter from Surya Dhungel to Messrs. Joe Collins & Don Hutchinson (Aug. 5, 1997) (on file with author).

¹⁰ See Nepalese Civil Aviation Rules of 1962, Rule 9, cl. 1 (promulgated under the Nepalese Civil Aviation Act of 1959).

¹¹ See Section 7 of the Nepalese Ship (License and Logbook) Act of 1970.

¹² See Sections 11-13 of the Nepalese Drugs Act of 1976.

foreign laws — one relies on foreign regulation as a screening device for domestic regulation and the second employs foreign regulation as at least a partial substitute for domestic regulation.

1. Foreign Regulation As a Screening Device for Domestic Regulation

One way in which foreign regulations are incorporated into domestic laws is as a screening device, to identify foreign firms that are presumptively well-regulated in their home jurisdictions. A prominent recent illustration of this approach can be found in a working group report on the Supervision of Cross-Border Banking that the Basle Committee on Banking Supervision released in October of 1996. In one of its principal recommendations, the report advised “all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under regulated financial centers.”¹³ The report went on to outline a checklist of supervisory functions associated with effective consolidated supervision.¹⁴ The gist of the working group’s recommendations is that host countries — for example, Nepal — should not allow a foreign bank to establish local operations unless the foreign bank’s home jurisdiction maintains adequate oversight of the bank’s consolidated operations. Thus, the foreign bank’s home legal system is, to a limited extent, incorporated into the host country’s regulatory structure.¹⁵

¹³ See The Supervision of Cross Border Banking: Report by a Working Group Comprised of Members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors ¶ 42 (Oct. 1996) (report available at <http://www.bis.org>).

¹⁴ See *id.* Annex B.

¹⁵ The Basle Committee’s recommendations are an extension of the earlier Basle Concordat’s endorsement of “consolidated bank supervision” and “home country” supervisory control for overseas branching. See generally D. Gail, J. Norton, & M. O’Neal, *The Foreign Bank Supervision Act of 1991: ‘Expanding the Umbrella of Supervisory Regulation,’* 26 INT’L LAW. 993 (1992). The working group’s proposals are, moreover, analogous to the U.S. Foreign Bank Supervision Enforcement Act of 1991, which requires federal banking regulators to consider the

In the United States, the Securities and Exchange Commission has experimented with similar structures. Regulation S is a case in point. Adopted in the early 1990's, Regulation S defines when the registration procedures of the Securities Act of 1933 apply to foreign offerings of securities. Under this regulation, the SEC distinguishes between foreign transactions that take place on "designated offshore securities markets,"¹⁶ and other kinds of foreign transactions. The term designated offshore securities markets is defined to include a list of recognized international exchanges plus other markets the Commission designates as adequately supervised. Under

adequacy of home country supervision before allowing a foreign country to establish operations in the United States. See 12 U.S.C. § 3105(d).

¹⁶ See Section 902(a) of Regulation S, 17 C.F.R. § 230.902(b) (1998). The definition reads as follows:

(b) "Designated offshore securities market" means:

(1) The Eurobond market, as regulated by the International Securities Market Association; the Alberta Stock Exchange; the Amsterdam Stock Exchange; the Australian Stock Exchange Limited; the Bermuda Stock Exchange; the Bourse de Bruxelles; the Copenhagen Stock Exchange; the European Association of Securities Dealers Automated Quotation; the Frankfurt Stock Exchange; the Helsinki Stock Exchange; The Stock Exchange of Hong Kong Limited; the Irish Stock Exchange; the Istanbul Stock Exchange; the Johannesburg Stock Exchange; the London Stock Exchange; the Bourse de Luxembourg; the Mexico Stock Exchange; the Borsa Valori di Milan; the Montreal Stock Exchange; the Oslo Stock Exchange; the Bourse de Paris; the Stock Exchange of Singapore Ltd.; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; the Warsaw Stock Exchange and the Zurich Stock Exchange; and

(2) Any foreign securities exchange or non-exchange market designated by the Commission. Attributes to be considered in determining whether to designate an offshore securities market, among others, include:

- (i) Organization under foreign law;
- (ii) Association with a generally recognized community of brokers, dealers, banks, or other professional intermediaries with an established operating history;
- (iii) Oversight by a governmental or self-regulatory body;
- (iv) Oversight standards set by an existing body of law;
- (v) Reporting of securities transactions on a regular basis to a governmental or self-regulatory body;
- (vi) A system for exchange of price quotations through common communications media; and
- (vii) An organized clearance and settlement system.

Id.

Regulation S, transactions that take place on designated offshore securities markets are subject to less stringent registration requirements in the United States. Thus, the SEC relaxes its oversight of transactions taking place in a selected number of well-regulated markets, but not its regulation of transactions taking place in other foreign markets.

The idea that foreign regulation could be used as a screening device for domestic oversight is a notion that the SEC may well extend in the near future. In the last decade, the Commission has expressed considerable interest in the approach in several different areas. For example, in a 1989 concept release on the regulation of foreign broker-dealers in the United States, the Commission explored

a conceptual approach to regulation of foreign broker-dealers that would recognize comparable foreign regulation of broker-dealers in order to achieve the goal of facilitating international securities transactions without compromising the essential protections of the U.S. broker-dealer regulatory regime. In view of the development of comprehensive supervisory schemes in other countries, the Commission [offered for public consideration] an exemption from broker-dealer registration that would rely on comparable foreign regulatory regimes and cooperation with foreign securities authorities to regulate certain foreign broker-dealers conducting a limited business from outside the United States with major U.S. institutional investors.¹⁷

Though not yet incorporated into U.S. law, the release proceeded on the notion that the Commission could rely on well-developed foreign regulatory structure for the oversight of foreign broker-dealers that did only a limited amount of business in the United States and limited their interactions to sophisticated institutional investors.

Just last year, the Commission reaffirmed its interest in using foreign regulatory structures as a screening device for access to U.S. markets. In a concept release discussing, among other

¹⁷ See 54 Fed. Reg. 30,087 (July 18, 1989).

things, the application of U.S. capital market regulations to foreign securities markets, the Commission wrote:

One option would be for the Commission to rely solely on the law of the primary regulators of foreign markets, if those foreign markets are subject to regulation comparable to U.S. securities regulation. Under this approach, the Commission could specify foreign markets that it determines are subject to comparable regulations . . .

This approach might have several advantages. First, it could provide regulatory certainty to foreign [securities] markets entering the United States. Second, it would not impose any additional regulatory costs on foreign markets. As a result foreign markets would be able to provide their services to U.S. investors at lower costs. Third, this approach would recognize that principles of international comity support reasonable deference to a home country's governance of its own markets, particularly with respect to trading in the securities of home country issuers.¹⁸

The release went on to consider a number of drawbacks to the limited incorporation of foreign regulation — most notably the potential of confusion for domestic investors — and also discussed several other alternatives to the problem for foreign exchange. The excerpt highlights, however, that the incorporation of, or deference to, foreign regulatory structures has become an increasingly common policy option for dealing with a variety of cross-border transactions, particularly where the activity in question takes place largely outside the host jurisdiction.

2. Foreign Regulation As a Substitute for Domestic Regulation

An extension of this approach is to incorporate foreign regulation into domestic law as a complete or near-complete substitute for domestic regulation.¹⁹ Most commonly, foreign regulation is accepted as a substitute for

¹⁸ Concept Release on Regulation of Exchanges, SEC Release No. 34-38,672 (May 23, 1997).

¹⁹ Admittedly, the line between applying differential regulation for qualified foreign entities and accepting foreign regulation as a regulatory substitute is imprecise. Several of the illustrations described above as screening devices could be considered partial substitutes, and some of the regimes categorized as substitutes in this section could also be characterized as a screening device. I make the distinction, however, to focus on the fact that there are varying degrees to which a jurisdiction can incorporate foreign regulations into its own law. Where the reliance is partial and incomplete, I categorized the incorporation as a screening device — *e.g.*, the Basle Committee's approach to cross border transactions — where foreign regulation assumes a predominant supervisory role — *e.g.*, in Russia's reliance on U.S. drug approval procedures — I denominate the use as a substitute.

domestic regulation when countries have roughly comparable or intentionally harmonized regulatory systems. The phenomenon also occurs, however, where there are substantial disparities between regulatory structures.

a. Harmonized Systems. The European Community presents perhaps the most developed example of a harmonized regulatory system in which home country supervision of financial transactions is accepted as a substitute for host country regulation in such fundamental areas as prudential supervision of banks and disclosure obligations for securities offerings.²⁰ While community wide guidelines establish baseline norms, home country supervision is the predominant source of regulatory oversight, regardless of where in the Community the service is offered. Cross-border deference is a hallmark of EC supervision.

To a lesser degree, the United States incorporates foreign financial regulation into its regulatory structure. Perhaps the best illustration is the SEC's multijurisdictional disclosures system ("MJDS"), adopted in 1991.²¹ Under the MJDS, qualified Canadian issuers can use Canadian disclosure documents to sell securities in the United States. Thus, Canadian disclosure requirements are accepted as a near-complete substitute for otherwise applicable SEC rules. (The MJDS does not, however, fully incorporate Canadian law in that U.S. anti-fraud rules still govern Canadian securities sold in the United States, and the Commission has also insisted on some reconciliations to U.S. GAAP accounting.)²²

²⁰ See generally HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION ch 5 (3d ed. 1996).

²¹ 58 Fed. Reg. 30,036 (1991).

²² Within the United States, an analogous incorporation of external law takes place in state insurance regulation. Historically, U.S. insurance markets have been regulated at the state level. For many years, however,

b. Non-Harmonized Systems. Though less common, incorporation of regulatory structures also occurs across non-harmonized systems. Within the U.S., a long-standing example is the SEC's rule 12g-3, which allows certain foreign companies to supply home country periodic disclosure documents rather than more elaborate 1934 filings typically required of U.S. public companies.²³ For qualifying foreign companies, the SEC simply accepts whatever disclosure standards apply in the company's home jurisdiction, even if those requirements are much less extensive than analogous SEC's rules for U.S. domestic firms.²⁴ Another illustration from the insurance field is U.S. reliance on foreign regulation of reinsurance. Though subject to limited supplemental oversight in the U.S., foreign reinsurers doing business in the United States are principally regulated in their home markets.²⁵

3. Contractual Incorporation of Foreign Law

An analytically distinct but still analogous method for foreign regulatory structures to be incorporated into domestic transactions is through contractual choice-of-law provisions. In many contexts, private contracting parties will choose to apply foreign legal standards to financial

insurance companies incorporated in their own state have been allowed to do business across state lines. With coordinating support from the National Association of Insurance Commissioners, state insurance regulators defer in large part to home state regulatory control. For an introduction to this regulatory structure, see HOWELL E. JACKSON & EDWARD S. SYMONS, *THE REGULATION OF FINANCIAL INSTITUTIONS* ch. 8 (forthcoming 1998).

²³ See 17 C.F.R. § 240.12g2-3 (1997).

²⁴ This exemption is much more limited than the MJDS in that it is not available to companies that make public offerings in the United States or that have securities trading in the major US public markets.

²⁵ See Insurance Regulation: State Reinsurance Oversight Increased, but Problems Remain (May 1990) (GAO/GGD-90-82) (U.S. General Accounting Office Report).

transactions. Often, the parties select regulatory systems that are more developed than those that would ordinarily govern in the absence of an express choice-of-law provision. In the EC, for example, issuers from France and Denmark — jurisdictions with less developed systems of securities regulations — have been known to structure their securities offerings to the more complete legal requirement of U.K. law.²⁶ Although less systematic than public incorporation of foreign regulation, these choice-of-law provisions offer another mechanism for applying foreign legal systems to domestic financial transactions.²⁷

III. Theoretical Considerations

Having established that direct incorporation of foreign law is a common practice in international finance and elsewhere including Nepal, I now turn to the normative question of under what circumstances the practice is an appropriate path for developing a legal system.²⁸ Here, it is

²⁶ See Scott & Wellons, *supra* note 20, at 314.

²⁷ Choice-of-law provisions do, of course, present some public policy concerns. For example, courts are occasionally called upon to decide whether such private arrangements are binding in subsequent disputes. Within the U.S. at least, the courts have tended to enforce such provisions, provided the parties to the contracts were fully informed of the provisions when the contract was executed and provided the foreign regime selected is roughly comparable to U.S. law. And there is an academic literature supporting this approach on efficiency grounds, see Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245 (1993), and also as a basis for promoting relations in a transnational society, see Anne-Marie Slaughter, *International Law in a World of Liberal States*, 6 EUROPE. J. INT'L L. 503, 518-21 (1995).

²⁸ Although the analysis presented in this section is conventional, I have been unable to discover prior academic writing on the subject of this paper: under what conditions should a country incorporate the laws of another jurisdiction. The most helpful articles I have uncovered are only indirectly on point. See Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functional: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69 (1994) (discussing incorporation of foreign regulation in the context of regionalism and multinationalism); Sydney J. Key & Hal S. Scott, *International Trade in Banking Services: A Conceptual Framework* (1991) (Group of Thirty Occasional Papers No. 35) (considering the advantages of home-

important to emphasize my frame of reference. While various perspectives are possible, I will focus my attention on the perspective of the host country contemplating the incorporation of foreign regulation — that is, the perspective of Nepal. At various points, I will also make reference to the perspective of foreign financial firms that might make investments in Nepal in the future. Their concerns are also important, for if the regulatory regime is not attractive to foreign investors, the entire purpose of the exercise — to facilitate the development of an international financial services center in Nepal — would be defeated. Still, my focus here is on the antecedent question of conditions under which it would be in Nepal's best interest to incorporate foreign regulations into its legal system.

A. Basic Analytical Tools

As an introductory matter, I offer a brief overview of the analytical tools I will be using in this part. First, I describe the basic justifications for public regulation of financial intermediaries. Second, I review the principal regulatory tools used to achieve those regulatory purposes. Finally, I make a few points about the costs and benefits of financial regulation. This overview is not meant to be comprehensive, but rather to introduce a vocabulary for readers who may not be familiar with academic writings on the subject

1. Justifications for Financial Regulation

Although the justifications for regulating financial intermediaries vary from jurisdiction to

country, host-country, or harmonized regulation in the context of international banking services).

jurisdiction, four basic policy considerations inform most legal intervention in this field:

a. *Protection of customers.* The most familiar justification of regulating financial intermediaries is to protect the financial interests of members of the public who do business with these intermediaries. Typically of greatest concern is the protection of those who invest financial resources with intermediaries — the depositors of banks, the policyholders of insurance companies, the shareholders of investment funds. However, some regulatory interventions also safeguard the interests of borrowers and other clients — ensuring that they are treated fairly and are fully informed of the nature of the relationship with the intermediaries.

Exactly how much protection customers should receive is a point on which jurisdictions differ considerably. Under the most paternalistic regulatory systems, customers are protected from almost all risks. This occurs, for example, when a government guarantees all deposits made in a country's banks. Other regulatory systems offer a lesser degree of protection, seeking only to ensure that customers incur no more risk than they would have chosen to accept had they been fully and completely informed of all relevant facts at the time of their investments. This approach to regulation — sometimes referred to as the hypothetical contract model — still offers customers a considerable amount of protection, just not as much as the absolute protection model.

b. *Prevention of Systemic Risks and Other Externalities.* Most systems of financial regulation, however, have goals beyond the simple protection of financial intermediary customers. Most systems are also concerned with potential problems that the failure of financial institution could cause other economic interests. This second justification for financial regulation is based on the assumption that the failure of financial intermediaries can have effects beyond direct losses imposed upon those who do business with an intermediary.²⁹ These externalities can take many forms,

²⁹ It is this point that distinguishes externalities from the protection of customers. Even if a bank took

but typically are thought to include irrational bank panics, systemic risk transmitted through the payment systems, general economic disturbance caused by interruptions in the provision of credit, or simply the withering of public confidence in an economy.³⁰ Concern over these externalities leads to more stringent regulation than would be required if the government's sole concern was protection of customers in privity with financial intermediaries.

c. Redistributive Policies and Other Equitable Norms. Though not inherent in the nature of financial intermediation, redistribution policies and other equitable norms are often factored into financial regulation in many parts of the world. Policies of this sort are most apparent in the insurance field, where regulatory systems often restrict the kinds of classifications insurance companies can employ. (In the United States, for example, many states prohibit women from being charged lower automobile insurance premiums on the grounds that gender distinctions perpetuate illegitimate stereotypes.) In many countries, usury rules prohibit the charging of interest rates above certain levels, and in some Islamic countries all

no more risks that its customers wanted and even if a government guaranteed a bank's depositors, the failure of that bank could have negative consequences on other parts of the economy. The existence of such third-party effects is thus a separate justification for financial regulation.

³⁰ Within the academic literature, there is considerable disagreement about the extent of these externalities, particularly in advanced economies where other regulatory devices (such as central bank lending and counter-cyclical monetary policy) can be used to limit undesirable side-effects of intermediary failures. Even in advanced countries, however, government officials remain skeptical of theoretical solutions to systemic risks, and proceed on the assumption that financial intermediaries need to be regulated to mitigate these concerns.

interest charges are prohibited. Legal requirements of this sort are not intended to preserve the solvency of financial intermediaries — indeed, at the margin, they probably impair solvency; rather, their purpose is to achieve various cross-subsidies through the financial system, typically advancing redistributive or other equitable norms.

d. Considerations of Political Economy. A final set of justifications for regulation of financial intermediaries are considerations of political economy. The prevention of monopolies is, for example, a goal of many political systems, and antitrust norms are often built into financial regulatory systems. Political factors lead to other structural constraints on the financial services industry. It is, for example, not uncommon for countries to prohibit foreign participation in certain sectors of the financial services industry, and barriers to internal expansion of financial units also exist. In the United States, for example, the federal government for many years restricted the interstate expansion of banks. The justification for these structural restraints is, again, not to improve the performance of financial intermediaries, but rather to ensure that the industry comports with some broader political vision of appropriate financial structure.

2. Mechanisms of Regulatory Control

The mechanisms of regulation in the field of financial institutions are numerous, and a complete analysis of these tools is beyond the scope of this paper. Still, to facilitate subsequent discussion, I have divided these regulatory mechanisms into four basic groups, the first two of which cover substantive legal requirements, and the second two of which concern enforcement mechanisms:

a. Portfolio-Shaping Rules. The most important and elaborate regulatory requirements are the mandatory rules that determine how financial intermediaries do

business. Capital requirements, diversification restrictions, limitations on investments and lending practices — all of these are examples of portfolio shaping rules. Portfolio shaping rules are characteristically used to constrain risk in financial intermediaries, but can also be used to advance redistributive norms or goals of political economy. (For example, in the United States, the Community Reinvestment Act imposes mandatory obligations on bank lending practices in order to increase lending into certain under-served markets.)

b. Fiduciary Standards and Prudential Norms. Because not all legal principles can be reduced to mandatory rules, financial regulations typically also include more open-ended norms that set general standards of behavior. Banks typically are prohibited from engaging in unsafe and unsound practices. Broker-dealers often owe open-ended fiduciary duties to their customers. Advisors to mutual funds have similarly opaque obligations with respect to fund shareholders. Unlike portfolio shaping rules, which are precise but cover only a limited number of circumstances, open-ended norms provide general standards of conduct that may be instructive in a broad range of cases. Like portfolio-shaping rules, open-ended norms can be used to control risk or advance other purposes.

c. Supervisory Oversight. In most jurisdictions, public supervisory oversight is the most important mechanism for enforcing the substantive rules governing financial institutions. Initial licensing procedures, periodic examinations, routine reviews of call reports, change-of-control applications — all are important vehicles of supervision. Mature regulatory systems also have well-developed enforcement mechanisms that supervisory authorities can use to force the correction of any violations of substantive law that the supervisory process uncovers.

d. Private Enforcement Mechanisms. Finally, in some jurisdictions, private enforcement mechanisms supplement public supervision. In the United States, for example, private securities litigation in courts and arbitration fora are important mechanisms for ensuring compliance with regulatory requirements. The presence of these private enforcement mechanisms allows the SEC to be somewhat less comprehensive in its enforcement efforts.

3. The Cost of Financial Regulation and its Benefits

Although it is extremely difficult to calculate the true costs and benefits of any system of financial regulation, one can make several general statements about the theoretical relationship between costs and benefits. First, financial regulation is costly. Economic resources must be expended to train and maintain a supervisory system. Regulated entities spend resources coming into compliance with regulatory requirements. Moreover, to the extent that regulation is effective, certain economy activity that would otherwise have occurred — some of which will have positive economic value — will be disrupted or even prevented.

At a theoretical level, whether a regulatory system is too costly depends on two separate considerations. The first consideration turns on whether more efficient regulatory mechanisms are available. A regulatory system is too costly, for example, if it could be improved through more judicious use of computerized reporting systems and fewer physical examinations of bank premises. Similarly, if some degree of private enforcement could effectively supplement more expensive public oversight, a regulatory system could be too costly. Although in practice it will often be extremely difficult to determine whether more efficient regulatory mechanisms are available, in theory a system is too costly if more efficient alternatives are feasible but not employed.

A second, deeper question is whether a regulatory system generates social benefits in excess of its costs. If it does not, then the regulatory system is also too costly. Again, in practice, this calculation is difficult to compute. As outlined above in subsection A.1 of this Part, financial regulation serves multiple social functions. While some are largely economic (prevention of loss to customers and elimination of externalities), others are not (redistributive norms and considerations

of political economy). It will therefore be difficult to say whether the costs associated with, for example, limitations on foreign ownership of domestic banks equal the social benefits. In theory, however, the regulation is too costly if the benefits do not outweigh the costs.

Characterizing financial regulation as a balancing of costs and benefits does, however, make one point clear. Although financial intermediaries gain considerably from regulatory oversight,³¹ intermediaries do not absorb all of the benefits of regulation. For example, the benefits derived from advancing redistributive norms or considerations of political economy do not accrue to financial intermediaries; similarly the benefits of controlling negative externalities do not fully accrue to intermediaries. Accordingly, financial regulation is not an area in which we would expect to find the public interest fully served through a legal system that relies entirely on private ordering or self-regulation. And, indeed, most developed countries impose extensive public mandatory regulations on their intermediaries.

B. Theoretical Implications of Direct Incorporation of Foreign Regulation

Moving from theoretical generalities to the subject matter of this paper, I will now consider the conditions under which it might be advantageous for Nepal to rely on foreign legal systems for the limited purpose of overseeing the international financial services center it hopes to develop within its borders.

³¹ For example, the presence of credible regulatory oversight makes it possible for intermediaries to raise more funds at lower rates than they could if there were no regulatory oversight.

1. Tentative Assumptions

To facilitate analysis, I will make a number of tentative assumptions regarding Nepal's perspective with respect to International Financial Operations in Nepal (IFONs). First, I will assume that Nepal's purposes in overseeing foreign financial operations in Nepal consist of some combination of regulatory justifications outlined above in subsection A.1. That is, Nepal is not interested in establishing a wholly-unregulated international financial services center.³² Second, I will assume that Nepal currently lacks a regulatory apparatus — by which I mean both substantive rules and enforcement mechanisms — adequate to supervise sophisticated financial intermediaries doing business in Nepal. Accordingly, to achieve its regulatory goals through conventional means, Nepal would have to expand its indigenous, domestic regulatory system or adopt a new regulatory system based, most likely, on foreign models. To pursue either of these paths of legal development would be costly and time-consuming, especially for a country such as Nepal in immediate need of economic stimulus.

2. Direct Incorporation of Foreign Regulation as an Efficient and Expeditious Alternative

Given the preceding assumptions, the critical question is whether the direct incorporation of foreign regulation offers Nepal an attractive regulatory alternative. As a first approximation — putting aside for a moment substantial difficulties of implementation and political acceptability — the answer to this question would appear to be yes. At least if the incorporation is of an existing foreign regulatory system with a fully developed regulatory structure, there will only be incremental

³² In this respect, the proposed approach is quite distinct from traditional off-shore financial centers that attempt to attract foreign investment by loosening regulatory constraints. See Mark Hampton, *The Offshore Interface: Tax Havens in the Global Economy* (1996).

costs and delay associated with extending that system to Nepalese operations. The lengthy and uncertain process of developing and implementing an untested legal regime would be unnecessary. No new substantive rules need be developed; no enforcement devices contrived. In numerous jurisdictions around the world, well-developed systems of substantive law and enforcement mechanisms are already operational. All His Majesty's Government of Nepal needs do is to determine which of these existing legal regimes are appropriate for incorporation into Nepalese law.³³

³³ Another way of making this point is that relatively small countries such as Nepal do not have an adequate scale of regulatory authority to develop cost-effective supervisory mechanisms. Nepal's size disadvantage is made all the more apparent when larger economies have already developed regulatory structures that can, this paper asserts, be incorporated into Nepalese law for purposes of overseeing foreign international financial operations.

To be sure, there will be some costs associated with applying foreign regulations to Nepal. Supervisors will have to oversee and sometimes physically inspect Nepalese operations. Enforcement efforts will entail expenditures. And, there will be compliance costs for foreign enterprises that operate in Nepal under these regimes. But all of these costs would also be part of any domestic Nepalese regulatory effort. And many of the other costs associated with the development of new domestic regulation — amortization of substantial start-up costs and expenses associated with shaking down a new legal system — would be absent.³⁴ Thus, the incorporation of foreign legal systems offers a more expeditious and cost-effective path for developing financial regulation in Nepal than other alternative paths of legal development.

In addition, there are other ancillary benefits to direct incorporation of foreign laws. For one thing, Nepal would have its choice amongst the most advanced and best developed legal systems in the world for supervising international financial activities within its borders. Not only would the incorporation of these world-class legal systems make Nepal a more attractive investment location for foreign companies, but their application to Nepalese operations would expose Nepalese

³⁴ Analyses of regulatory barriers to international trade have made a similar point, albeit in an inverted context. For example, economists object to regulatory barriers to international trade on the grounds that these barriers often imposed redundant regulation on international transactions. See Alan O. Sykes, *The Economics of Regulatory Protectionism and Its Implications for Trade Regulation: The WTO and Other Systems* (Apr. 8, 1997) (unpublished draft on file with author). But cf. Michael Trebilcock & Robert Howse, *Trade Liberalization and Regulatory Diversity: Reconciling Competitive Markets with Competitive Politics* (May 7, 1997) (unpublished draft on file with author) (expressing greater skepticism as to the costs of bona fide non-tariff barriers).

professionals and government officials to the most advanced regulatory techniques. The mechanism of direct incorporation of foreign laws also ensures that Nepal's legal system in this field will be constantly kept up-to-date, for as foreign jurisdictions amend their laws those changes could automatically be incorporated into Nepalese law.

3. Distinguishing Prior Examples of Regulatory Oversight

At this point, readers familiar with existing examples of direct incorporation of foreign law (described above in Part II.C) might question why, if direct incorporation of foreign regulation is so cost-effective, we tend to see it employed on a piecemeal basis, either as only a screening device or for limited application to some relatively narrow category of cross-border transactions. This is a good question, and reveals, I believe, cost-benefit tradeoffs of the sort described above. One reason that direct incorporation of foreign laws tends to be limited is that most of the current applications of the approach represent regulatory accommodations between advanced countries with comparable regulatory systems. As a result, both countries in question have established regulatory systems that could be expanded at a small incremental cost to cover the cross-border transaction. Neither country is considering the creation of a new regulatory system; rather the challenge is to consider which system (or combination of systems) is appropriate for some cross-border activity that is not clearly within one jurisdiction or the other.³⁵

To make this point more concrete, consider the regulation of a German bank establishing a branch in the United States. Consistent with the Basle Concordat, the U.S. largely defers to German regulation of that branch since it is part of a corporate entity centered in Germany. (The U.S. does

³⁵ For an analysis based on this premise, see Key & Scott, *supra* note 28.

however, insist on licensing the branch and limiting its retail operations.) If the German bank decides to reorganize its U.S. branch as a separate bank subsidiary, then the United States assumes plenary responsibility for its regulation, with minor accommodations in recognition of its international parentage. The logic of this structure is to apply U.S. regulation once an entity is predominantly American. There are no cost constraints on pursuing this logic, because the United States has a fully operational regulatory system and is probably in a better position to supervise a U.S. subsidiary of a German bank than are German authorities.

In the case of Nepal, however, the cost issue is quite different. Assume, for example, that Nepal followed the U.S. model of deferring to foreign authorities in the regulation of foreign bank branches established in Nepal. Should Nepal also invoke plenary jurisdiction over foreign bank subsidiaries in Nepal? Though the ultimate answer to this question may be difficult to determine, it is clear that it is more costly for Nepal to accept that additional regulatory task than it is for the United States, for Nepal lacks a sophisticated system of bank regulation. This difference suggests that when less developed countries pursue a strategy of direct incorporation, cost and timing considerations are likely to lead such countries to adopt a more complete system of incorporation than that is commonly found in the direct incorporation of laws between regimes with comparable regulatory structures. In addition, to the extent that developing countries seek to make themselves more attractive locations for foreign investment, the complete incorporation of established foreign laws is likely to be perceived as benefit to foreign firms that have a choice of various jurisdictions in which to locate overseas operations.

C. Reservations, Limitations, Caveats & Extensions

Having outlined a number of arguments favoring direct incorporation of foreign regulation, I will now consider a series of potential objections to the practice. In this subsection, I will consider utilitarian objections to the approach and in the following section I will turn to broader grounds of opposition that might loosely be described as political. My response to potential objections will proceed on several different levels. In some cases, I will deal with an issue at a theoretical and general level. Other times, I will respond on narrower grounds, focusing on the relatively limited way in which Nepal would be incorporating foreign regulation in the area I am considering. Finally, I will sometimes respond to potential objections by proposing further refinement of the Nepalese proposal, in essence dealing with potential objections through a further narrowing of the scope of direct incorporation being considered.

1. Divergence between goals of Foreign and Nepal legal regimes

An implicit premise of the foregoing analysis is that there is substantial convergence between the goals of Nepalese regulation and the goals of the jurisdictions whose laws are to be incorporated.³⁶ In many areas of regulation, this assumption may constitute a substantial leap of faith. As outlined in subsection III.A.1 above, however, the justifications for the regulation of financial regulation are limited and, in my experience, generally consistent across national boundaries. Indeed, given the limited connections between the Nepalese economy and foreign entities that would operate in the proposed international financial services center, I believe it is likely

³⁶ Without this alignment, incorporated foreign regulations would be unlikely to achieve the policy goals of the Nepalese government.

that the policy interests of home country authorities will be more substantial and expansive than those of Nepal. Consider the four basic policy justifications for financial regulation:

a. Protection of Customers. As envisioned in this paper, the principal customers of IFONs will be corporations outside of Nepal. The public suppliers of capital — depositors, insurance policyholders, and investors — will all reside outside of Nepal. Moreover all or almost all of the borrowing and investment of an IFON will be with non-Nepalese entities. Thus, while Nepal will have relatively limited interests in protecting IFON customers, the foreign regulatory structures incorporated into Nepal's law will likely place considerable emphasis on protecting these interests.

b. Externalities from Entity Failures. The elimination of externalities from IFON failures is analogous if not identical. Most of an IFON's financial interactions as well as its participation in payment systems and credit underwriting will involve organizations and markets outside of Nepal, principally one would assume in the IFON's home jurisdiction. Accordingly, most of the negative externalities of an IFON's failure — particularly if it were accompanied with the failure of its parent organization — would not affect economic activity Nepal. To be sure, Nepal might suffer some indirect reputational effects if an IFON were to fail, but this impact is almost necessarily less substantial than the impact of an IFON's failure in the eyes of its home country authorities.³⁷

This discussion of externalities does, however, suggest some important reservations. If an IFON were wholly remote from its parent organization, its failure would not necessarily present systemic risks or other negative externalities to home country authorities. Accordingly, to ensure congruence of interest between home country authorities and Nepalese interests, it would be important that there be strong

³⁷ On this dimension, the very limited role of IFONs in the Nepalese economy is critical. If IFONs were to engage in substantial retail operations in Nepal, the potential for negative externalities in Nepal would be much greater.

ties between an IFON and its parent organization. If the IFON were organized as a branch of the parent organization, this linkage would exist through operation of law.

If, however, the IFON were organized as a separate corporate entity — such as a subsidiary — then the linkage might have to be contractual (perhaps as a parent guarantee of subsidiary obligations) or perhaps through reputational bonding if the IFON did business under a name that was substantially similar to that of the parent organization.

c. Redistributive Goals. Redistributive policies and other equitable considerations tend to vary considerably from country to country, and so it is unlikely that these kinds of policies would be the same in Nepal as in the countries whose laws are incorporated for use in the Nepalese international financial center. However, since IFONs will play only a limited role in the domestic Nepalese economy, these policy differences may not present a substantial conflict for Nepalese authorities. Typically, redistributive policies impose a system of cross-subsidies within a political system: wealth is transferred from urban to rural regions or from the wealthy to lower income groups. For the most part, elements of the Nepalese economy will not participate in the financial operations of IFONs, and so these entities will *not* provide a natural mechanism for ordinary redistributive policies. Moreover, because Nepalese residents will generally be barred from doing business with IFONs, their presence will not disrupt existing redistributive policies in Nepal. Accordingly, the presence of IFONs in Nepal will simply be orthogonal to the country's existing redistributive policies, and thus distinctions between Nepalese goals in this sphere and those of incorporated jurisdictions may be irrelevant.³⁸

³⁸ Conceivably, if a foreign jurisdiction had a redistributive policy that was offensive to Nepalese values, it might be problematic for the country to allow foreign regulations implementing that policy to effect any aspect of Nepalese operations. Redistributive norms are not, however, generally prominent in the regulation of international finance, and this concern strikes me as more hypothetical than real. It does, however, bear monitoring as the proposal is implemented. If particular foreign regulations were inappropriate for application to an IFON, Nepalese authorities could insist on a waiver of those regulations when the IFON begins operations.

The organization of IFONs in Nepal will, however, have certain redistributive aspects apart from those that foreign regulation imposes. Whatever licensing fees and other charges Nepal imposes on IFONs will distribute wealth from the IFONs to the Nepalese public treasury. (His Majesty's Government of Nepal will also receive additional revenues from taxes on Nepalese businesses that provide services to IFONs, as well as income taxes on wages of employees working for IFONs.) Since Nepal itself will set these charges, they will presumably be congruent with the country's values. In addition, there will be a number of additional economic interactions between IFONs on the one hand and Nepalese employees and service providers on the other. These interactions, which may have redistributive aspects, are the subject of a separate section below.

d. Considerations of Political Economy. Like redistributive norms, considerations of political economy are likely to differ across national boundaries, and there is unlikely to be full consistency between Nepalese interests in this area and those of foreign jurisdictions. Full consistency is, however, not essential. The relevant question is whether the establishment of IFONs in Nepal accords with the political values of Nepal and the relevant foreign jurisdictions. For purposes of this analysis, we can assume that IFONs will be established only by organizations from jurisdictions that have concluded IFONs to be consistent with their political process. The only question that remains is whether these operations are also consistent with Nepal's political values. That issue, presumably, is one that His Majesty's Government of Nepal will decide if and when it authorizes the establishment of IFONs within its boundaries. In other words, the authorization of IFONs — along with the attendant limitations on the scope of their operations in Nepal — will constitute a political endorsement of IFONs. Whether there is substantial overlap between other aspects of Nepal's political economy and those of other foreign jurisdictions is for present purposes irrelevant.³⁹

³⁹ Other political aspects of the establishment of IFONs are considered below in subsection III.D. These considerations will likely inform internal debates over whether Nepal should accept IFONs as part of the country's program of economic development.

2. Racing to the Bottom

If IFONs are able to incorporate foreign regulations into Nepalese law, a potential problem arises that some organizations will seek to incorporate legal structures of jurisdictions that nominally embrace regulatory policies congruent with Nepal's interests, but that have no commitment to enforcing those policies. Within the academic literature, this process is sometimes described as a race to the bottom.⁴⁰

To a limited extent, the market will prevent a complete race to the bottom from occurring.

IFONs governed by a toothless regulatory system may encounter difficulties in raising capital or gaining access to certain markets. Private self-interest, however, is unlikely to be sufficient to forestall some degree of undesirable regulatory forum shopping. As mentioned above, the private benefits of financial regulation are usually thought to be less than the total social benefits.

Accordingly, some degree of mandatory public controls are needed.

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In U.S. legal academic literature over the past few years, there has been considerable interest in the question of whether a race to the bottom is likely to occur in a global economy with many national regulatory systems. Several recent articles have argued that, at least in area of corporate securities, market forces would prevent a race to the bottom. These articles have therefore recommended that corporate issuers be allowed to choose whatever legal system they like and then "import" those legal systems into their home jurisdictions. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. __ (June 1998); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, __ S. CAL. L. REV. ____ (July 1998); see also Paul G. Mahoney, *The Exchange As Regulator*, 83 VA. L. REV. 1453 (1997) (arguing that stock exchanges be allowed to establish legal regimes). But see Merritt B. Fox, *Securities Disclosure in a Globalized Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997) (arguing against issuer choice of regulatory regimes).

The approach I recommend for Nepal in this paper has certain similarities to these articles advocating "regulatory competition" in securities markets. Both approaches envision benefits from fostering competition among regulatory systems. My proposal is, however, much more conservative. Under my approach, a sovereign country — that is Nepal — rather than individual companies selects the foreign regulatory regimes to be incorporated into Nepalese law. Under my proposal, only a small number of well-established legal structures are to be incorporated into Nepalese law, at least as an initial matter. In addition, my approach contemplates that Nepalese authorities will admit foreign financial institutions on a case-by-case basis only after concluding that each firm is qualified for admission into Nepal. Firms without proven reputations need not be admitted. Finally, under my proposal, IFON activities within Nepal will be limited so as to prohibit financial transactions with ordinary Nepalese citizens, who may lack the sophistication to understand the differences between local Nepalese regulation and the regulatory systems applicable to IFONs. The proposals for regulatory competition cited above generally lack these limitations.

Perhaps the best way for Nepal to prevent a race to the bottom is to screen the regulatory regimes eligible for incorporation for use in its international financial center. A policy of “selective incorporation” will prevent IFONs from exploiting renegade regulatory systems. While determining which jurisdictions to incorporate is a complex question, one approach would be to start with the regulatory systems of the most advanced financial centers. These countries are likely to have the greatest experience in overseeing the sort of sophisticated financial transactions that IFONs are likely to undertake. Moreover, since their income levels are substantially higher than Nepal’s, it is likely that their regulatory systems will be more complete than those of less wealthy jurisdictions.⁴¹

3. Free Riding and Other Problems of Effective Enforcement

Assuming Nepal were to pursue a policy of selective incorporation, limiting access to financial intermediaries from well-regulated jurisdictions, there would remain a question of whether regulatory authorities from the foreign jurisdiction would in fact enforce their regulatory standards with the respect to IFONs with the same intensity and diligence as applied to financial activities in the authorities’ home jurisdictions. Conceivably, Nepal could be perceived as “free-riding” on the regulatory apparatus of other nations. In addition, there might be practical and political impediments to the extraterritorial application of the home jurisdiction’s regulatory apparatus. I will deal with each of these considerations in turn.

To meet the free-rider problem, foreign regulatory authorities would have to be compensated

⁴¹ This point is the flip-side of the common observation that developing countries cannot usually afford regulatory systems as costly as those employed in more wealthy countries (for example, in the area of environmental regulation). By incorporating the regulatory systems of wealthy countries, Nepal will have some assurance that the regulatory systems it obtains will be at least extensive as those that Nepal would develop itself if it were to pursue more traditional paths of legal development.

for their oversight of Nepalese operations. Payments of this sort are not, however, uncommon in the financial services industry. In many countries, the financial service industry “pays” for its supervision through examination fees, registration charges, and public insurance premiums. Ideally, IFONs should pay their home regulatory authorities the incremental costs incurred with the supervision of IFON operations in Nepal. To the extent that supervision of IFONs utilize other home country resources — *e.g.*, judicial adjudication or arbitration procedures — IFONs should also cover those costs. A payment arrangement of this sort should largely solve the free-rider problem.⁴²

⁴² To be sure, Nepal will still benefit from other elements of home country law not reflected in the incremental costs of supervising IFONs in Nepal. For example, IFONs will make use of regulatory systems and legal precedents that the home jurisdiction has developed over many years at considerable expense. These are, in a sense, public goods that can be reused without detriment to the home jurisdiction. Over the long term, one might worry that home countries will under-invest in these goods if they do not receive complete compensation from all users. However, given the relative size of the Nepalese economy, this concern strikes me as of only marginal significance.

But even if home countries are compensated for supervising IFONs, can we be confident that the oversight will be substantially comparable to domestic enforcement? Obviously, the physical distance between Nepal and the home jurisdictions of many IFONs is likely to be substantial. There are, however, good reasons to believe that physical distance does not present an insuperable problem in an era of telecommunications and computerized networks.⁴³ While periodic physical inspections remain an important regulatory tool, much modern supervision can be accomplished at a distance through electronic call reports and computer-assisted tracking techniques. And, in fact, much extraterritorial supervision already takes place today. American banking regulators, for example, supervise the offshore branches of American banks. Indeed, the Basle Committee on Banking Supervision has recommended that home country regulators assume offshore supervision in certain circumstances.⁴⁴ While it remains an empirical question whether practical barriers impede effective extraterritorial oversight of IFONs, there are at least ample precedents for the practice.⁴⁵

Of course the ability to supervise effectively does not ensure the administrative or political

⁴³ Lately, there has been considerable discussion in the popular press about consumers using the internet to escape local regulation by purchasing goods or services in less-regulated foreign markets. In a sense, this proposal is using the same technologies to move established regulatory systems across national boundaries to police less regulated foreign jurisdictions.

⁴⁴ See Basle Committee on Bank Supervision, Consultative Paper on Core Principles for Effective Banking Supervision 39-40 (Apr. 1997) (“Where host country supervision is inadequate, the parent supervisor may need to take special additional measures to compensate, such as through on-site examinations, or by requiring additional information from the bank’s head office or external auditors.”). The logic of the Basle Committee’s approach is that the activities of foreign operations have an impact with the home jurisdiction, hence the emphasis on consolidated supervisory oversight. In a sense, direct incorporation of foreign supervision into Nepal simply expands upon this logic.

⁴⁵ A distinct question, which must be considered for each potential home jurisdiction, is whether the regulatory authorities are authorized to exert jurisdiction over extra-territorial IFONs. In some jurisdictions, perhaps even the United States, additional legislative authority may be required.

will to follow through on that ability. To some extent, administrative oversight is a response to public pressures. When an administrative agency such as the SEC brings an enforcement action against an errant broker-dealer, it is often the result of consumer complaints or even inquiries from a member of Congress. To the extent that such factors propel enforcement, one may wonder whether Nepalese oversight will not necessarily suffer.⁴⁶ Again, this presents an empirical uncertainty. Perhaps distance will dilute enforcement efforts. On the other hand, if home authorities take on supervisory authority for IFONs, they may feel obliged to police those entities with the same rigor as domestic operations or at least treat complaints involving IFONs with the same seriousness as they approach comparable domestic complaints. There tends, moreover, to be an ethos of enforcement in well-managed regulatory agencies, and that ethos often carries over to all areas of the agency's jurisdiction. In addition, somewhat more speculatively, it is possible to imagine that home jurisdictions will take pride in their extraterritorial operations — perhaps even competing for new assignments in other jurisdictions — and that this competitive spirit would ensure effective supervision in Nepal.⁴⁷

4. Single versus Multiple Foreign Jurisdictions

Accepting the reasoning advanced so far, a separate question concerns the number of

⁴⁶ Conversely, it is possible that Nepal would learn to bring potential problems to the attention of U.S. regulatory authorities and even members of Congress, thus replicating for IFONs the pressures that domestic institutions have traditionally brought to bear on our political institutions. If this practice were to develop, it would help ensure adequate oversight of IFONs, although it would also expand the range of participants in U.S. political processes.

⁴⁷ Within the United States, for example, Delaware has developed a reputation for having the “best” corporate law, and the state is thought to profit by “exporting” that law to the regions of the country. For a discussion of Delaware's emergence as the leading producer of corporate law in the United States, see Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON & ORGANIZATION 225 (1985).

jurisdictions eligible for incorporation for use in Nepal's international financial services center. I have already suggested that Nepal should limited itself to countries with established regulatory systems. But should it, perhaps, go further and select the single regulatory structure that seems most appropriate for its needs? Incorporating a single regulatory structure would, after all, simplify things to a considerable degree. Nepal would need to coordinate its efforts with only one home jurisdiction and consumers would face no confusion as which country's laws applicable to IFONs.

Although for certain exercises of direct incorporation a single jurisdiction's law may be preferable,⁴⁸ I believe a more expansive approach would be appropriate here. To begin with, it is not clear which foreign jurisdiction would be best for operating an IFON in Nepal. Allowing multiple jurisdictions to be selected gives private parties the opportunity to experiment with different choices. Moreover, one of the principal advantages of the proposed approach is that it allows many financial entities to retain their home regulatory structure while establishing a presence in Nepal. This advantage — and the cost savings associated with it — would be lost if only one jurisdiction were authorized for incorporation. Finally, the primary customers of IFONs — participants in global financial markets — already have considerable experience dealing with firms organized and regulated under different laws. IFON customers should not be confused if Nepal sanctions the use of multiple foreign legal regimes to regulate these entities. And, in fact, a wider range of regulatory systems available to IFONs, the more foreign customers will likely find an IFON with which they

⁴⁸ If, for example, Nepal were incorporating foreign laws to govern retail operations in Nepal, the problem of consumer confusion would be substantial if multiple jurisdictions were authorized. Moreover, if the area of law required considerable coordination of interests — for example, a registry of land titles — a unified legal structure would be essential. As discussed in the main text, however, the supervision of IFONs does not appear to require unified oversight.

are willing to do business.

5. Allowing Financial Firms Latitude to Choose Among Approved Systems

Assuming His Majesty's Government of Nepal selects laws from multiple jurisdictions as eligible for incorporation, the question then arises whether an IFON from one jurisdiction would be required to comply with that jurisdiction's laws or whether the IFON would be permitted to choose the law of another eligible jurisdiction. For example, (assuming both the United States and Germany were eligible jurisdictions) could a U.S bank establish an IFON in Nepal and have it governed by German law, or would the IFON have to comply with American law? Although either approach has its advantages, my recommendation would be that IFONs be allowed to comply with the laws of any foreign jurisdiction that Nepal selects, provided the entity establishing the IFON be subject to substantial regulation in that jurisdiction. So, to return to the foregoing example, an American bank could have an IFON governed by German law as long as the bank used a regulated German affiliate to establish the IFON. Thus, a firm could choose to have an IFON governed by the law of any eligible jurisdiction in which their parent organizations had substantial regulated activities.

Several considerations favor this approach. First, even if Nepal were to designate multiple jurisdictions as eligible to oversee IFONS, one or two jurisdictions could prove to be the most attractive sources of regulation — by, for example, gaining initial expertise in overseeing these entities. If IFONs were limited to the laws of the home jurisdictions of their parent corporations, many companies might not be able to employ the best regimes for regulating IFONs. Allowing IFONs to choose among eligible regimes eliminates this problem. If one jurisdiction proves itself to be the best source or regulating IFONS, then IFONs from many jurisdictions will be able to take

advantage of that expertise.⁴⁹ In addition, allowing for this sort of “regulatory competition” might also serve to improve the quality of IFON supervision.⁵⁰ A further practical consideration is that it may often times be difficult to determine the “home” jurisdiction of an IFON, particularly if the IFON is affiliated with a financial conglomerate that does business in numerous jurisdictions. For all of these reasons, I would recommend that a IFON be permitted to designate as its “home country” any eligible jurisdiction in which the IFON has a regulated affiliate.

6. Interfacing with Nepalese Legal Structures

So far, my analysis has focused almost exclusively on issues of regulation. There are, however, many other spheres of legal authority: contract law, tort law, property law, even environmental law. To some degree, IFONs can bring elements of these other legal structures with them to Nepal. For example, future legislation could authorize all IFON contracts to be governed

⁴⁹ A further advantage of this approach is that it provides a means of establishing IFONs for firms from jurisdictions that His Majesty’s Government does not select for incorporation: these firms can established regulated affiliates in selected jurisdictions and use those affiliates to set up IFONs in Nepal.

⁵⁰ See supra subsection III.C.3.

by foreign law and even non-Nepalese employees of an IFON might be subject to labor law of the IFON's home jurisdiction. There will, however, remain some legal interactions of IFONs that will likely be governed by Nepalese law. I would assume, for example, that Nepalese law would extend to Nepalese employees of IFONs, Nepalese property that IFONs own or lease, and a variety of nonfinancial Nepalese legal structures from tort law to environmental regulations.

Thus, the question arises how His Majesty's Government of Nepal should coordinate the interface between the foreign legal regimes that will govern most aspects of IFON operations and those areas in which IFONs will necessarily be bound by Nepalese law. This issue is important because if there is any uncertainty as to which Nepalese laws apply to IFONs and how those laws will be applied in the future, some of the advantages of a regime of selective incorporation will be dissipated.⁵¹ This concern can, however, be addressed on both substantive and procedural dimensions. Substantively, the critical issue is defining which Nepalese laws will apply to IFONs and to what extent. Future legislation or implementing regulations could, for example, limit the application of Nepalese laws to IFONs to an enumerated list of laws. IFONs would be exempt from the application of all other Nepalese laws.

⁵¹ In particular, foreign firms will face uncertainty as to the substantive rules under which IFONs are to operate.

Procedurally, the goal would be to develop a fair and efficient mechanism for resolving disputes arising under these Nepalese laws and involving IFONs. Although there many ways of resolving disputes — including reliance on existing Nepalese judicial or administrative procedures — I would recommend that Nepalese authorize the resolution of any such disputes through well-established international arbitration procedures.⁵² This approach would build upon the increasingly popular commercial practice of relying on arbitration proceedings in international transactions rather than more traditional judicial dispute resolution techniques. It would, in addition, prevent IFONs from placing a burden on the Nepalese judicial system, while at the same time assuring foreign firms of fair and prompt resolution of disputes involving IFONs. Relying on international arbitration procedures would also be consistent with the philosophy underlying this general approach as it entails a further incorporation of international dispute resolution procedures into Nepalese law.

D. Alternative Perspectives on Selective Incorporation of Foreign Laws

Having evaluated the concept of selective incorporation of foreign laws from a largely utilitarian perspective, I now consider the proposal in several broader frames of reference. Though my treatment of these alternative perspectives is cursory, I believe it is important to include them as part of my analysis because, I suspect, some readers will be centrally concerned with the political and sociological aspects of the proposal.

1. Loss of Sovereignty and Potential for Exploitation

⁵² To ensure informed interpretation of Nepalese law, future legislation could specify that at least one of the arbitrators involved in such proceeding be a Nepalese lawyer.

Against the background of past experiences with colonialism and imperialism, a natural first question is whether selective incorporation of foreign law is not just a late twentieth century resurgence of prior western exploitation of developing economies. Colonial expansion of the west, after all, often included the imposition of western legal institutions on unwilling nations. Could selective incorporation of foreign regulation in Nepal be analogized to these practices?

Though the memory of colonial exploitation may resonate with some, my own sense is that there are important grounds for distinguishing this proposal. First and foremost, Nepal itself would initiate the incorporation of foreign law through its own sovereign act. Presumably His Majesty's Government of Nepal will take that step only after its political institutions conclude that selective incorporation is in the country's best interest. If Nepal follows this course, it will be a voluntary act, and not a step taken under the threat of gunboat diplomacy.⁵³ Deference to foreign regulatory structures is, moreover, not the exclusive province of developing nations. As I have outlined above in Part II.C, the incorporation of foreign regulatory systems has become a common practice in advanced industrialized countries, particularly in the regulation of the financial services industry. To my knowledge, Nepal would be the first developing nation to participate so fully in this trend. Of course, if the initiative is unsuccessful, Nepal could repeal its implementing legislation.⁵⁴ On the other hand, if the exercise is successful, Nepal could lead the world in a new course of legal

⁵³ There would, moreover, no reason for Nepal to limit itself to western countries; indeed, Nepal may well choose to incorporate the regulatory structure of Japan and certain other Asian jurisdictions.

⁵⁴ Repealing the regulatory structure would, however, not be costless to Nepal in that it might damage the country's reputation and discourage future foreign investment in the country. This cost might be mitigated, however, if investors in IFONs were protected by some form of political risk insurance that covered legal changes of this sort. Of course, were claims to be made under such insurance policies, that might also impose costs on Nepal.

development.

The surrender of sovereignty envisioned in this proposal is, moreover, quite limited. The interactions between IFONs and Nepalese residents will be restricted. IFONs will neither raise funds from nor provide resources to Nepalese residents. While IFONs will engage local employees and obtain local services of various sorts, these interactions (I have proposed) would be governed by Nepalese law, although disputes in these areas would be resolved in arbitration tribunals. In addition, Nepalese authorities will approve the establishment of each individual IFON. If one IFON violates the terms of its authorization — by, for example, soliciting unauthorized deposits from Nepalese consumers⁵⁵ — His Majesty's Government of Nepal would be free to revoke the offending IFON's license and require it to cease operations in the country. By limiting the scope of IFONs in this way, concerns of Nepalese sovereignty are greatly mitigated.

2. Impact on Economic and Legal Development in Nepal

⁵⁵ If the lines between IFON activities and the Nepalese economy were more complex, one might worry about policing the boundary and the possibility that Nepalese residents will recharacterize activities to come within the jurisdiction of foreign authorities. As proposed, however, the boundaries are simple and absolute, and the opportunities for recharacterization should be minimal.

A related, but separate question is whether the incorporation of foreign regulations will retard or otherwise interfere with other economic and legal developments in Nepal. The premise of such a question is that Nepalese institutions might develop faster and more appropriately in the absence of this initiative. While this is a complicated issue — with both empirical and philosophical dimensions — let me note some of the positive effects of the concept as it relates to Nepal's own development. First, if successful, the concept will bring to Nepal some of the world's most sophisticated financial institutions. These organizations will hire and train Nepalese nationals, either as direct employees or service providers. Other Nepalese may participate in arbitration proceedings used to resolve disputes involving IFONs. Even Nepalese regulatory authorities should benefit from the establishment of IFONs in Nepal. In approving applications to establish IFONs, Nepalese authorities will become more familiar with international supervisory practices in leading countries. While the premise of selective incorporation is that foreign regulators will have primary supervisory authority over IFONs, Nepalese officials will participate in these supervisory efforts to ensure, among other things, continued compliance with IFON licenses.⁵⁶ Over time, all of these interactions should enrich the human capital of Nepal, presumably helping the country develop legal institutions of its own.

There are, no doubt, other ways that Nepal could gain this sort of expertise. As mentioned

⁵⁶ Exactly how much Nepalese authorities should participate in the regulation of IFONs is an issue that will require further consideration as the proposal is implemented. Although, greater participation might contribute to the education of Nepalese authorities, too much intrusion would add unnecessary costs to the process and might, in the extreme, disrupt supervisory controls. My preliminary assessment is that active participation of Nepalese authorities should be limited, at least initially, to initial approval of IFON applications to do business in the country and that on-going active oversight be left to foreign authorities.

above, the country could pursue more traditional patterns of legal development — expanding indigenous structures or promulgating legal rules derived from existing foreign models. The critical question, however, is whether these alternative paths offer a realistic means of developing an international financial center in Nepal. My own intuition is that the selective incorporation of foreign laws represents a more plausible and efficient path to success.

IV. Implementing a Regime of Selective Incorporation for Nepal

To summarize and tie together the preceding analysis, I present in this final part a specific proposal for implementing a regime of limited selective incorporation of foreign financial regulations into Nepalese law. In addition, I identify a series of practical considerations that require further investigations and coordination as the project moves forward. As many of the issues covered in this section involve details of implementation, I will preface my analysis by summarizing my understanding of the steps that His Majesty's Government of Nepal would follow if it were to implement a system of selective incorporation of foreign laws as outlined in this paper.

As an initial step, His Majesty's Government of Nepal has already passed the International Financial Transactions Act of 1998, which establishes a general framework for encouraging the development of Nepal as an international financial services center. Among other things, this preliminary act creates a regulatory body to license IFONs and monitor their supervision ("Accreditation Committee"). The next step would be for His Majesty's Government of Nepal to adopt a series of more detailed legislation dealing with each specific area of the financial services industry. Currently, it is anticipated that the first of these more detailed statutes would cover the

banking industry and be titled the International Banking Act. Finally, it is anticipated that the Nepalese government will enact an International Financial Companies Activities Act (IFCA Act) that will deal with a number of legal issues applicable to all IFONs, including among other things the determination of which Nepalese laws will apply to these entities and how disputes involving these laws would be resolved. Many of the issues identified earlier in this paper and summarized in this section could be addressed through these implementing statutes or regulations promulgated thereunder. Others could be left to the discretion of the Accreditation Committee already created by statute.

A. Issues to Cover in Implementing Legislation

To implement a regime of selective incorporation, Nepal will have to address the following issues, either directly in implementing legislation or through some delegated rulemaking procedure.

1. Establishing Criterion for Selecting Eligible Regimes

First, the criteria for selecting eligible regimes will have to be determined. As discussed above, these regimes should have established systems of regulatory control and be well-recognized in international financial markets. These requirements will be important both to maintain the proper supervision of IFONs and to ensure that Nepal's financial service center has credibility in global financial markets. Conceivably, statutes such as the International Banking Act could include a list of eligible jurisdictions for each segment of the financial services industry. More likely, though, these statutes would simply establish criteria for determining eligibility, and leave the actual selection of jurisdictions to the Accreditation Committee.

2. Define Scope of Permissible Operations in Nepal

As discussed at numerous points in preceding sections, an important element of this proposal is the limited scope of IFON operations in Nepal. For both political and practical reasons, it is important that the boundaries of their authority be clearly defined. Presumably, IFONs will be prohibited from engaging in most kinds of financial transactions with Nepalese corporations and individuals. These limitations should not, however, prevent IFONs from doing business with other IFONs or from engaging in transactions with other foreign entities temporarily resident in Nepal. Indeed, Nepal presumably would want to encourage foreign travel to Nepal to negotiate transactions with IFONs. Finally, IFONs might be given some authority to make large-scale investments in Nepal — for example, financing hydroelectric or other development projects. In any event, the precise boundaries of IFON activities in Nepal should be clearly defined. Presumably, future legislation dealing with the various sectors of the financial services industry would be the appropriate place to establish those boundaries, as they may vary from sector to sector. The Accreditation Committee or some other regulatory body could, however, retain discretion to modify the list in the context of individual applications.

3. Establish Procedures for Approving IFON Applications

Although one could imagine IFONs establishing operations in Nepal without receiving prior approval from Nepalese authorities, I believe that an application procedure would be more appropriate, and this is apparently the structure that the preliminary statute contemplates. Future legislation, such as the International Banking Act, could include further procedures and criteria for approving applications to establish IFONs. At a minimum, the applicant would have to be from an

eligible jurisdiction,⁵⁷ and would have to demonstrate that regulatory authorities from that jurisdiction are prepared to provide adequate oversight of the IFON.⁵⁸ I also would recommend that at least initially IFONs be limited to firms that are well established in international financial markets. Firms with established reputations will be less likely to behave recklessly in Nepal and are more likely to generate substantial volumes of business. As mentioned above, IFONs should be required to operate under names that the general public will associate with their parent organizations. In situations in which there is some question about the connection between an IFON and its parent organization, Nepalese regulatory authority could have authority to require a formal guarantee of IFON liabilities as a condition to Nepal's approving the organization's application. The application procedures should also specify the terms under which His Majesty's Government of Nepal could revoke IFON licenses.

4. Authorize Application of Foreign Regulation to IFONs

The implementing legislation should also outline the general scope of foreign regulations that will govern IFONs. Although coverage will vary for each sector of the financial service industry,

⁵⁷ That presence should be more than nominal. Several of the premises of selective incorporation would be undermined if applicants from non-eligible countries were able to gain entrance into Nepal through the establishment of shell operations in eligible countries. Under these circumstances, the nominal home jurisdictions will have little incentive to police these entities faithfully. I would, however, be less concerned about firms from one eligible jurisdiction choosing to use an affiliate in another eligible jurisdiction to access Nepal (*e.g.*, a U.S. bank using a German affiliate to establish an IFON). As discussed above, such arrangements may serve valid business purposes. Whatever problems they create could be dealt with through supervisory coordination among regulators in all countries concerned.

⁵⁸ Obtaining credible assurances that foreign regulators will impose effective oversight of IFONs is critical to the success of this proposal. It would, I believe, be appropriate and desirable to consult with at least some foreign regulators as the proposal is implemented to ensure future cooperation and support of foreign authorities. In many ways, regulators in developed countries are already assisting their counterparts in the developing world to create effective supervisory systems. While selective incorporation of foreign laws is a unique form of regulatory assistance, it is generally consistent with existing practices.

in general the list should include both regulatory standards and enforcement mechanisms.⁵⁹ In some areas, private rights of action will govern IFONs. Since multiple jurisdictions are involved and a variety of different types of financial intermediaries — from insurance to banking to securities firms -- it would likely be impossible for future legislation to define precisely which statutes will apply in each case. A better approach, in my view, would be for each applicant to negotiate the array of regulatory standards that will govern its operations in Nepal.⁶⁰ Future legislation, such as the International Banking Act, could authorize this tailoring of regulatory standards.

5. Corporate Formalities for Establishing IFONs.

⁵⁹ In addition to portfolio shaping rules and open-ended standards of conduct, this list could include reporting obligations, money laundering statutes, and various other regulatory rules.

⁶⁰ For example, if a U.S. bank were to establish an IFON, it is unlikely that FDIC insurance or CRA lending requirements would extend to deposits in the IFON, but most other U.S. regulatory provisions could apply.

The corporate formalities for establishing IFONs are a separate issue. Future statutes could authorize two different approaches. The first approach would be a licensing approach in which the foreign firm would establish a branch in Nepal or organize a foreign subsidiary (*e.g.*, a Delaware corporate subsidiary of a U.S. insurance company) to do business in Nepal. From the perspective of foreign investors, this may be the cleanest approach because the corporate governance rules of the entity's home jurisdiction would normally apply to operations (and future legislation could confirm the application of home country governance rules in this context). There is, however, a potential problem with this approach: the IFONs may not be Nepalese enough to be treated as Nepalese entities for regional tax treaties and special foreign exchange treatment.⁶¹ An alternative approach would be for the future legislation to authorize the creation of a Nepalese legal entity that will have all the powers, privileges, legal responsibilities and legal characteristics of a legal entity in the applicant's home jurisdiction.⁶² (So, an American securities firm setting up an IFON in Nepal might elect to have the entity governed as a Delaware corporation.)

In defining corporate formalities, the critical question is what it will take for IFONs to be considered Nepalese entities for various treaty and other purposes.⁶³ This is a subject which requires

⁶¹ It is my understanding that under certain Nepal treaties special benefits are extended to corporations resident in Nepal, but not to foreign entities simply doing business in Nepal. Accordingly, to gain benefits under these treaties, IFONs would have to qualify as Nepalese residents.

⁶² Note: To the extent that IFONs consist of Nepalese entities operating under the laws of an eligible jurisdiction, attorneys duly licensed to practice in that jurisdiction should be fully authorized to give legal advice with respect to those entities.

⁶³ The approach Nepal takes on this issue may also have an impact on the kind of supervision foreign regulatory authorities will be willing or authorized to provide. For example, U.S. banking regulators take a more active role in policing overseas branches of U.S. banks than they do with respect to corporate affiliates or subsidiaries of banks.

further investigation and coordination as the proposal is implemented. Depending on what these investigations reveal, it may also be desirable to require certain IFON activities to take place in Nepal — for example, requiring contracts to be executed in Nepal, requiring board meetings to be conducted in Nepal or through telephone conferences initiated in Nepal, requiring that a majority of IFON employees be Nepalese, *etc.* On the other hand, it is important that these formalities not unduly burden IFON operations. In addition, care will have to be taken to ensure that these supplemental, purely Nepalese requirements do not conflict with legal or regulatory requirements of an IFON's home jurisdiction. Future legislation should allow Nepalese authorities to make adjustments in these requirements, where appropriate, as part of the IFON application procedures.

6. Establish Mechanisms for Coordination with Nepalese Authorities

As mentioned above, coordinating the application of foreign regulatory laws to IFONs will likely need to be negotiated on a case-by-case basis. It would probably be appropriate for Nepalese officials to have authority to coordinate with foreign regulators in working out these arrangements and to negotiate appropriate accommodations on a case-by-case basis. Through these negotiations, Nepalese officials will be able to satisfy themselves that each IFON will be adequately overseen and that no inappropriate or redundant foreign regulatory requirements are applied to IFONs.⁶⁴ In

Accordingly, it may be easier to get U.S. authorities to assume responsibilities with respect to IFONs organized as branches than those organized as separate corporate entities. (Conceivably, U.S. authorities might be willing to treat corporate entities as branches, although such a legal fiction could entail novel interpretations of statutory authority.) In this area, the goal of bringing effective foreign regulatory oversight to IFONs may conflict with the goal of making IFONs sufficiently Nepalese to qualify for various treaty purposes.

⁶⁴ As mentioned above, some foreign regulations such as FDIC insurance may be inappropriate for IFONs and other requirements, such as foreign redistributive programs, may simply be inapplicable to a foreign financial center.

addition, these negotiations could be used to establish ongoing consultative arrangements between Nepal and foreign regulatory authorities. As mentioned above, these ongoing relations will help educate Nepalese officials as to foreign regulatory practices and generally enhance the human capital of the country.

7. Delineate Interface between Foreign Laws and Nepalese Law

A further point requiring clarification is the precise line between foreign legal jurisdiction and Nepalese law. As mentioned above, certain non-regulatory foreign legal rules will likely apply to IFONs: substantive laws incorporated into IFON financial contracts; corporate governance standards for IFONs organized as separate entities; even foreign labor law rules for IFON employees who are not Nepalese. Other aspects of IFON operations will be subject to Nepalese law: presumably local labor contracts, property rights, tort law, environmental laws, *etc.* To reduce uncertainty over these lines of interaction, either the IFCA Act or perhaps regulations or orders promulgated under that Act could specify the division of legal authority as clearly as possible. To create an efficient mechanism for resolving future disputes over the application of Nepalese laws to IFONs, I also have recommended that all disputes involving the application of Nepalese law to IFONs be subject to international arbitration mechanisms.

8. Authorize Foreign Dispute Resolution Procedures

Future legislation should specifically address the use of international arbitration procedures to resolve a wide range of disputes involving IFONs.⁶⁵ The goal here is to provide a prompt and

⁶⁵ It may also be desirable for each IFON to negotiate its own arbitration agreement with the Nepalese government. For a concise and insightful discussion of how arbitration procedures could be developed in this context, see William W. Park, *An International Financial Services Center in Nepal: A Guide to Dispute Resolution* (Aug. 1998)

credible mechanism for resolving disputes involving IFONs, without relying on or burdening the Nepalese judicial system. For certain categories of cases, it may be desirable to require at least one arbitrator to be licensed to practice law in Nepal. The category of disputes subject to international arbitration procedures should include any financial agreement of an IFON that contains a valid arbitration clause, any dispute involving an IFON arising under Nepalese law, and all regulatory, administrative or other legal action brought by a Nepalese governmental agency or official against an IFON or by an IFON against a Nepalese government agency or official. All such arbitrations should be allowed to take place outside of Nepal and under the rules and regulations of established foreign arbitration procedures.

9. Establish Schedule of Licensing Fees

Finally, future legislation should include a mechanism for establishing a reasonable schedule of fees and charges applicable to IFONs and also resolve their taxation under Nepalese law.

B. Practical Considerations for Further Investigation

If His Majesty's Government on Nepal chooses to proceed with implementation of this proposal, there are several areas where further research and investigation would be useful, particularly as more detailed legislation, such as the International Banking Act and the IFCA Act, are being drafted.

1. Business Reactions to the Concept of Selective Incorporation

First and foremost, I strongly recommend that the concept of selective incorporation be

(on file with author).

vetted with foreign financial firms that the regime is designed to attract to Nepal. These entities may very well have a number of suggestions as to how the approach could be refined and improved. Their comments and reactions are also likely to be helpful in drafting the International Banking Act and other implementing legislation and regulations.

2. Perspective of Regulatory Authorities in Jurisdictions that Would be Incorporated

Another perspective to obtain is that of the regulatory authorities in potentially eligible jurisdictions. While the extraterritorial application of regulatory law is increasingly common, the notion that a country such as Nepal would affirmatively and comprehensively borrow another country's regulatory system may strike some as novel. While there are ample precedents for the practice, it will require some explanation. A number of issues — how foreign regulators are to be compensated, how they will coordinate oversight with Nepalese officials, which regulations can practically be exported to Nepal, whether the concept is consistent with foreign legal requirements — all will require further investigation and coordination. Hopefully, regulators from at least some jurisdictions will express an interest working with Nepalese authorities on developing this new form of regulatory assistance and overseeing some of the initial IFONs. In addition, the assistance of foreign regulatory authorities could be helpful in future drafting efforts necessary to implement the concept of selective incorporation.

3. International Arbitration Issues

A separate issue concerns the enforcement of the arbitration procedures I have proposed. A preliminary analysis of the literature indicates a willingness on the part of courts in most countries to enforce arbitration agreements that are commercial in nature, but certain aspects of the proposal

may test the outer bounds of that doctrine (particularly if arbitration is used to resolve labor disputes and other matters arising under Nepalese law). These issues require further investigation as the concept is implemented.⁶⁶

4. Specific Issues Related to India and Other Countries in the Region

Finally, additional investigation is needed into the relationship between IFONs and the laws of India and other countries in the region. The proposal is in part premised on the availability of certain tax treaty and potentially foreign exchange zone benefits for IFONs. To the extent possible, it is important to clarify that IFONs will indeed be eligible for these benefits and to determine whether any changes in the structure of IFONs is needed to confirm that eligibility.⁶⁷ A further premise of the proposal is that IFONs will be subject only to the regulatory requirements of their home jurisdictions. It is important that their operations not bring them under overlapping regulatory control of India or other countries in the region, lest the benefits of the structure be undermined thereby. Finally, there is a question of whether foreign jurisdictions might change their legal rules if Nepal were to pursue this concept. While reactions of foreign jurisdictions are beyond the control of His Majesty's Government of Nepal, it may be possible to implement the proposal in ways that will be more acceptable to other countries in the region. This possibility requires further

⁶⁶ Professor Park's paper, see supra note 65, offers an initial and very helpful treatment of these issues.

⁶⁷ As noted above, steps taken to address these concerns may have an impact on the ability and willingness of foreign regulatory authorities to supervise IFONs. The two issues will thus require coordination.

investigation as the proposal is implemented.

5. Availability of Political Risk Insurance

Finally, since the concept of selective incorporation of foreign law is unique, some foreign investors may be concerned about the stability of the arrangement and Nepal's commitment to the regime over the long term. Accordingly, it may be appropriate to investigate the availability of either public or private political risk insurance to guard foreign investors against unanticipated changes in legal structure. Such insurance would provide foreign investors financial protection against the cost of such changes, though it would not affect the ability of His Majesty's Government of Nepal to undertake such changes in the future.

Conclusion

To summarize the preceding analysis, my conclusion is that a regime of selective incorporation of foreign regulation into Nepalese law has many advantages for both Nepal and potential foreign investors. For foreign firms, the ability to have their Nepalese investments governed by established regulatory systems is attractive because it reduces legal uncertainty and the costs associated with operating under a system of redundant and potentially conflicting legal structures. For Nepal, this approach is advantageous because it offers an efficient and inexpensive means of transforming its legal structure into one that is hospitable to a highly attractive form of foreign investment. Not only will the approach make Nepal a more attractive jurisdiction for foreign investment, it will also introduce the Nepalese to some of the world's most advanced regulatory systems. Moreover, because the initiative is limited to international financial services — involving

the transfer of capital from one foreign jurisdiction to another — this approach should not undermine Nepalese sovereignty over local economic activities and legal rules. While implementation of a regime of selective incorporation of foreign regulatory systems into Nepalese law will entail considerable amounts of additional efforts, the approach is a promising one for assisting Nepal in its goal of becoming an international financial services center.